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CREDIT MANAGEMENT MODULE - D

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Credit Management Module - D (Updated Syllabus)

Principles of Credit Management Credit Appraisal Analyzing Financial Performance - Relationship between items in Balance Sheet and Profit and Loss Account. Trend Analysis, Comparative Statement - Common Size Statement, Preparation of projected Financial Statements. - Ratio analysis - Interpretation and analysis of different Ratios, Limitation of the use of ratios. Statement of Sources and Applications of Funds. Structuring a Credit Proposal - Working Capital Concept and Management Appraisal techniques for different constituents - trade cycle - credit rating - Technical and economic feasibility studies - Credit Rating - Rating Methodology - Objectives and benefits of rating - Term Lending - Debt Service Coverage Ratio - Cash Flow Analysis - Cash Budget - Bill Finance - Deferred Payment Guarantee - Credit Scoring - Credit Delivery System - Documentation - Post sanction supervision, Control and monitoring of credit - Consortium finance, Multiple banking, Syndication of loans. Infrastructure financing. Dealing with credit defaults, Stressed assets, Corporate Debt restructuring, SARFAESI, NPAs, recovery options, write-off. Disclosure of the list of defaulters: objectives and procedure. Appraisal methodology for different type of clients/ products.

Credit Overview

CONCEPT OF CREDIT MANAGEMENT:

Banks and financial institutions mobilize deposits and utilize them for lending. Generally lending business is encouraged as it has the effect of funds being transferred from the system to productive purposes which results into economic growth. The borrower takes fund from bank in a form of loan and pays back the principal amount along with the interest. Sometimes in the non – performance of the loan assets, the fund of the banks gets blocked and the profit margin goes down. To avoid this situation, bank should manage its overall credit process. Bank should deploy its credit in such a way that every sectors of economy can develop. Credit management comprises two aspects; from one angle it is that how to distribute credit among all sectors of economy so that every sector can develop and banks also get profit and from the other angle, how to grant credit to various sectors, individuals and businesses to avoid credit risk.

Credit management is concerned mainly with using the bank's resource both productively and profitably to achieve a preferable economic growth. At the same time, it also seeks a fair distribution among the various segments of the economy so that the economic fabric grows without any hindrance as stipulated in the national objectives, in general and the banking objectives, in particular.

CREDIT DEFINITIONS:

1. Prof. Kinley:

"By credit, we mean the power which one person has to induce another to put economic goods at his deposal for a time on promise or future payment. Credit is thus an attribute of power of the borrower.

2. Prof. Gide:

"It is an exchange which is complete after the expiry of a certain period of time".

3. Prof. Cole:

"Credit is purchasing power not derived from income but created by financial institutions either as on offset to idle income held by depositors in the bank or as a net addition to the total amount or purchasing power."

4. Prof. Thomas:

"The term credit is now applied to that belief in a man‟s probability and solvency which will permit of his being entrusted with something of value belonging to another whether that something consists, of money, goods, services or even credit itself as and when one may entrust the use of his good name and reputation."

On the basis of above definitions it can be said that credit is the exchange function in which, creditor gives some goods or money to the debtor with a belief that after sometime he will return it. In other words „Trust‟ is the „Credit‟.

5. Vasant Desai:

"To give or allow the use of temporarily on the condition that some or its equivalent will be returned.

CHARACTERISTICS OF CREDIT:

Some characteristics of credit are of prime importance while extending credit to an individual or to a business enterprise.

1. Confidence:

Confidence is very important for granting or extending any credit. The person or authority must have confidence on debtor.

2. Capacity:

Capacity of the borrower to repay the debt is also very crucial thing to be considered. Before granting or extending any advance, creditor should evaluate the borrower‟s capacity.

3. Security:

Banks are the main source of credit. Before extending credit, bank ensures properly about the debtor‟s security. The availability of credit depends upon property or assets possessed by the borrower.

4. Goodwill:

If the borrower has good reputation of repaying outstanding in time, borrower may be able to obtain credit without any difficulty.

5. Size of credit:

Generally small amount of credit is easily available than the larger one. Again it also depends on above factors.

6. Period of credit:

Normally, long term credit cannot easily be obtained because more risk elements are involved in its security and repayments.

FEATURES OF COMMERCIAL BANK CREDIT:

1. Banks provide credit majority to trade and industries than agriculture. Because of the greater risks and inability of agriculturists to furnish good security.

2. The short term loans are given for the seasonal needs and working capital requirements.

3. Short term loans may be in the form of cash credit and overdraft, demand loans and the purchase and discount of bills. Among these, cash credit and overdraft are the most popular.

4. Indian banks sanction loans against sound security.

5. Banks take all possible protective steps to minimize their risks while granting loans to the firms.

TYPES OF CREDIT:

The credit assistance provided by a banker is mainly of two types,

i)Fund based credit support

ii)Non-fund based.

The difference between fund based and non-fund based credit assistance provided by a banker lies mainly in the cash out flow.7 Banks generally allow fund based facilities to customers in any of the following manners.

TRADITIONAL CREDIT PRODUCTS:

1. Cash credit:

Cash credit is a credit that given in cash to business firms. A cash credit account is a drawing account against a fixed credit limit granted by the bank and is operated exactly in the same manner as a current account with all overdraft facilities. It is an arrangement by which, a bank allows its customers to borrow money up to a certain limit against tangible securities or share of approved concern etc. cash credits are generally allowed against the hypothecation of goods/ book debts or personal security. Depending upon the nature of requirement of a borrower, bank specifies a limit for the customer, up to which the customer is permitted to borrow against the security of assets after submission of prescribed terms and conditions and keeping prescribed margin against the security. It is on demand based account. The borrowing limit is allowed to continue for years if there is a good turnover in account as well as goods. In this account deposits and withdrawals may be affected frequently. In India, cash credit is the most popular mode of advance for businesses.

2. Overdraft:

A customer having current account, is allowed by the banks to draw more than his deposits in the account is called an overdraft facility. In this system, customers are permitted to withdraw the amount over and above his balance up to extent of the limit stipulated when the customer needs it and to repay it by the means of deposits in account as and when it is convenient. Customer of good standing is allowed this facility but customer has to pay interest on the extra withdrawal amount.

3. Demand loans:

A demand loan has no stated maturity period and may be asked to be paid on demand. Its silent feature is, the entire amount of the sanctioned loan is paid to the debtor at one time. Interest is charged on the debit balance.

4. Term loans:

Term loan is an advance for a fixed period to a person engaged in industry, business or trade for meeting his requirement like acquisition of fixed assets etc. the maturity period depends upon the borrower‟s future earnings. Next to cash credit, term loans are assumed of great importance in an advance portfolio of the banking system of country.

5. Bill purchased:

Bankers may sometimes purchase bills instead of discounting them. But this is generally done in the case of documentary bills and that too from approved customers only. Documentary bills are accompanied by documents of title to goods such as bills of loading or lorry and railway receipts. In some cases, banker advances money in the form of overdraft or cash credit against the security of such bills.

6. Bill discounted:

Banker loans the funds by receiving a promissory note or bill payable at a future date and deducting that from the interest on the amount of the instrument. The main feature of this lending is that the interest is received by the banker in advance. This form of lending is more or less a clean advance and banks rely mainly on the creditworthiness of the parties.

CREDIT INSTRUMENTS:

Credit instruments prove very helpful in encouragement and the development of credit and help in the promotion and development of trade and commerce. Some of the credit instruments are,

1. Cheque:

Cheque is the most popular instrument. It is an order drawn by a depositor on the bank to pay a certain amount of money which is deposited with the bank.

2. Bank draft:

Bank draft is another important instrument of credit used by banks on either its branch or the head office to send money from one place to other. Money sent through a bank draft is cheaper, convenient and has less risk.

3. Bill of exchange:

It enables a seller of commodity to issue an order to a buyer to make the payment either to him or to a person whose name and address is mentioned therein either on the site of the bill or within a period of time specified therein.

4. Promissory note:

According to the Indian negotiable instrument act, „a promissory note‟ is an instrument in writing containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or the order of certain person or the bearer of the instrument.

5. Government bonds:

Government issues a sort of certificate to the person who subscribes to these loans. Such certificates are called government bonds. Some of them are income tax free.

6. Treasury bills:

These bills are also issued by the government. They are issued in anticipation of the public revenues.

7. Traveler‟s cheque:

This is the facility given by bank to the people. It was most useful when recent technological instrument like ATMs were not available. A customer was used to deposit money with the banks and banks give traveler‟s cheque in turn. It was used to avoid risk of having cash while travelling.

ADVANTAGES OF CREDIT:

Credit plays an important role in the gross earnings and net profit of commercial banks and promotes the economic development of the country. The basic function of credit provided by banks is to enable an individual and business enterprise to purchase goods or services ahead of their ability. Today, people use a bank loan for personal reasons of every kind and business venture too. The great benefit of credit with a bank is probably very low interest rates. Majority people feel comfortable lending with bank because of familiarity.

1. Exchange of ownership:

Credit system enables a debtor to use something which does not own completely. This way, debtor is provided with control as distinct from ownership of certain goods and services.

2. Employment encouragement:

With the help of bank credit, people can be encouraged to do some creative business work which helps increasing the volume of employment.

3. Increase consumption:

Credit increases the consumption of all types of goods. By that, large scale production may stimulate which leads to decrease cost of production which in turn also lowers the price of product which in result rising standard of living.

4. Saving encouragement:

Credit gives encouragement to the saving habit of the people because of the attraction of interest and dividend.

5. Capital formation:

Credit helps in capital formation by way that it makes available huge funds from able people to unable people to use some things. Credit makes possible the balanced development of different regions.

6. Development of entrepreneurs:

Credit helps in developing large scale enterprises and corporate business. It has also helped the different entrepreneurs to fight with difficult periods of financial crisis. Credit also helps the ordinary consumers to meet requirements even in the inability of payment. One can borrow money and grow business at a greater return on investment than the interest rates of loan.

7. Easy payment:

With the help of various credit instruments people can pay without much difficulty and botheration. Even the international payments have been facilitated very much.

8. Elasticity of monetary system:

Credit system provides elasticity to the monetary system of a country because it can be expanded without much difficulty. More currency can be issued providing for proportionate metallic reserves.

9. Priority sector development:

Credit helps in developing many priority sectors including agriculture. This has greatly helped in rising agriculture productivity and income of the farmers. Banks in developing countries are providing credit for development of SSI in rural areas and other priority sectors too.

DISADVANTAGES OF CREDIT:

Credit is a mixed consent. It involves certain advantages and some dangers also at the same time. Credit is useful as well as harmful to the user even. So it should be used very cautiously otherwise it may spoil all industries and enterprises. Credit, if not properly regulated and controlled it has its inherent dangers.

1.Encouragement of expenditure:

Credit encourages wasteful expenses by the individuals as well as commercial institutions. As people irresponsibly think that the money is not their own. Easy availability leads to over trading over exposure that ultimately leads to bad debts.

2. Encourage weakness:

Credit encourages big entrepreneurs to continue to hide their weakness. Their own shortcomings are met by the borrowed capital. Even the loosing concerns continue with the help of borrowed capital in the hope to survive. In this condition, if business fails, it not only leads the borrowers in dangers but also thousands of those people who advanced credit to such people.

3. Economic crisis:

In several occasions credit is directly responsible for economic crisis. It leads to recession and depression in an economy as boom of credit facilities has its own evil effect on the economy. Financially weak concern having credit facility takes the economy to weaker effects.

4. Dangers beyond limit:

Credit in a country expanded beyond certain limits which results in over investment. Over issue credit takes beyond safe limits that result in over investment, over production and rise of prices. This danger has been emphasized by Prof. Thomas in his „Elements of Economics‟, in his words: "There is no automatic limit to the expansion of a credit system as there is to an expansion of a metallic circulation through the intervention of human element. Uncertainty and variableness is the chief source of danger in a credit organization".

5. Evil of monopoly:

Credit system has also resulted in the creation of monopolies; monopolistic exploitation is due to money placed at the disposal of individuals or companies that leads to monopolist exploitation. The different organizations have growth with the emergence of credit and have worked to the damage of both the consumers and the workers.

ROLE OF CREDIT IN ECONOMY:

Commercial banks continue to remain in the forefront of Indian financial system. Banks provide necessary finance for planned development. In developed and developing countries both, credit is the foundation upon which the economic structure is strengthening. Bank credit would play a significant role by influencing the types of commodities and quantum of their output. To achieve high rate of economic growth over a long period, agriculture and industrial credit should be increased. At the time of sanctioning the credit, the purpose should be investigated by the bank to ensure that the end use of funds confirms to overall national objectives. Banks also give credit to the priority and neglected sectors by which the sectoral development can be possible. Easy availability of credit promotes the entrepreneurial and self employment venture in the country.

Credit instruments are used as media of exchange in place of metallic or paper currency. These instruments are more effective and convenient in all business transactions. Bank credit provides assistance to production and business process. Institutional credit provides a ready flow of money to the business. Bank credit fulfills the capital requirement of an entrepreneur which increases the production at higher level by which production cost decreases and as a result price of product also decreases that affects the economy positively.

Credit provides financial ability to use advanced technology in the production. So the quality of production and product may increase. And business can survive in an international market too. Credit makes common person to change into entrepreneur. Surplus fund utilized for credit bring return that further increase the volume of funds. Credit makes it easy and convenient for the consumers to purchase or hire durable goods. In the period of declining market, there is greater availability of cheaper source of funds through credit. Corporate borrowers paid greater attention towards banks for their financial requirements. This enables the entrepreneurs to run their business and day to day transactions very smoothly. Bank‟s power to create money is of great economic significance. This gives an elastic credit system which is necessary for steady economic progress. This system geared to the seasonal demands of business. Bank lending operation acts as a governor controlling the economic activity in the country. Bank lending is very important to the economy, for it makes possible the financing of the agricultural, industrial and commercial activities of the country. According to an economist, “Credit has done more to enrich nations than all the gold mines in the world put together.”

Statement of Financial Performance

What Is a Statement of Financial Performance?

A statement of financial performance is an accounting summary that details a business organization's revenues, expenses and net income. Three financial statements comprise the statement of financial performance: income statement, balance sheet and cash flow statement.

Income statement: The income statement reflects a company's revenues and expenses. It shows the company's bottom line so you can see how profitable your company is during a certain period of time, such as quarterly or annually. The statement of financial performance takes into account sales revenue, cost of goods sold and other operating expenses and income.

Balance sheet: The balance sheet reflects where your business stands financially at a certain point in time. This statement of financial performance takes into account assets, liabilities and shareholder equity to make sure assets are equal to the other two factors. The balance sheet incorporates the net income determined on your income statement.

Cash flow statement: The cash flow statement looks at how money moves through your business. It shows increases and decreases in cash from operations, investing and financing during a period of time. This statement of financial performance shows the net change in cash balance using numbers from both the income statement and the balance sheet.

These statements are prepared monthly, quarterly or annually, and give businesses a big picture of there they stand financially. A corporation's accounting department may prepare a statement of financial performance at any given point in time or throughout the year, depending on business requirements. For example, you may ask your accounting manager to prepare a statement of financial performance for the last two weeks of July and the first three weeks of November to understand what factors affect sales and whether sales are seasonal.

Financial Performance Factors for a Business

Preparing a statement of financial performance means knowing a lot of important information about how money comes into your business and how it goes out. These financial performance factors for a business should be tracked regularly:

- **Assets:** An asset is anything your business owns or has that will be of value in the future. This includes tangible assets such as products, buildings and equipment. It also includes intangible assets such as contracts, marketing and consumer mailing lists. These are all things that can be sold in the future that would add value to your company.
- **Liabilities:** A liability is anything you might owe in the future and is often based on a contract. For example, if one of your employees crashes the company car, you may

be liable for paying the car's insurance deductible since you contract with the insurance company.

- **Equity:** Equity is the value of your business that remains after deducting liabilities from assets. In corporations, this value is known as the shareholder's equity.
- **Owner investment:** Business owners typically invest their own cash and resources into the business. This is known as the owner investment, which establishes equity in the business. If future business partners want equity in your business, how much they invest determines their equity share. For example, a limited liability corporation, or LLC, with two equal partners who contributed 50 percent has an owner investment of 50 percent of the business.
- **Owner distribution:** If those partners later sell their shares, they would receive an owner distribution. This results in decreased equity in the business.
- **Revenue:** Revenue represents income that a company earns during a certain period. It includes sales, interest income and gains on short-term investments. Revenue may be a short-term item if it is earned in a year or less or a long-term item if it is earned after a year. For example, a business' short-term revenues include sales and interest income, while long-term revenues can include interest income, such as from a corporate savings account, that is earned in two years.
- **Expenses:** Expenses represent costs that a company incurs during a certain period. They include the cost of sales, interest expense, production or delivery costs, as well as losses on short-term investments.
- **Gains and losses:** These are increases and decreases in equity that result from transactions incidental to your business. For example, if your primary business is book printing and distribution, you likely have machinery needed to bind books. If you sell a book binder used to manufacture books, you would sell it either for more than you paid for it (a gain) or less (a loss).

A statement of financial performance can also include comprehensive income, asset use, market share and other factors that affect your business.

Why You Need a Statement of Financial Performance

There are many reasons why businesses need a statement of financial performance. Generally, a statement of financial performance is important to understanding if your business is profitable and, if not, where to make needed changes. It shows the current financial status of your business, how cash is used and where the unnecessary costs are.

A statement of financial performance allows a company's top management to identify major revenue and expense items that affect the company's bottom line, or net income. For example, you can review your company's statement of financial performance for the months of June, September and November to understand and compare sales revenue levels and which expense items increase based on seasonal business demands.

The statement of financial performance also helps management see which business segments or products are worth investing more money in and which the company may need to stop putting money into. If you're investing a lot of money in a product that historically costs more to produce than it earns profit, you can make the best decision for your company based on information learned from the statement of financial performance.

A statement of financial performance also provides significant insight into an organization's overall profitability. It helps investors, lenders or regulators gauge a corporation's economic standing. This comes into play in such situations as seeking a bank loan. The bank's credit officer may review your statement of financial performance over a five-year period to gauge profitability levels or sales trends and ensure that you will have available cash to repay the loan.

Potential investors look at your statement of financial performance to help them decide if they want to invest in your company. Likewise, someone wanting to purchase or acquire the business will use the statement of financial performance to help determine a purchase price. When done properly, the statement of financial performance tells future investors or purchasers everything they need to know about your company.

While only publicly traded companies are required to maintain statements of financial performance, keeping track of your company's finances will help you when it comes time to file tax returns.

How to Improve Financial Performance

After all of the calculations are in, you may find that the statement of financial performance isn't showing the profits you expected. This can be disheartening to anyone who invests a lot of time, energy and money into their business enterprise, but there are ways to improve the financial performance of your company:

- **Maintain ongoing financial statements.** One of the best ways to improve financial performance is to regularly review how your business is doing. Instead of preparing the statement of financial performance annually, you may want to do it quarterly, or even monthly, to see where improvements can be made. What you don't want to do is make rash decisions based on one bad month, so be sure to

look at financials month-to-month, quarter-to-quarter or year-to-year to make the most informed decisions.

- **Be proactive.** With regular financial performance statements, you can see if things are operating as efficiently as they should. With ongoing financial statements, you can get a sense of what is currently happening in your company, what is going to happen, and if any changes need to be made. Being proactive can save you a lot of money and positively impact your bottom line.
- **Have a realistic budget.** One of the quickest ways to improve financial performance is to have a realistic budget. Don't spend a lot of money in areas that don't make sense, since it will negatively affect your bottom line. Make sure you have a budget that is realistic and in line with company goals. When you work within that budget, you may see the financials move in the direction you want.
- **Price your products correctly.** Know how much your products are actually worth on the market by doing competitor research. If you can increase the price of your product or service, you may be able to see immediate improvements in the company's financial performance, especially if costs stay the same.
- **Set achievable goals.** In addition to a realistic budget, make sure your goals are achievable. Don't try to provide services you don't have the resources for. Don't try to double your profits within one month. What you want to do is strategically plan where to invest resources and money, and then set goals that the company can actually achieve. Meeting smaller goals helps improve financial performance in the short-term, while ultimately meeting your long-term financial goals.
- **Get everyone on board.** Make sure your entire team is onboard with the budget. This ensures they abide by how much to spend and when to cut their losses. It also ensures that your team is engaged and committed to your company's goals and bottom line. Satisfied employees can boost your financial goals since they are more likely to do what it takes to help your company succeed and stick around for the long-term.
- **Make sure your systems are current.** Your company is only as efficient as the people and technology you employ. Outdated technology and systems can slow things down so much that you waste both money and time. Periodically check in with your staff to make sure they are making effective use of their time and efficiently processing anything related to your company's finances, such as invoices and collecting overdue payments. Keeping the computers and software up to date will also keep things operating more smoothly. Utilizing financial performance apps and newer computer programs is key in today's fast-changing world.

Relationship between items in Balance Sheet and Profit and Loss Account.

Balance Sheet, or otherwise known as position statement, is a statement which shows the financial position of the company on a specific date. It lists all the ownership, i.e. assets and owings, i.e. liabilities of the company.

Profit & Loss Account, on the other hand, also known as income statement is the account that shows the revenue earned and expenses sustained by the company, during the course of business, in a financial year.

The two statements are an integral part of the financial statement, meaning that financial statement cannot be reported without these two. These are useful to the interested parties in knowing the overall performance, profitability, and position of the company, so as to enable them to make a decision.

Comparison Chart

BASIS FOR COMPARISON	BALANCE SHEET	PROFIT AND LOSS ACCOUNT
Meaning	A statement that shows company's assets, liabilities and equity at a specific date.	Account that shows the company's revenue and expenses over a period of time.
What is it?	Statement	Account
Represents	Financial position of the business on a particular date.	Profit earned or loss suffered by business for the accounting period
Preparation	Prepared on the last day of financial year.	Prepared for the financial year.
Information	Assets, liabilities, and capital of	Income, expenses, gains

BASIS FOR COMPARISON	BALANCE SHEET	PROFIT AND LOSS ACCOUNT
Disclosed	shareholders.	and losses.
Accounts	Accounts shown in the Balance Sheet do not lose their identity, rather their balance is carry forward to next year as opening balance.	Accounts transferred to Profit and Loss account are closed and cease to exist.
Sequence	It is prepared after the preparation of Profit & Loss Account.	It is prepared before the preparation of Balance Sheet.

Key Differences Between Balance Sheet and Profit & Loss Account

1. The Balance Sheet is prepared at a particular date, usually the end of the financial year while the Profit and Loss account is prepared for a particular period.
2. The Balance Sheet reveals the entity's financial position, whereas the Profit & Loss account discloses the entity's financial performance, i.e. profit earned or loss suffered by the business for the accounting period.

3. Balance Sheet is a statement of assets and liabilities. In contrast, Profit & Loss Account is an account.
4. A Balance Sheet is a gives an overview of assets, equity, and liabilities of the company, but the Profit and Loss account is a depiction of entity's revenue and expenses.
5. Accounts which are transferred to profit and loss account are closed and lose their identity. On the contrary, those accounts which are transferred to Balance sheet do not cease to exist rather their balance is carried forward to the next accounting year and considered as opening balances.
6. The Balance sheet is prepared on the basis of the balances transferred from the Profit and Loss account.

TREND ANALYSIS

Trend analysis is a method used in technical analysis that tries to predict the future. Under this system, Revenue and cost information from a company's income statement is arranged on a trend line for multiple reporting periods and then examined for trends and inconsistencies. The object of trend analysis is to spot actionable patterns from the information. The method is quite useful for reviewing early financial statements for inaccuracies and to see whether adjustments can be made before the statements are presented for general use.

For example, if the management notices abrupt increase in the business expenses in the first month followed by sharp decline in the second month signs a possibility that the expense was booked twice in the first month. In such cases, the account section of the company has to verify the reason and see whether adjustment can be made before final statement is presented. Thus, the trend analysis is one of the most useful management tools available for 'Revenue and Cost analyses' of a business.

Trend analysis system is also useful for scrutinizing revenue pattern of a business. In a business review, the management would evaluate why sales are declining for certain products, customers, or a particular sales region. Further it scrutinizes expense report to check for presence of any fraudulent claims, unusual expenditure which would lead to further investigation. Further, the 'Trend analysis' is useful in budgeting for the following season particularly in respect of revenue and expense line items.

Comparative Statement

A comparative statement is a document used to compare a particular financial statement with prior period statements. Previous financials are presented alongside the latest figures in side-by-side columns, enabling investors to identify trends, track a company's progress and compare it with industry rivals.

How Comparative Statements Work

Analysts, investors, and business managers use a company's income statement, balance sheet, and cash flow statement for comparative purposes. They want to see how much is spent chasing revenues from one period to the next and how items on the balance sheet and the movements of cash vary over time.

Comparing the P&L Statement and the Balance Sheet

Comparative statements show the effect of business decisions on a company's bottom line. Trends are identified and the performance of managers, new lines of business and new products can be evaluated, without having to flip through individual financial statements.

Comparative statements can also be used to compare different companies, assuming that they follow the same accounting principles. For example, they can show how different businesses operating in the same industry react to market conditions. Reporting just the latest dollar amounts makes it hard to compare the performances of companies of various

sizes. Adding prior period figures, complete with percentage changes, helps to eliminate this problem.

Cash Flow Statement

Every business must generate sufficient cash inflows to pay for operations. For example, managers may compare the ending balance in cash each month over the past two years to determine if the ending cash balance is increasing or declining. If company sales are growing, the manufacturer requires more cash to operate each month, which is reflected in the ending cash balance.

A downward trend in the ending cash balance means that the receivable balance is growing and that the firm needs to take steps to collect cash faster.

Income Statement

A percentage of sales presentation is often used to generate comparative financial statements for the income statement — the area of a financial statement dedicated to a company's revenues and expenses. Presenting each revenue and expense category as a percentage of sales makes it easier to compare periods and assess company performance.

Comparative Statement Example

Assume, for example, that a manufacturer's cost of goods sold (COGS) increases from 30% of sales to 45% of sales over three years. Management can use that data to make changes, such as finding more competitive pricing for materials or training employees to lower labor costs. On the other hand, an analyst may see the cost of sales trend and conclude that the higher costs make the company less attractive to investors.

Comparative Statement Limitations

Comparative statements are less reliable when companies undergo huge changes. A big acquisition and move into new end markets can transform businesses, making them different entities from previous reporting periods.

For example, if Company A acquires Company B it may report a sudden sharp jump in sales to account for all the extra revenues that Company B generates. At the same time, profit margins might tighten at an alarming rate because Company B has a less lean manufacturing process, spending more money to produce the goods it sells.

Common Size Statement

A common size financial statement displays all items as percentages of a common base figure rather than as absolute numerical figures. This type of financial statement allows for

easy analysis between companies or between time periods for the same company. The values on the common size statement are expressed as ratios or percentages of a statement component, such as revenue or income.

While most firms don't report their statements in common size format, it is beneficial for analysts to compute it to compare two or more companies of differing size or different sectors of the economy. Formatting financial statements, in this way, reduces bias that can occur and allows for the analysis of a company over various time periods, revealing, for example, what percentage of sales is the cost of goods sold, and how that value has changed over time. Common size financial statements commonly include the income statement, balance sheet, and cash flow statement.

Common Size Balance Sheet Statement

The balance sheet provides a snapshot overview of the firm's assets, liabilities and shareholders' equity for the reporting period. A common size balance sheet is set up with the same logic as the common size income statement. The balance sheet equation is assets equals liabilities plus stockholders' equity.

As a result, analysts define the balance sheet as a percentage of assets. Another version of the common size balance sheet shows asset line items as a percentage of total assets, liabilities as a percentage of total liabilities and stockholders' equity as a percentage of total stockholders' equity.

Common Size Cash Flow Statement

The cash flow statement provides an overview of the firm's sources and uses of cash. The cash flow statement is divided among cash flows from operations, cash flows from investing and cash flows from financing. Each section provides additional information about the sources and uses of cash in each business activity.

One version of the common size cash flow statement expresses all line items as a percentage of total cash flow. The more popular version expresses cash flow in terms of total operational cash flow for items in cash flows from operations, total investing cash flows for cash flows from investing activities, and total financing cash flows for cash flows from financing activities.

Preparation of projected Financial Statements

GUIDELINES FOR PREPARING PROJECTED FINANCIAL STATEMENTS

Before entering into the nitty-gritty of the precautions to be taken by the professionals, first of all, I would like to throw some lights on the definitions of the basics of the Projected Financial Statements:

WHAT IS FINANCIAL FORECASTS AND PROJECTIONS?

Financial forecasts and projections are two types of prospective financial statements that attempt to reflect a company's expected financial position and expected results of operations.

FINANCIAL FORECAST

A financial forecast reflects, to the best of the company's knowledge, the expected financial results of a future period. It is based on expected conditions and expected courses of action. It is to be noted that in almost all situations, the party responsible for the prospective financial statements is the management of the company.

FINANCIAL PROJECTIONS

A financial projection is different than a forecast in that it is based on hypothetical assumptions. A projection reflects the financial position and results of operations based on a "What if" type of scenario. It is to be noted that only a financial forecast is appropriate for general use.

Now, I would like to touch upon those areas, which needs to be taken care of and needs some fine-tuning before accepting any assignment of preparing/compiling of projected financial statements.

PRECAUTIONS TO BE TAKEN BY THE PROFESSIONALS BEFORE COMPILING PROJECTED FINANCIAL STATEMENTS

1. Make sure that the assumptions used in preparing projected financial statements are reasonable and supported by documentary evidence. Though the compiler (i.e. Professional) is not under obligation to gather the supporting evidences but he should be aware of obvious inappropriate assumptions used to construct the projected financial statements.

2. The compiler of the projected financial statements needs not to be independent but he must disclose lack of independence.

3. Compiler should take a summary of significant assumptions (preferably through Representation Letter from Client) that are used in preparation/compilation of projected financial statements.

4. The professional who has prepared/compiled the projected financial statement should issue a "**Compilation Report"** for the party who is going to use it. I personally of the opinion and strongly recommend that professionals should submit the **"Compilation Report"** along with projected financial statements to make it clear about the extent of checking they have made and the extent of responsibility they are going to take. The format of the report should be more or less in the format as given in Annexure-1.

OTHER MATTERS TO TAKE CARE OF BY THE COMPILER OF THE PROJECTED FINANCIAL STATEMENTS

1. Take an appointment letter from the client, which clearly mention the terms and conditions, time period to complete the job and preferably the fees to be paid.

2. Take a Representation Letter from the management of the co., which usually contain the following matters:

~ The purpose of issuing of projected financial statements;

~ List of assumptions on the basis of which projected financial statement has been issued and the procedure adopted to collect these assumptions;

~ Name of the responsible party (I.e. a financial institute or banker) who is going to use it;

~ Report on rating of the company, if any given in the past by any financial institute or rating agency;

~ Any attempt made in the past in this matter with any other financial institute or any other professional and result thereof.

PROCEDURES FOR INDEPENDENT EVALUATIONS TO BE MADE BY THE PROFESSIONAL OF THE REPRESENTATIONS MADE BY THE MANAGEMENT

1. Gather the information about the industry, in which client is involved. The information can be gathered from the web browsing or some Govt. / Private publications on the subject matter.

2. Analyse the past financial statements of the client, which include the analysis of relevant ratios, which reflect the financial health of the company.

3. Analyse the past track record of the client regarding repayment obligations.

4. Independent meeting with the concern persons of the management on the subject matter, with specific questionnaire and agenda.

Ratio analysis

Ratio analysis is the comparison of line items in the financial statements of a business. Ratio analysis is used to evaluate a number of issues with an entity, such as its liquidity, efficiency of operations, and profitability. This type of analysis is particularly useful to analysts outside of a business, since their primary source of information about an organization is its financial statements. Ratio analysis is less useful to corporate insiders, who have better access to more detailed operational information about the organization. Ratio analysis is particularly useful when used in the following two ways:

Trend line: Calculate each ratio over a large number of reporting periods, to see if there is a trend in the calculated information. The trend can indicate financial difficulties that would not otherwise be apparent if ratios were being examined for a single period. Trend lines can also be used to estimate the direction of future ratio performance.

Industry comparison: Calculate the same ratios for competitors in the same industry, and compare the results across all of the companies reviewed. Since these businesses likely operate with similar fixed asset investments and have similar capital structures, the results of a ratio analysis should be similar. If this is not the case, it can indicate a potential issue, or the reverse - the ability of a business to generate a profit that is notably higher than the rest of the industry. The industry comparison approach is used for sector analysis, to determine which businesses within an industry are the most (and least) valuable.

There are several hundred possible ratios that can be used for analysis purposes, but only a small core group is typically used to gain an understanding of an entity. These ratios include:

Current ratio: Compares current assets to current liabilities, to see if a business has enough cash to pay its immediate liabilities.

Days sales outstanding: Determines the ability of a business to effectively issue credit to customers and be paid back on a timely basis.

Debt to equity ratio: Compares the proportion of debt to equity, to see if a business has taken on too much debt.

Dividend payout ratio: This is the percentage of earnings paid to investors in the form of dividends. If the percentage is low, it is an indicator that there is room for dividend payments to increase substantially.

Gross profit ratio: Calculates the proportion of earnings generated by the sale of goods or services, before administrative expenses are included. A decline in this percentage could signal pricing pressure on a company's core operations.

Inventory turnover: Calculates the time it takes to sell off inventory. A low turnover figure indicates that a business has an excessive investment in inventory, and therefore is at risk of having obsolete inventory.

Net profit ratio: Calculates the proportion of net profit to sales; a low proportion can indicate a bloated cost structure or pricing pressure.

Price earnings ratio. Compares the price paid for a company's shares to the earnings reported by the business. An excessively high ratio signals that there is no basis for a high stock price, which could presage a stock price decline.

Return on assets: Calculates the ability of management to efficiently use assets to generate profits. A low return indicates a bloated investment in assets.

Analysis of different Ratios

i)Liquidity Ratios: Liquidity ratios analyze the ability of a company to pay off both its current liabilities as they become due as well as their long-term liabilities as they become current. In other words, these ratios show the cash levels of a company and the ability to turn other assets into cash to pay off liabilities and other current obligations.

Liquidity is not only a measure of how much cash a business has. It is also a measure of how easy it will be for the company to raise enough cash or convert assets into cash. Assets like accounts receivable, trading securities, and inventory are relatively easy for many

companies to convert into cash in the short term. Thus, all of these assets go into the liquidity calculation of a company.

Most common liquidity ratios:

Quick Ratio: The quick ratio or acid test ratio is a liquidity ratio that measures the ability of a company to pay its current liabilities when they come due with only quick assets. Quick assets are current assets that can be converted to cash within 90 days or in the short-term. Cash, cash equivalents, short-term investments or marketable securities, and current accounts receivable are considered quick assets.

Formula

The quick ratio is calculated by adding cash, cash equivalents, short-term investments, and current receivables together then dividing them by current liabilities.

Quick Ratio

$$\text{Quick Ratio} = \frac{\text{Cash + Cash Equivalents + Short Term Investments + Current Receivables}}{\text{Current Liabilities}}$$

Sometimes company financial statements don't give a breakdown of quick assets on the balance sheet. In this case, you can still calculate the quick ratio even if some of the quick asset totals are unknown. Simply subtract inventory and any current prepaid assets from the current asset total for the numerator. Here is an example.

Quick Ratio

$$\text{Quick Ratio} = \frac{\text{Total Current Assets - Inventory - Prepaid Expenses}}{\text{Current Liabilities}}$$

Acid Test Ratio: *Formula*

The quick ratio is calculated by adding cash, cash equivalents, short-term investments, and current receivables together then dividing them by current liabilities.

Quick Ratio

$$\text{Quick Ratio} = \frac{\text{Cash + Cash Equivalents + Short Term Investments + Current Receivables}}{\text{Current Liabilities}}$$

Sometimes company financial statements don't give a breakdown of quick assets on the balance sheet. In this case, you can still calculate the quick ratio even if some of the

quick asset totals are unknown. Simply subtract inventory and any current prepaid assets from the current asset total for the numerator. Here is an example.

Quick Ratio

$$\text{Quick Ratio} = \frac{\text{Total Current Assets - Inventory - Prepaid Expenses}}{\text{Current Liabilities}}$$

Current Ratio: The current ratio is a liquidity and efficiency ratio that measures a firm's ability to pay off its short-term liabilities with its current assets. The current ratio is an important measure of liquidity because short-term liabilities are due within the next year.

This means that a company has a limited amount of time in order to raise the funds to pay for these liabilities. Current assets like cash, cash equivalents, and marketable securities can easily be converted into cash in the short term. This means that companies with larger amounts of current assets will more easily be able to pay off current liabilities when they become due without having to sell off long-term, revenue generating assets.

Formula

The current ratio is calculated by dividing current assets by current liabilities. This ratio is stated in numeric format rather than in decimal format. Here is the calculation:

Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Working Capital: The working capital ratio, also called the current ratio, is a liquidity ratio that measures a firm's ability to pay off its current liabilities with current assets. The working capital ratio is important to creditors because it shows the liquidity of the company.

Current liabilities are best paid with current assets like cash, cash equivalents, and marketable securities because these assets can be converted into cash much quicker than fixed assets. The faster the assets can be converted into cash, the more likely the company will have the cash in time to pay its debts.

Working Capital Ratio

$$\text{Working Capital Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Working Capital Ratio:

Working Capital Ratio

$$\text{Working Capital Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Times Interest Earned Ratio: The times interest earned ratio, sometimes called the interest coverage ratio, is a coverage ratio that measures the proportionate amount of income that can be used to cover interest expenses in the future.

In some respects the times interest ratio is considered a solvency ratio because it measures a firm's ability to make interest and debt service payments. Since these interest payments are usually made on a long-term basis, they are often treated as an ongoing, fixed expense. As with most fixed expenses, if the company can't make the payments, it could go bankrupt and cease to exist. Thus, this ratio could be considered a solvency ratio.

Formula

The times interest earned ratio is calculated by dividing income before interest and income taxes by the interest expense.

Times Interest Earned Ratio

$$\text{Times Interest Earned Ratio} = \frac{\text{Income before Interest and Taxes or EBIT}}{\text{Interest Expense}}$$

ii)Solvency ratios: Solvency ratios, also called leverage ratios, measure a company's ability to sustain operations indefinitely by comparing debt levels with equity, assets, and earnings. In other words, solvency ratios identify going concern issues and a firm's ability to pay its bills in the long term. Many people confuse solvency ratios with liquidity ratios. Although they both measure the ability of a company to pay off its obligations, solvency

ratios focus more on the long-term sustainability of a company instead of the current liability payments.

Solvency ratios show a company's ability to make payments and pay off its long-term obligations to creditors, bondholders, and banks. Better solvency ratios indicate a more creditworthy and financially sound company in the long-term.

The most common solvency ratios include:

Debt to Equity Ratio: The debt to equity ratio is a financial, liquidity ratio that compares a company's total debt to total equity. The debt to equity ratio shows the percentage of company financing that comes from creditors and investors. A higher debt to equity ratio indicates that more creditor financing (bank loans) is used than investor financing (shareholders).

Formula

The debt to equity ratio is calculated by dividing total liabilities by total equity. The debt to equity ratio is considered a balance sheet ratio because all of the elements are reported on the balance sheet.

Debt to Equity Ratio
$\text{Debt to Equity Ratio} = \dfrac{\text{Total Liabilities}}{\text{Total Equity}}$

Equity Ratio: The equity ratio is an investment leverage or solvency ratio that measures the amount of assets that are financed by owners' investments by comparing the total equity in the company to the total assets.

The equity ratio highlights two important financial concepts of a solvent and sustainable business. The first component shows how much of the total company assets are owned outright by the investors. In other words, after all of the liabilities are paid off, the investors will end up with the remaining assets.

Equity Ratio
$\text{Equity Ratio} = \dfrac{\text{Total Equity}}{\text{Total Assets}}$

Debt Ratio: Debt ratio is a solvency ratio that measures a firm's total liabilities as a percentage of its total assets. In a sense, the debt ratio shows a company's ability to pay off its liabilities with its assets. In other words, this shows how many assets the company must sell in order to pay off all of its liabilities.

This ratio measures the financial leverage of a company. Companies with higher levels of liabilities compared with assets are considered highly leveraged and more risky for lenders.

Debt Ratio
$\text{Debt Ratio} = \dfrac{\text{Total Liabilities}}{\text{Total Assets}}$

iii)Efficiency ratios: Efficiency ratios also called activity ratios measure how well companies utilize their assets to generate income. Efficiency ratios often look at the time it takes companies to collect cash from customer or the time it takes companies to convert inventory into cash—in other words, make sales. These ratios are used by management to help improve the company as well as outside investors and creditors looking at the operations of profitability of the company.

Efficiency ratios go hand in hand with profitability ratios.

Most common efficiency ratios include:

Accounts Receivable Turnover:

Formula
Accounts receivable turnover is calculated by dividing net credit sales by the average accounts receivable for that period.

Accounts Receivable Turnover Ratio
$\text{Accounts Receivable Turnover Ratio} = \dfrac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$

Working Capital Ratio:

Working Capital Ratio

$$\text{Working Capital Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Asset Turnover Ratio:

Formula

The asset turnover ratio is calculated by dividing net sales by average total assets.

Asset Turnover Ratio

$$\text{Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{AverageTotal Assets}}$$

Total Asset Turnover Ratio:

Formula

The asset turnover ratio is calculated by dividing net sales by average total assets.

Asset Turnover Ratio

$$\text{Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{AverageTotal Assets}}$$

Inventory Turnover:

Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Days' sales in Inventory

Days' Sales in Inventory

$$\text{Days' Sales in Inventory} = \frac{\text{Ending Inventory}}{\text{Cost of Goods Sold}} \times 365$$

iv) Profitability ratios compare income statement accounts and categories to show a company's ability to generate profits from its operations. Profitability ratios focus on a company's return on investment in inventory and other assets. These ratios basically show how well companies can achieve profits from their operations.

Gross Margin Ratio:

Gross Margin Ratio	
Gross Margin Ratio =	$\frac{\text{Gross Margin}}{\text{Net Sales}}$

Profit Margin:

Profit Margin Ratio	
Profit Margin Ratio =	$\frac{\text{Net Income}}{\text{Net Sales}}$

Return on Assets:

Return on Assets Ratio	
Return on Assets Ratio =	$\frac{\text{Net Income}}{\text{Average Total Assets}}$

Return on Capital Employed:

Formula

Return on capital employed formula is calculated by dividing net operating profit or EBIT by the employed capital.

Return on Capital Employed	
Return on Capital Employed =	$\frac{\text{Net Operating Profit}}{\text{Employed Capital}}$

If employed capital is not given in a problem or in the financial statement notes, you can calculate it by subtracting current liabilities from total assets. In this case the ROCE formula would look like this:

Return on Capital Employed

$$\text{Return on Capital Employed} = \frac{\text{Net Operating Profit}}{\text{Total Assets - Current Liabilities}}$$

It isn't uncommon for investors to use averages instead of year-end figures for this ratio, but it isn't necessary.

Return on Equity:

Return on Equity Ratio

$$\text{Return on Equity Ratio} = \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

v)Market Prospect ratios: Market Prospect ratios are used to compare publicly traded companies' stock prices with other financial measures like earnings and dividend rates. Investors use market prospect ratios to analyze stock price trends and help figure out a stock's current and future market value.

In other words, market prospect ratios show investors what they should expect to receive from their investment. They might receive future dividends, earnings, or just an appreciated stock value. These ratios are helpful for investors to predict how much stock prices will be in the future based on current earnings and dividend measurements. For instance, a downward trend in earnings per share and dividend yield point to profitability problems and could even raise going concern issues. All of these issues point to a lower stock evaluation.

Earnings Per Share:

Earnings Per Share

$$\text{Earnings Per Share} = \frac{\text{Net Income - Preferred Dividends}}{\text{Weighted Average Common Shares Outstanding}}$$

Price Earnings Ratio or P/E Ratio:

Price Earnings Ratio
$\text{Price Earnings Ratio} = \dfrac{\text{Market Value Price per Share}}{\text{Earnings per Share}}$

Dividend Payout Ratio:

Dividend Payout Ratio
$\text{Dividend Payout Ratio} = \dfrac{\text{Total Dividends}}{\text{Net Income}}$

Dividend Yield:

Dividend Yield
$\text{Dividend Yield} = \dfrac{\text{Cash Dividends per Share}}{\text{Market Value per Share}}$

vi)Financial leverage ratios: Financial leverage ratios, sometimes called equity or debt ratios, measure the value of equity in a company by analyzing its overall debt picture. These ratios either compare debt or equity to assets as well as shares outstanding to measure the true value of the equity in a business.

In other words, the financial leverage ratios measure the overall debt load of a company and compare it with the assets or equity. This shows how much of the company assets belong to the shareholders rather than creditors. When shareholders own a majority of the assets, the company is said to be less leveraged. When creditors own a majority of the assets, the company is considered highly leveraged. All of these measurements are important for investors to understand how risky the capital structure of a company and if it is worth investing in.

Most common financial leverage ratios.

Debt Ratio:

Debt Ratio
$\text{Debt Ratio} = \dfrac{\text{Total Liabilities}}{\text{Total Assets}}$

Debt to Equity Ratio:

Debt to Equity Ratio

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

Equity Ratio:

Equity Ratio

$$\text{Equity Ratio} = \frac{\text{Total Equity}}{\text{Total Assets}}$$

Interpretation of Ratios

The interpretation of ratios is an important factor. Though calculation of ratios is also important but it is only a clerical task whereas interpretation needs skill, intelligence and foresightedness. The inherent limitations of ratio analysis should be kept in mind while interpreting them. The impact of factors such as price level changes, change in accounting policies, window dressing etc., should also be kept in mind when -attempting to interpret ratios.

A single ratio in itself does not convey much of the sense. To make ratios useful, they have to be further interpreted. For example, say, the current ratio of 3 : 1 does not convey any sense unless it is interpreted and conclusion is drawn from it regarding the financial condition of the firm as to whether it is very strong, good, questionable or poor.

The interpretation of the ratios can be made in the following ways:

1. Single Absolute Ratio: Generally speaking one cannot draw any meaningful conclusion when a single ratio is considered in isolation. But single ratios may be studied in relation to certain rules of thumb which are based upon well proven conventions as for example 2: 1 is considered to be a good ratio for current assets to current liabilities.

2. Group of Ratios: Ratios may be interpreted by calculating a group of related ratios. A single ratio supported by other related additional ratios becomes more understandable and meaningful. For example, the ratio of current assets to current liabilities may be supported by the ratio of liquid assets to liquid liabilities to draw more dependable conclusions.

3. Historical Comparison: One of the easiest and most popular ways of evaluating the performance of the firm is to compare its present ratios with the past ratios called comparison overtime. When financial ratios are compared over a period of time, it gives an indication of the direction of change and reflects whether the firm's performance and financial position has improved, deteriorated or remained constant over a period of time. But while interpreting ratios from comparison over time, one has to be careful about the changes, if any, in the firm's policies and accounting procedures.

4. Projected Ratios: Ratios can also be calculated for future standards based upon the projected or proforma financial statements. These future ratios may be taken as standard for comparison and the ratios calculated on actual financial statements can be compared with the standard ratios to find out variances, if any. Such variances help in interpreting and taking corrective action for improvement in future.

5. Inter-Firm Comparison: Ratios of one firm can also be compared with the ratios of some other selected firms in the same industry at the same point of time. This kind of comparison helps in evaluating relative financial position and performance of the firm. But while making use of such comparison one has to be very careful regarding the different accounting methods, policies and procedures adopted by different firms.

Limitations of Ratio Analysis

While ratios are very important tools of financial analysis, they d have some limitations, such as

- The firm can make some year-end changes to their financial statements, to improve their ratios. Then the ratios end up being nothing but window dressing.
- Ratios ignore the price level changes due to inflation. Many ratios are calculated using historical costs, and they overlook the changes in price level between the periods. This does not reflect the correct financial situation.

- Accounting ratios completely ignore the qualitative aspects of the firm. They only take into consideration the monetary aspects (quantitative)
- There are no standard definitions of the ratios. So firms may be using different formulas for the ratios. One such example is Current Ratio, where some firms take into consideration all current liabilities but others ignore bank overdrafts from current liabilities while calculating current ratio
- And finally, accounting ratios do not resolve any financial problems of the company. They are a means to the end, not the actual solution.

Structuring of credit Proposal

The following are the key issues to be subject matter of discussion in a credit proposal:

1. **Purpose:** The purpose of financing sets the main parameters for designing the credit structure, because it affects the safety of repayment and earnings from the business. The proposal should be bankable. The following proposals are relevant for the proposal:
- Compliance of bank's internal policy (for example financing for preferred sector and sun rise industries).
- The commercial and economic logic of the purpose to be financed.
- The ability and experience of management to handle the proposed venture.
- Compliance with bank's legal requirements.
- Legal complications arising from the purpose of the financing which may impair the creditworthiness of the advance.

2. **Amount:** Is it adequate for the purpose? The loan should be need-based, not more and not less. A bank which leads inadequately not caring how the balance requirement will be funded may create problem for itself as well as for the customer.

3. **Margin contribution:** This is the stake of the proponent in the project. In project lending secured by fixed assets, a cash contribution from the company itself acts as evidence of commitment and cushion to the lenders against failure of the project or failure of the secured assets to generate repayment. In unsecured transactions, the focus shifts to the financing mix of debt and equity.

4. **Portfolio consideration:** Bank's proposed exposure to the relevant corporate group/ industry should be considered. It is not advisable to put all eggs in one

basket.

5. **Credit risk and term**: Banks will wish to limit their exposure to individual high risk and long term advances more tightly than to lower risk and short term advances.

6. **Yield:** Increasingly banks are concerned with maximizing their yield from the use of their balance sheet and the amount lent can be a significant determinant of the overall return from the deal. The more the spread, the better for the bank.

7. **Legal Consideration:** Whether the company has borrowing power to borrow the amount and the bank to lend it.

8. **Repayment**: The key issue is how the bank is to be repaid and what is the margin of error if operations deteriorate. The following factors will be looked into in this regard.

- The type of repayment source
- The quality of repayment source
- The currency of income from the repayment source
- Cash flows protection (i.e. the margin of error)
- Financial flexibility (i.e. the alternative sources of fund to cover shortages)
- Asset protection to cover the bank if cash flow is inadequate
- The need for good documentation

9. **Security and Quasi-security:** Security whether main or collateral is the banker's protection against non-payment from the primary repayment source. It is the insurance against failure and takes the form of a legally enforceable claim on tangible assets or a third party guarantee. However, unsecured transactions may be acceptable where cash flow protection is generous and reliable and adequate asset cover is available for general creditors of the company.

10. **Control and monitoring:** The ability to take control of lending situation, before deterioration in borrower's condition become terminal, is crucial. It is achieved by insertion in the documentation of provisions which is breached, will enable the bank to switch over from tern facility to one immediately repayable on demand.

11. **Designing Credit Facilities**: Designing the details of credit facilities within the broad parameters of benefits to the borrower and protection and remuneration for the bank broadly involves:
- Fixing up cash and working capital demand loan limits
- Bills purchase and /or discounting facilities
- Term loan / deferred payment facilities
- Contingent liabilities limits for LCs and guarantees

12. **Pricing:** This is a very important aspect of lending especially in a competitive environment for achieving satisfactory remuneration for the bank. Pricing is based on the directives issued by the central bank from time and the market rates. It will consider:
- The risk-reward ratio
- The cost of administration and overheads
- Capital adequacy cost and cost of statutory reserves
- The need to optimize yields on investments

Working Capital Management

What is Working Capital Management?

Traditionally, investors, creditors and bankers have considered working capital as a critical element to watch, as important as the financial position portrayed in the balance sheet and the profitability shown in the income statement. Working capital is a measure of the company's efficiency and short term financial health. It refers to that part of the company's capital, which is required for financing short-term or current assets such a cash marketable securities, debtors and inventories. It is a company's surplus of current assets over current liabilities, which measures the extent to which it can finance any increase in turnover from other fund sources. Funds thus, invested in current assets keep revolving and are constantly converted into cash and this cash flow is again used in exchange for other current assets. ***That is why working capital is also known as revolving or circulating capital or short-term capital.***

Formula for Working Capital: "Current Assets – Current Liabilities"

Illustration to calculate working capital:

Components of the balance sheet: (Rs)

Current Assets		Current Liabilities	
Cash	1500	*Accounts payable*	1500
Marketable securities	500	*Accrued expenses*	1000
Accounts receivables	2000	*Notes payable*	500
Inventory	2500	*Current portion- long term debt*	1500
Total current assets	6500	*Total current liabilities*	4500

WC = CA- CL

=6500-4500

=2000

Net working capital is defined as the excess of current assets over current liabilities. Working capital mentioned in the balance sheet is an indication of the company's current solvency in repaying its creditors. That is why when companies indicate shortage of working capital they in fact imply scarcity of cash resources.

Factors effecting working capital:

• **Nature of business:** generally working capital is higher in manufacturing compared to service based organizations

• **Volume of sales:** higher the sale, higher the working capital required

• **Seasonality:** peak seasons for sales need more working capital

• **Length of operating and cash cycle:** longer the operating and cash cycle, more is the requirement of working capital

Working capital Approaches:

A) Matching or hedging approach: This approach matches assets and liabilities to maturities. Basically, a company uses long term sources to finance fixed assets and permanent current assets and short term financing to finance temporary current assets.

Example: A fixed asset which is expected to provide cash flow for 5 years should be financed by approx 5 years long-term debts. Assuming the company needs to have additional inventories for 2 months, it will then seek short term 2 months bank credit to match it.

B) Conservative approach: it is conservative because the company prefers to have more cash on hand. That is why, fixed and part of current assets are financed by long-term or

permanent funds. As permanent or long-term sources are more expensive, this leads to "lower risk lower return".

C) Aggressive approach: The Company wants to take high risk where short term funds are used to a very high degree to finance current and even fixed assets.

Classification of Working Capital:

Working capital can be categorized on basis of Concept (gross working capital and net working capital) and basis of time (Permanent/ fixed WC and temporary/variable WC). The two major components of Working Capital are Current Assets and Current Liabilities. One of the major aspects of an effective working capital management is to have regular analysis of the company's currents assets and liabilities. This helps to take into account unforeseen events such as changes in the market conditions and competitor activities. Furthermore, steps taken to increase sales income and collecting accounts receivable also improves a company's working capital.

Working Capital in adequate amount:

For every business entity adequate amount of working capital is required to run the operations. It needs to be seen that there is neither excess nor shortage of working capital. Both excess, as well as a shortage of working capital situations, are bad for any business. However, out of the two, inadequacy or shortage of working capital is more dangerous from the point of view of the company operations. Inadequate working capital has its disadvantages where the company is not capable to pay off its short term liabilities in time, difficulty in exploring favorable market situations, day to day liquidity worsens and ROA and ROI fall sharply. On the other hand, one should keep in mind that excess of working capital also leads to wrong indications like idle funds, poor ROI, unnecessary purchase and accumulation of inventories over required level due to low rate of return on investments, all of which leads to fall in the market value of shares and credit worthiness of the company.

Working capital cycle:

The working capital cycle (WCC) is the amount of time it takes to turn the net current assets and current liabilities into cash. The longer the cycle is, the longer a business is tying-up funds in its working capital without earning any return on it. This is also one of the essential parameters to be recorded in working capital management.

Working Capital Management:

Working Capital Management (WCM) refers to all the strategies adopted by the company to manage the relationship between its short term assets and short term liabilities with the objective to ensure that it continues with its operations and meet its debt obligations when

they fall due. In other words, it refers to all aspects of administration of current assets and current liabilities. Efficient management of working capital is a fundamental part of the overall corporate strategy. The WC policies of different companies have an impact on the profitability, liquidity and structural health of the organization. Although investing in good long-term capital projects receives more emphasis than the day-to-day work associated with managing working capital, companies that do not handle this financial aspect (working capital) well will not attract the capital necessary to fund those highly visible ventures; in other words, you must get through the short run to get to the long run.

Components associated with WCM:

Often the interrelationships among the working capital components create real challenges for the financial managers. Inventory is purchased from suppliers, sale of which generates accounts receivable and collected in cash from customers to pay off those suppliers. Working capital has to be managed because the firm cannot always control how quickly the customers will buy, and once they have made purchases, exactly when they will pay. That is why; controlling the "cash-to-cash" cycle is paramount.

The different components of working capital management of any organization are:

- Cash and Cash equivalents
- Inventory
- Debtors / accounts receivables
- Creditors / accounts payable

A) Cash and Cash equivalents:

One of the most important working capital components to be managed by all organizations is cash and cash equivalents. Cash management helps in determining the optimal size of the firm's liquid asset balance. It indicates the appropriate types and amounts of short-term investments along with efficient ways of controlling collection and payout of cash. Good cash management implies the co-relation between maintaining adequate liquidity with minimum cash in bank. All companies strongly emphasize cash management as it is the key to maintain the firm's credit rating, minimize interest cost and avoid insolvency.

B) Management of inventories:

Inventories include raw material, WIP (work in progress) and finished goods. Where excessive stocks can place a heavy burden on the cash resources of a business, insufficient stocks can result in reduced sales, delays for customers etc. Inventory management involves the control of assets that are produced to be sold in the normal course of business.

For better stock/inventory control:

o Regularly review the effectiveness of existing purchase and inventory systems

o Keep a track of stocks for all major items of inventory

o Slow moving stock needs to be disposed as it becomes difficult to sell if kept for long

o Outsourcing should also be a part of the strategy where part of the production can be done through another manufacturer

o A close check needs to be kept on the security procedures as well

C) Management of receivables:

Receivables contribute to a significant portion of the current assets. For investments into receivables, there are certain costs (opportunity cost and time value) that any company has to bear, alongwith the risk of bad debts associated to it. It is, therefore necessary to have proper control and management of receivables which helps in taking sound investment decisions in debtors. Thereby, for effective receivables management one needs to have control of the credits and make sure clear credit practices are a part of the company policy, which is adopted by all others associated with the organization. One has to be vigilant enough when accepting new accounts, especially larger ones. Thereby, the principle lies in establishing appropriate credit limits for every customer and stick to them.

Effectively managing accounts receivables:

o Process and maintain records efficiently by regularly coordinating and communicating with credit managers' and treasury in-charges

o Prepare performance measurement reports

o Control accuracy and security of accounts receivable records.

o Captive finance subsidiary can be used to centralize accounts receivable functions and provide financing for company's sales

D) Management of accounts payable:

Creditors are a vital part of effective cash management and have to be managed carefully to enhance the cash position of the business. One has to keep in mind that purchasing initiates cash outflows and an undefined purchasing function can create liquidity problems for the company. The trade credit terms are to be defined by companies as they vary across industries and also among companies.

Factors to consider:

o Trade credit and the cost of alternative forms of short-term financing are to be defined

o The disbursement float which is the amount paid but not credited to the payers account needs to be controlled

o Inventory management system should be in place

o Appropriate methods need to be adopted for customer-to-business payment through e-commerce

o Company has to centralize the financial function with regards to the number, size and location of vendors

Trade Cycle

A trade cycle refers to fluctuations in economic activities specially in employment, output and income, prices, profits etc. It has been defined differently by different economists. According to Mitchell, "Business cycles are of fluctuations in the economic activities of organized communities. The adjective 'business' restricts the concept of fluctuations in activities which are systematically conducted on commercial basis.

The noun 'cycle' bars out fluctuations which do not occur with a measure of regularity". According to Keynes, "A trade cycle is composed of periods of good trade characterised by rising prices and low unemployment percentages altering with periods of bad trade characterised by falling prices and high unemployment percentages".

Features of a Trade Cycle:

1. A business cycle is synchronic. When cyclical fluctuations start in one sector it spreads to other sectors.

2. In a trade cycle, a period of prosperity is followed by a period of depression. Hence trade cycle is a wave like movement.

3. Business cycle is recurrent and rhythmic; prosperity is followed by depression and vice versa.

4. A trade cycle is cumulative and self-reinforcing. Each phase feeds on itself and creates further movement in the same direction.]5. A trade cycle is asymmetrical. The prosperity phase is slow and gradual and the phase of depression is rapid.

6. The business cycle is not periodical. Some trade cycles last for three or four years, while others last for six or eight or even more years.

7. The impact of a trade cycle is differential. It affects different industries in different ways.

8. A trade cycle is international in character. Through international trade, booms and depressions in one country are passed to other countries.

Phases of a Trade Cycle:

Generally, a trade cycle is composed of four phases – depression, recovery, prosperity and recession.

Depression: During depression, the level of economic activity is extremely low. Real income production, employment, prices, profit etc. are falling. There are idle resources. Price is low leading to a fall in profit, interest and wages. All the sections of the people suffer. During this phase, there will be pessimism leading to closing down of business firms.

Recovery: Recovery denotes the turning point of business cycle form depression to prosperity. In this phase, there is a slow rise in output, employment, income and price. Demand for commodities go up. There is increase in investment, bank loans and advances. Pessimism gives way to optimism. The process of revival and recovery becomes cumulative and leads to prosperity.

Prosperity: It is a state of affairs in which real income and employment are high. There are no idle resources. There is no wastage of materials. There is rise in wages, prices, profits and interest. Demand for bank loans increases. There is optimism everywhere. There is a general uptrend in business community.

However, these boom conditions cannot last long because the forces of expansion are very weak. There are bottlenecks and shortages. There may be scarcity of labour, raw material

and other factors of production. Banks may stop their loans. These conditions lead to recession.

Recession: When the entrepreneurs realize their mistakes, they reduce investment, employment and production. Then fall in employment leads to fall in income, expenditure, prices and profits. Optimism gives way to pessimism. Banks reduce their loans and advances. Business expansion stops. This state of recession ends in depression.

Credit Rating

Credit Rating in India

If we talk about an ideal world, everyone would have enough money to take care of their needs. However, facing the reality, most of us have little option but to take credit to meet our life goals, especially the ones involving a huge amount like taking a car, home, etc. To making borrowing money from bank easier, it is important to have a good credit history which is determined by not only the credit score but also the credit rating.

Credit Rating – Meaning & Functions

Credit Rating is an assessment of the borrower (be it an individual, group or company) that determines whether the borrower will be able to pay the loan back on time, as per the loan agreement. Needless to say, a good credit rating depicts a good history of paying loans on time in the past. This credit rating influences the bank's decision of approving your loan application at a considerate rate of interest.

It is usually expressed in alphabetical symbols. Although, it is a new concept in Indian financial market but slowly its popularity has increased. It helps investors to recognize the risk involved in lending the money and gives a fair assessment of the borrower's creditability.

Importance of Credit Rating

Here are the benefits of credit rating:

For The Money Lenders

Better Investment Decision: No bank or money lender companies would like to give money to a risky customer. With credit rating, they get an idea about the credit worthiness of an individual or company (who is borrowing the money) and the risk factor attached with them. By evaluating this, they can make a better investment decision.

Safety Assured: High credit rating means an assurance about the safety of the money and that it will be paid back with interest on time.

For Borrowers

Easy Loan Approval: With high credit rating, you will be seen as low/no risk customer. Therefore, banks will approve your loan application easily.

Considerate Rate of Interest: You must be aware of the fact every bank offers loan at a particular range of interest rates. One of the major factors that determine the rate of interest on the loan you take is your credit history. Higher the credit rating, lower will the rate of interest.

How do Credit Ratings Work in India?

As a matter of fact, every credit rating agency has their algorithm to evaluate the credit rating. However, the major factors are credit history, credit type and duration, credit utilization, credit exposure, etc. Every month, these credit rating agencies collect credit information from partner banks and other financial institutions. Once the request for credit rating has been made, these agencies dig out the information and prepare a report based on such factors. Based on that report, they grade every individual or company and give them a credit rating. This rating is used by banks, financial institutions and investors to make a decision of investing money, buying bonds or giving loan or credit card. The better is the rating, more are the chances of getting money at payable interest rates.

Credit Rating Agencies in India

Credit rating agency is an organization that evaluates the credit worthiness of an individual, business or company who wishes to borrow money or apply for a credit card in the bank. Let's have a look at the credit agencies in India.

CRISIL

Credit Rating Information Services of India Limited is the first credit rating agency of the country which was established in 1987. It calculates the credit worthiness of companies based on their strengths, market share, market reputation and board. It also rates companies, banks and organizations, helping investors make a better decision before investing in companies' bonds. It offers 8 types of credit rating which are as follows:

- AAA, AA, A – Good Credit Rating
- BBB, BB – Average Credit Rating
- B, C, D – Low Credit Rating

ICRA

Investment Information and Credit Rating Agency of India was formed in 1991 and is headquartered in Mumbai. It offers comprehensive ratings to corporates via a transparent

rating system. Its rating system includes symbols which vary with the financial instruments. Here are the types of credit ratings offered by ICRA:

- Bank Loan Credit Rating
- Corporate Debt Rating
- Corporate Governance Rating
- Financial Sector Rating
- Issuer Rating
- Infrastructure Sector Rating
- Insurance Sector Rating
- Mutual Fund Rating
- Public Finance Rating
- Project Finance Rating
- Structured Finance Rating
- SME Rating

CARE

Credit Analysis and Research Limited (CARE) offers a range of credit rating services in areas like debt, bank loan, corporate governance, recovery, financial sector and more. Its rating scale includes two categories – long term debt instruments and short term debt ratings.

ONICRA

Onida Individual Credit Rating Agency of India established in 1993 which offers credit assessment and credit scoring services to both individuals and businesses. Along with this, it also offers risk assessment reports to individuals, small and medium businesses and corporates. Its ratings are based on two factors – Financial Strength and Performance Capability.

SMERA

Small Medium Enterprises Rating Agency Of India Limited has two divisions – SME Ratings and Bond Ratings. It was established in 2011 and is a hub of financial professionals. It offers credit ratings in the following format:

- AAA, AA, A – Low Credit Risk
- BBB, BB – Moderate Credit Risk
- B, C – High Credit Risk
- D- Defaulted

Brickwork Ratings India Private Limited

Headquartered in Bangalore, this credit rating agency is responsible to rate bank loans, municipal corporation, capital market instrument and SMEs. Other than this, it is also responsible to grade real estate investments, hospitals, NGOs, MFI, etc. It offers various rating system depending upon the different financial instrument.

So, What's the Difference Between Credit Rating and Credit Score?

Often, these two terms are interchanged but they are not exactly same. Here are the differences between the two:

Credit Rating is basically a credit worthiness of a business or a company. However, it is not really used to individuals like us. It gives an understanding the ability of the company. These ratings are based on corporate financial instruments and usually denoted in alphabetical symbols. Higher the rating, lower is the probability of default pays.

Whereas credit score is a number, calculated by credit bureau and given to individuals based on the credit information report. This number can be in between 300 and 900. Credit report plays an important role in loan and credit card approval process.

Technical and economic feasibility studies

TECHNICAL FEASIBILITY

A large part of determining resources has to do with assessing technical feasibility. It considers the technical requirements of the proposed project. The technical requirements are then compared to the technical capability of the organization. The systems project is considered technically feasible if the internal technical capability is sufficient to support the project requirements.
The analyst must find out whether current technical resources can be upgraded or added to in a manner that fulfills the request under consideration. This is where the expertise of system analysts is beneficial, since using their own experience and their contact with vendors they will be able to answer the question of technical feasibility.

The essential questions that help in testing the operational feasibility of a system include the following:

- Is the project feasible within the limits of current technology?
- Does the technology exist at all?
- Is it available within given resource constraints?
- Is it a practical proposition?

- Manpower- programmers, testers & debuggers
- Software and hardware
- Are the current technical resources sufficient for the new system?
- Can they be upgraded to provide to provide the level of technology necessary for the new system?
- Do we possess the necessary technical expertise, and is the schedule reasonable?
- Can the technology be easily applied to current problems?
- Does the technology have the capacity to handle the solution?
- Do we currently possess the necessary technology?

ECONOMIC FEASIBILITY

Economic analysis could also be referred to as cost/benefit analysis. It is the most frequently used method for evaluating the effectiveness of a new system. In economic analysis the procedure is to determine the benefits and savings that are expected from a candidate system and compare them with costs. If benefits outweigh costs, then the decision is made to design and implement the system. An entrepreneur must accurately weigh the cost versus benefits before taking an action.
Possible questions raised in economic analysis are:

- Is the system cost effective?
- Do benefits outweigh costs?
- The cost of doing full system study
- The cost of business employee time
- Estimated cost of hardware
- Estimated cost of software/software development
- Is the project possible, given the resource constraints?
- What are the savings that will result from the system?
- Cost of employees' time for study
- Cost of packaged software/software development
- Selection among alternative financing arrangements (rent/lease/purchase)

The concerned business must be able to see the value of the investment it is pondering before committing to an entire system study. If short-term costs are not overshadowed by long-term gains or produce no immediate reduction in operating costs, then the

system is not economically feasible, and the project should not proceed any further. If the expected benefits equal or exceed costs, the system can be judged to be economically feasible. Economic analysis is used for evaluating the effectiveness of the proposed system.

The economical feasibility will review the expected costs to see if they are in-line with the projected budget or if the project has an acceptable return on investment. At this point, the projected costs will only be a rough estimate. The exact costs are not required to determine economic feasibility. It is only required to determine if it is feasible that the project costs will fall within the target budget or return on investment. A rough estimate of the project schedule is required to determine if it would be feasible to complete the systems project within a required timeframe. The required timeframe would need to be set by the organization.

Credit Rating Methodology

How is the credit rating set?

The credit rating agencies rate short term debt, long term debt, local currency debt and foreign currency debt differently. Short term debt is rated on a different scale than long tenor debt, because the ability of the issuer to meet obligations in the short term is related to different parameters than the ability to repay in the long term. Thus, the ability to repay short tenor obligations is based more on financial liquidity than the issuer's growth or risk potential.

The rating scale is divided into "Investment Grade" and "Speculative Grade," with both categories divided into three sub-levels. For example, an "A" rating is divided into: A-, A, A+ by S&P and Fitch, and A3, A2, A1 by Moody's.

In addition to the rating decision the rating agencies comment on the credit outlook. This judgement predicts future development trends in the credit rating. Outlooks are divided into three types as well: negative, stable and positive. Each outlook reflects the probability for nonpayment of debt; it relies on financial and accounting parameters and data analysis.

As part of monitoring Israel's credit rating, the Debt Management Unit analyzes market and economic factors in relation to the Agencies' Methodology after each Israel-related agency publication. This analysis allows the Debt Management Unit to predict, based on internal and external data, the rating scale.

Moody's, Fitch and S&P Long Term Rating Scale

S&P	**Fitch**	**Moody's**
AAA	AAA	Aaa
AA+	AA+	Aa1
AA	AA	Aa2
AA-	AA-	Aa3
A+**	**A+****	**A1****
A	A	A2
A-	A-	A3
BBB+	BBB+	Baa1
BBB	BBB	Baa2
BBB-	BBB-	Baa3
BB+	BB+	Ba1
BB	BB	Ba2
BB-	BB-	Ba3
B+	B+	B1
B	B	B2
B-	B-	B3

CCC+	CCC+	Caa1
CCC	CCC	Caa2
CCC-	CCC-	Caa3
CC	CC	Ca
C	C	C
D	D	

* The ratings in black type are investment grade. Red typeface indicates non-investment grade.

** Israel rating

What are the credit rating agencies reviewing?

The credit rating agencies utilize a large number of economic and other ratios when assessing a sovereign. The most important variables examined include: **debt to GDP ratio, deficit to GDP ratio, deficit trend and inflation rate**.

Debt Characteristics

The relative debt size and structure, as well as the government's degree of liquidity affect a sovereign's ability to meet debt obligations. .

Key indicators evaluated by credit rating agencies:

- Debt to GDP ratio
- External debt as % of total debt
- Interest payments as % of GDP and revenue
- Foreign reserves as % of short term debt
- Foreign currency balance in terms of months of imports
- Average time to maturity

Economy Characteristics

The economy bears the main burden of financing the government expenditure and thus its resilience directly impacts the government's ability to meet its obligations.

Key indicators tested by credit rating agencies:

- Gross Domestic Product (GDP) or Gross National Product (GNP)

- GDP per capita
- GDP growth rate
- Sectorial distribution of the GDP and the weight of industrial production

Foreign Trade

Trade and capital flows have a major influence on foreign exchange resources available to the government. This activity has a direct impact on the government's ability to pay its foreign debt. For small economies such as Israel, reliant on trade and open exchange regimes, the foreign sector is an important factor in economic activity.

Key indicators tested by credit rating agencies:

- The economy openness to trade and capital flows
- Balance of payments
- Debt to export ratio
- Cost of recycling debt to export ratio
- Real and nominal exchange rates

Monetary Environment

The monetary environment has a direct impact on investors' yields in bonds denominated in local currency, and indirectly on real economic activity. Therefore, fear or instability may increase the risk facing investors and lead to a reduction in the credit rating.

Key indicators tested by Credit Rating Agencies:

- Inflation rate and target
- Domestic interest rate
- Amount of money
- Volume of credit

Government Budget

The fiscal balance of the government directly affects its debt burden and the risk of non-repayment to the investor. Moreover, the budget deficit requires the government to raise additional funds in the capital markets, resulting in surplus supply, higher yields and falling bond prices. Therefore, a profound deficit or fear of the projected future deficit can cause a downgrade of a country credit rating.

Key indicators tested by Credit Rating Agencies:

- Revenues and expenditure
- Deficit to GDP ratio

- Deficit trend over time
- Government expenditure to GDP ratio
- Savings to GDP ratio

Domestic Political Characteristics

The political system and the stability of the governing coalition affect the government's ability to maintain a balanced budget and to avoid the provision of funds, to maintain coalition unity and public support. Consequently, political instability may lead to increased investor risk and rating downgrade.

Key indicators tested by Credit Rating Agencies:

- Size of the coalition
- Public support in the Government
- Election year

External Political Characteristics

Instability in the international arena (regionally or globally) may require the government to increase defense expenditures. Moreover, a war could cause damage to economic activity through decreased worker productivity, or the physical destruction of infrastructure and factories. Security instability may also lead to a reduction in foreign investment and a decline in bilateral trade. Instability has an effect on output and the monetary environment in which the economy operates. Therefore, international instability or destabilization expectations may lead to a decline in the country's credit rating.

Objectives and benefits of rating

The main objective of a credit rating agency is to generate income from the collection and resale of consumer borrowing records and company accounting records.

For an average consumer, a credit agency may collect information on credit agreements such as **loans, credit cards, mortgages, insurance payments, mobile phone payments, utility payments, social security numbers, ID numbers, and electoral roll (voter registration) data.** They may also collect court information such as county court judgements, bankruptcies and tax liens.

This information can then be purchased and used by lenders to make decisions on granting credit such as loans and mortgages. Some lenders/institutions may also purchase credit data to carry out identity checks.

Credit bureaus typically collect and resell data both for individuals (i.e. consumers).

Benefit:

In today's Indian economy, due to an increase in market orientation the investors assess two types of risk such as business risk and the other payment risk. The main target for the unlisted corporate debt is the small investors so in order to protect the interest of small investors' credit rating concept was introduced. Credit rating is widely used by Indian companies. So it became essential to check cibil score free for various perspective as mentioned below.

Credit rating is an opinion which is formed by the rating agencies who ascertain the future ability and the obligation of an individual to meet its debt obligation when they arise. The credit rating measures an individual probability of paying back a loan without defaulting and delaying it. It is an essential tool for an individual to have access to loans and credit cards. Credit ratings act as a link between the risk and return. It helps to determine the level of the risk inherent in the instrument. With the help of, rating an investor assesses the risk level which is being associated with the debt or any other instrument and compares the offered rate of return with the expected rate of return in order to optimize his risk return.

In India, there are mainly two regulators of credit rating Reserve Bank of India and Securities and Exchange Board of India who use the credit rating in order to determine the eligibility criteria of various instruments. Credit rating agencies have been set up with an aim to provide a rating to the company with their expert knowledge, research studies and the confidentiality of information.

FACTORS WHICH ARE AFFECTING CREDIT RATING

The rating is an opinion which is formed by the agencies after examining all the aspects of the information through their consistent efforts. **The various factors which mainly influence the credit ratings are as follows:**

- Company outstanding debt on the basis of volume and composition.
- Company stability of future cash flow and earning capacity affect the rating of the company.
- Likelihood of an individual to meet the fixed interest obligation.
- The operational efficiency also affects the credit rating of the company in respect of the optimum utilization of resources and their investment.
- A past record of the company's promoters, directors and staff also affect the good rating of the company.

BENEFITS OF CREDIT RATING

Credit rating plays a pivotal role in today's economy. It is beneficial from the investor point of view, from a company point of view and an individual and intermediaries' point of view.

From the investor point of view:

(i) Investment decision making: Credit rating helps the investors in making the investment decision. It gives an idea to the investor about the creditability of a company and also helps the investor to assess the risk level of a particular instrument. If the credit rating is higher than more will be the willingness of an investor to make an investment.

(ii) Provides safety: If the credit rating of a company is high then it gives an assurance of safety to the investors related to their investment and there will be also a minimum risk of bankruptcy.

(iii) Saves time and effort: Credit rating helps the investor to take the investment decision quickly by depending upon the ratings which are done by the professional cibil score repair agency. The investor need not waste his time and effort in gathering and analyzing the financial information about the credit standing of a company.

(**iv)Done by expertise professionals:** Credit rating is generally done by the professionals having the expert knowledge. The investors can easily rely on such ratings and make an investment decision without fear in their minds. The investor is able to know and analyze different credit instruments.

(v) Recognition of risk and returns: Credit rating is an essential tool which helps in determining the risk attached to a credit instrument and returns expected. It helps the investor to have the understandability the worth of the company.

From a company point of view

(I) Increases goodwill: High credit rating helps the company to increase the goodwill of the company thus creating confidence and trust in the minds of the investors, shareholders, customers, suppliers about the image of the company.

(II) Healthy credit score: The Company having high credit rating implies that the credit score of the company is high. A high CIBIL score paves the way for quicker loan approvals from the financial institutions at low-interest rates and they also enjoy various credit benefits like a lower rate of interest on loans.

(III) Helps in growth and expansion: High credit rating helps the company in getting the loans from the banks quickly because of the high credit score which helps the company to utilize that amount in expansion and diversification and modernization.

(IV) Ensures liquidity: In the market, a company with a good credit rating ensures liquidity for various credit instruments and mobilization of the funds.

From the consumer's point of view

(1) Helps in channelizing the funds: High credit rating companies channelize the savings of the people into productive investments which in turn increases the investment and develop saving habits among the individuals.

(2) Protection of interest: No company can try to cheat any individual with a high rate of interest without credit rating which in turn protects the interest of an individual.

Debt Service Coverage Ratio

The debt service coverage ratio is a financial ratio that measures a company's ability to service its current debts by comparing its net operating income with its total debt service obligations. In other words, this ratio compares a company's available cash with its current interest, principle, and sinking fund obligations.

The debt service coverage ratio is important to both creditors and investors, but creditors most often analyze it. Since this ratio measures a firm's ability to make its current debt obligations, current and future creditors are particularly interest in it.

Creditors not only want to know the cash position and cash flow of a company, they also want to know how much debt it currently owes and the available cash to pay the current and future debt.

Unlike the debt ratio, the debt service coverage ratio takes into consideration all expenses related to debt including interest expense and other obligations like pension and sinking fund obligation. In this way, the DSCR is more telling of a company's ability to pay its debt than the debt ratio.

Formula

The debt service coverage ratio formula is calculated by dividing net operating income by total debt service.

Debt Service Coverage Ratio

$$\text{Debt Service Coverage Ratio} = \frac{\text{Operating Income}}{\text{Total Debt Service Costs}}$$

Net operating income is the income or cash flows that are left over after all of the operating expenses have been paid. This is often called earnings before interest and taxes or EBIT. Net operating income is usually stated separately on the income statement.

Total debt service refers to all costs related to servicing a company's debt. This often includes interest payments, principle payments, and other obligations. The debt service amount is rarely given in a set of financial statements. Many times this is mentioned in the financial statement notes, however.

Analysis

The debt service coverage ratio measures a firm's ability to maintain its current debt levels. This is why a higher ratio is always more favorable than a lower ratio. A higher ratio indicates that there is more income available to pay for debt servicing.

For example, if a company had a ratio of 1, that would mean that the company's net operating profits equals its debt service obligations. In other words, the company generates just enough revenues to pay for its debt servicing. A ratio of less than one means that the company doesn't generate enough operating profits to pay its debt service and must use some of its savings.

Generally, companies with higher service ratios tend to have more cash and are better able to pay their debt obligations on time.

Example

Abhinav's Shoe Store is looking to remodel its storefront, but it doesn't have enough cash to pay for the remodel it self. Thus, Abhinav is talking with several banks in order to get a loan. Abhinav is a little worried that he won't get a loan because he already has several loans.

According to his financial statements and documents, Abhinav's had the following:

Net Operating Profits	$150,000
Interest Expense	$55,000

Principle Payments	$35,000
Sinking Fund Obligations	$25,000

Here is Abhinav's debt service coverage calculation:

Debt Service Coverage Ratio

$$1.3 = \frac{\$150,000}{\$55,000 + \$35,000 + \$25,000}$$

As you can see, Abhinav has a ratio of 1.3. This means that Abhinav makes enough in operating profits to pay his current debt service costs and be left with 30 percent of his profits.

Cash Flow Analysis

Cash Flow Analysis is the evaluation of a company's cash inflows and outflows from operations, financing activities, and investing activities. In other words, this is an examination of how the company is generating its money, where it is coming from, and what it means about the value of the overall company.

What Does Cash Flow Analysis Mean?

Cash Flow Analysis is a technique used by investors and businesses to determine the value of overall companies as well as the individual branches of large companies by looking at how much excess cash they produce. They typically use the Statement of Cash Flows, a document that shows the actual cash that came in and out of the business during a certain period from investing activities, financing activities, and operational activities, as well as a few other reports.

Example

Michelis the CFO of a large, public car manufacturer, and he has to periodically review the company's financials make sure they are not in violations of any SEC rules. At the end of the second quarter, he reviews the financial statements and pays close attention to the statement of cash flows. He talks to the managers of the company's branches to get some color on the numbers, and digs deep into the cash flow statement.

He sees that the ultimate change in cash is $1,000,000, and looks to see why that is. Starting with Net Income, he sees that Cash Flow from Operations has increased cash by $5,000,000, while Cash Flow from Investing Activities has decreased cash on hand by $15,000,000 which seems to be due to a large investment in new plant equipment, information given to him from the manager.

This results in a -$10,000,000 cash balance before Cash from Financing Activities, which provides $11,000,000 due to an issue of stock, which valued at $50 means that the company issued 220,000 shares. Seeing nothing out of order after his conversations with his managers and that thorough review, he sends in the statements to the SEC.

Outside investors also do this same analysis to see how profitable the company's operations actually are. For instance, the cash position of the company changed $1M during the year, but its investing activities actually lost $15M. They had to issue $11M of new stock to reach this $1M surplus. This is a sign that the operations are not strong and the stock value will reflect it sooner or later.

Cash Budget

The Cash Budget is a budget prepared to estimate the cash inflows and outflows during a specific period of time. In other words, cash budget shows the cash inflows and cash outflows expected to occur in the immediate future period.

The purpose of preparing the cash budget is to determine that whether the enterprise has sufficient cash balance to meet out its short-term cash requirements or whether too much cash is being left idle and unproductive in the organization. Thus, it helps the management to determine the surplus and shortage of funds so that suitable actions can be undertaken.

One of the major advantages of cash budget is that it provides a clear picture of all the expected cash flows, thereby enabling the firms to plan their expenditures accordingly. Also, the companies can raise adequate funds in case of the shortage of the cash balance and can make an optimum utilization of funds in case of cash surplus, for example investing in marketable securities.

But however, these cash budgets are not free from the limitations. These are less reliable as the future is uncertain and the cash forecast may not be correct. For example, unseen demands of cash, delayed cash collection, unanticipated cash disbursements, etc. Also, the cash budget is inefficient to track a significant movement in the working capital items.

Deferred Payment Guarantee

Deferred Payment Guarantee is a guarantee for a payment usually on installments which has been deferred or postponed. Banks issue DPG in the cases of purchase of capital goods/machinery where the seller offers credit to the buyer and buyer's bank guarantees the due payments to the seller. Here the seller draws drafts of different maturities on the buyer which are accepted by the buyer and co-accepted by the Buyer's bank. Thereby the buyer's bank guarantees due payment of those drafts drawn by the seller which represents the total consideration of the contract of sale/supply. The seller avail the refinance from his bank against co-accepted bills. DPG involves substitution of the term loan. Unlike all other Guarantees here the payment will have to be made by the bank on the accepted due dates and thereafter the installment is recovered from the borrower on whose behalf guarantee is issued. Hence procedure applicable for assessment of term loan must be followed for DPG limit viz. projection under operating statement, Funds flow statement, DSCR, BEP etc. The proposal is also examined having regard to the profitability / cash flows of the project to ensure that sufficient surpluses are generated by the borrowing unit to meet the commitments as a bank has to meet the liability on the accepted due dates at regular intervals.

As per Reserve Bank of India guidelines, Banks, which intend to issue deferred payment guarantees on behalf of their borrowers for acquisition of capital assets should ensure that the total credit facilities including the proposed deferred payment guarantees do not exceed the prescribed exposure ceilings.

Credit scoring system

What is a credit scoring system?

Lenders use a credit scoring system, or a numerical system, to measure how likely it is that a borrower will make payments on the money he or she borrows. It is created by assigning scores to various attributes associated with the applicant's creditworthiness.

Deeper definition

A credit scoring system allows lenders and other financial institutions to determine the creditworthiness of an individual. Some financial organizations establish their own credit scoring method.

Most will use a third-party professional service such as the Fair Isaac Corp.'s credit scoring system. This system, also known as FICO, is the most widely used model available. FICO's scoring system assigns a numerical representation of creditworthiness that ranges from 300 to 850. The higher the number, the higher the individual's credit score.

Many factors contribute to credit scores assigned through the systems. Factors include payment interest, length of time using credit, amount of debt a person has and the types of debt that person has.

Lenders use these methods to determine how much risk a particular borrower places on them if they decide to lend to that person. These figures are risk-based.

If an individual has a low credit score, he or she is likely to pay more to borrow money to buy a home or finance a car purchase than someone with a higher credit score. While credit scoring systems establish a guideline, individual lenders determine which level is acceptable and how much to charge in interest.

Credit scoring system example

Abby is 22 years old. She has one credit card she pays off on time every month. She has a car loan she makes monthly payments on as well. Based on her history of credit use, good repayment history and varied types of debt, Abby's credit score is 710, using the FICO credit scoring system.

Post sanction supervision

The banker's responsibility does not end up with the sanctioning of the loan after Pre sanction procedures. When you borrow loans from financial institutions, it comes up with certain rules and regulations. The banks should verify the end use of the loan. For this, post-sanction inspection should be conducted by banks for the following purposes:

PURPOSE OF POST SANCTION INSPECTION:

1. The main purpose of Post Sanction Inspection by banks is to verify the actual use of the loan to see whether it has been used for the purpose for which it was originally sanctioned.

2. During post sanction inspection, the bankers verify whether the borrower is stipulating to all the terms and conditions of the loan agreement.

3. Bankers also look for the progress in the project and whether it correlates with the estimates and if there is any variation, the reasons for the same should also be notified.

4. The existence and maintenance of the security. The value of the security should be ascertained at periodic intervals. Any adverse changes be carefully noted and steps taken to secure the advances.

5. Post sanction inspections by banks are conducted to verify inventory – From the balance sheet and also the stock registers, the banker should verify the level of inventory and also the financial position of the unit.

6. If there is any default in the repayment of loan by the borrower, reasons for the same should be ascertained and steps to rectify the same should also be initiated.

7. Care should be taken to ensure that all stocks and properties of the borrower are insured fully and insurance premium is paid regularly.

8. During the post sanction inspection process, the production and sales records are compared with the stock level and inventory level.

9. Collection from debtors and payment to creditors should also be verified to ensure smooth working of the unit. If the banker notices any deviation during the post sanction inspection, he may nominate a person of his confidence on the board of directors of the borrowing concern to rectify matters.

Control and monitoring of credit

Credit control and monitoring, often referred as Loan Review Mechanism (L R M), plays an important role in the following aspects:

(1) To ensure that the funds provided by the bank are put to the intended use and continue to be used properly.

(2) To ascertain that the business continues to run on the projected lines.

(3) If the deterioration of the business continues despite appropriate action, the bank should decide if any harsh action like, recalling the advance or seizing the security, etc. is necessary.

Credit Monitoring

Ensure end use, performance, warning signals and action to be taken

Available Tools for Credit Monitoring / L R M

(1) Conduct of the Accounts with the Bank

(2) Periodic Information Submitted as per the Terms of the Advance

(3) Audit of Stocks and Receivables Conducted by the Bank

(4) Financial Statements of the Business, Auditors' Report

(5) Periodic Visits and Inspection

(6) Interaction

(7) Periodic Scrutiny

(8) Market Reports about the, Borrower and the Business Segment

(9) Appointing Bank's Nominee on Company's Board

(10) Credit Audit

CONSORTIUM FINANCING

Under consortium financing, the banks formally join, by way of an inter- se agreement, to meet the credit needs of the borrowers, In case of project financing, the banks and term lending institutions come together. As per Oct 1996 credit policy, RBI allowed the individual consortium, to frame their own norms for consortium lending.

Compulsory consortium formation: Banks have to ensure that their exposure does not exceed the prudent credit exposure ceiling (max 15 % of their capital fund for individual borrowers and 40 % for group borrowers).

No. of banks and new banks- There is no ceiling on the no. of banks to participate. Without the consent of the existing consortium members, no bank can extend any credit facility.

Disposal of loan application- 60 days (45 for export) for fresh loans or enhancements, 45 days (30) for renewal and 30 days (15) for ad hoc facilities. Where the participating banks are unable to adhere to the time frame, borrowers are free to bring in new banks.

Appraisal- The lead banks is responsible for preparation of appraisal note, its circulation, arrangement for convening meeting etc. It receives fee from the borrower for this.

Documentation- The documents are obtained under the Single Window Scheme, i.e. for all banks, one set of documents is obtained.

Asset classification- Each bank is to classify the loan account, according to conduct of accounts with the bank concerned, irrespective of the classification with other banks.

Post sanction follow –up : Regular meeting of consortium members is a normal requirement where the banks share information about conduct of account & performance of the borrowing unit.

Interest Rate– Since Jan 1995, the banks can fix their own rates.

Charge on securities: The banks have pari – passu charge over the securities which means they share the charge in the ratio of their exposure approved by the consortium through a formal agreement.

Multiple Banking

"Multiple Banking: Multiple Banking is a banking arrangement where a borrowal avails of finance independently from more than one bank. Thus, there is no contractual relationship between various bankers of such borrower. Also in such arrangement each banker is free to do his own credit assessment and old security independent of other bankers."

"In multiple banking arrangement, a borrower gets freedom to deal with each bank separately and thus can negotiate borrowal terms one to one with each bank. As rider, such borrower also has to spend more time and effort in dealing with multiple banks. "

Syndication of loans

What Is a Syndicated Loan?

A syndicated loan is a loan from a group of banks to a single borrower. When an individual lender is unable or unwilling to fund a particularly large loan, borrowers can work through one or more lead banks to arrange financing. That syndicate manager works with the borrower to arrive at interest rates, payment terms, and other details described in a term sheet.

From a borrower's perspective, syndicated loans make it relatively easy to borrow a significant amount. The borrower can secure funding with one agreement instead of attempting to borrow from several different lenders individually.

From a lender's perspective, syndicated loans enable financial institutions to take on as much debt as they have an appetite for—or as much as they can afford due to regulatory lending limits.1 Lenders can stay diversified but still participate in large, high-profile deals. What's more, they gain access to industries or geographic markets that they don't ordinarily work with. These loans are contractual obligations, making them similar to other senior sources of capital, and they may even be secured with collateral.

How Syndicated Loans Work

Loans come in a variety of forms, and a single loan might have several different types of debt.

Revolving debt allows borrowers to take only what they need, when they need it, and come back for more later. Lenders set a maximum credit limit, and borrowers may be able to borrow and repay repeatedly (or "revolve" the debt) against a line of credit.

Term loans provide one-time financing that borrowers typically pay off with gradually with fixed payments. Some term loans feature a large balloon payment at maturity instead of amortizing payments.

Letters of credit (LOCs) are bank guarantees that provide security to somebody the borrower is working with. For example, a standby letter of credit might protect a municipality that pays millions of dollars for an infrastructure project—but the contractor fails to complete the project. The LOC would provide funds to the municipality (at the contractor's expense), enabling them to pay other contractors or fix the problem in other ways.

Other arrangements may exist, such as delayed-draw lines, which provide approved funding that borrowers use over time for planned expenditures.

A syndicated loan might feature several different terms. For example, a loan might have a portion of the debt due in seven years, with the remainder due after ten years. Plus, those loans might have interest rates that are fixed for the life of the loan or variable interest rates that fluctuate with an index (such as LIBOR).

Who Uses Syndicated Loans?

Syndicated loans make sense when a loan is too big for any individual lender to reasonably offer. Government bodies might borrow for massive infrastructure improvements requiring hundreds of millions of dollars. A company might borrow to purchase equipment or build sophisticated facilities for large-scale manufacturing. Businesses use these loans to buy other companies, and they also obtain syndicated loans to refinance existing debts.

Lenders include large financial institutions such as banks and finance companies, as well as institutional investors who want to earn interest by participating in syndicates. In some cases, the lenders sell their interests or assign the loan to other investors so they can replenish cash and reduce their exposure to any individual borrower.

Infrastructure Finance Company

The Infrastructure Finance Company is yet another financial institution engaged in the principal business of infrastructure loan. The credit facility (term loans, project loans, etc.) granted by the non-banking financial companies to the borrowers in the specific infrastructure sectors Viz. Transport, Energy, Water and Sanitation, Communication, and Social and Commercial Infrastructure are called as the Infrastructure Laon.

As per RBI, any non-banking financial company can be registered as an Infrastructure Finance Company, subject to, these should be a non-deposit accepting loan company and must comply with the following conditions:

- Minimum, 75% of the total assets of the company, should be deployed in the infrastructure loans.
- The company must have a minimum net worth of **Rs 300 Crore.**
- The capital to risk weighted asset ratio or CRAR of the company should be **at 15% with Tier-I capital at 10%.**
- The company should have a minimum **credit rating of "A"** or equivalent of CRISIL, or equivalent to any other accrediting rating agencies.

Note: The company's request to be recognized as an infrastructure finance company must be advocated by the Statutory Auditor's Certificate confirming the company's pattern of the asset as on March 31, of the latest financial year.

Stressed assets

Now stressed assets are getting increased attention as the trend of deteriorating asset quality has emerged as a big economic risk for the Indian banking sector. Stressed assets is a powerful indicator of the health of the banking system. To understand stressed assets we have to understand NPA and Restructured assets. This is because:

Stressed assets = NPAs + Restructured loans + Written off assets

Assets of the banking system comprises of loans given and investment (in bonds) made by banks. Quality of the asset indicates how much of the loans taken by the borrowers are repaid in the form of interests and principal. The most important scale of asset quality is Non Performing Assets (NPA). An NPA means interest or principal is not repaid by the borrower during a specified time period.

Bad assets are further classified into substandard asset, doubtful asset, and loss assets depending upon how long a loan remains as an NPA.

Measuring stressed assets

But NPA alone doesn't tell the whole story of bad asset quality of loans given by banks. Some of the loans are restructured by banks by giving a further opportunity to the borrower if they default. This opportunity is in the form of an extended time period for repayment and a reduced interest rate or such soft conditions. Hence a new classification is made in the form of stressed assets that comprises restructured loans and written off assets besides NPAs.

Stressed assets = NPAs + Restructured loans + Written off assets

What is an NPA?

A loan whose interest and/or installment of principal have remained 'overdue ' (not paid) for a period of 90 days is considered as NPA.

What is restructured loans?

Restructured asset or loan are that assets which got an extended repayment period, reduced interest rate, converting a part of the loan into equity, providing additional financing, or some combination of these measures. Hence, under restructuring a bad loan is modified as a new loan. A restructured loan also indicates bad asset quality of banks. This is because a restructured loan was a past NPA or it has been modified into a new loan. Whether the borrower will repay it in future remains a risky element. Corporate Debt Restructuring Mechanism (CDM) allows restructuring of loans.

Written off Assets

Written off assets are those the bank or lender doesn't count the money borrower owes to it. The financial statement of the bank will indicate that the written off loans are compensated through some other way. There is no meaning that the borrower is pardoned or got exempted from payment. His debt will remain and recovery measures against him will continue. But in the balance sheet of the bank, a bad asset should not remain bad forever. It should do some corrective action. In India, the major corrective action is provisioning.

Click Here

Corporate Debt restructuring

The Reserve Bank of India (RBI) is moving to shut down the corporate debt restructuring (CDR) system, its very first loan recast mechanism, following its latest framework on stressed asset resolution, three people familiar with the matter said. The regulator has directed the CDR cell to transfer all pending cases to respective lead banks to complete the resolution process, the people cited above said on condition of anonymity.

According to the latest available data, the CDR cell has approved restructuring of stressed loans worth ₹ 4 trillion since its inception in 2001. Of this, ₹ 84,677 crore worth of loans exited the CDR cell successfully and ₹ 1.84 trillion exited without success. Nearly ₹ 1.32 trillion worth of bad loans are presently undergoing restructuring in the cell.

circular on 12 February 2018 withdrawing all existing restructuring schemes. This included the CDR scheme, strategic debt restructuring (SDR) scheme and scheme for sustainable structuring of stressed assets (S4A) and 5/25. The central bank has asked all banks to initiate resolution plans as soon as a corporate default happens, and refer it for bankruptcy proceedings in the event of a failure in restructuring.

The CDR system was framed 17 years ago to restructure corporate debt outside the purview of debt recovery tribunals (DRT) and the Board for Industrial and Financial Reconstruction. Its three-tiered structure consisted of CDR Standing Forum, CDR Empowered Group and CDR Cell. The Standing Forum was responsible for laying down all policies and guidelines related to debt restructuring, while the CDR cell was responsible for scrutinising all restructuring proposals from borrowers and lenders. The final decision on approving the restructuring package was taken by the CDR Empowered Group.

CDR report card

The CDR cell has approved restructuring of stressed loans worth ₹4 trillion since its inception in 2001. Of this, ₹84,677 crore of loans exited successfully and ₹1.85 trillion exited without success.

	Amount (₹ crore)	No. of cases
Total cases referred since inception	4,74,351	656
Total cases not admitted/rejected	70,998	125
Total cases approved	4,03,353	531
Cases exited successfully	84,677	111
Cases withdrawn/exited on failure	1,84,581	298
Live cases	1,32,948	121
Case approved in FY18, but not implemented	349	1

Source: CDR cell

Under the CDR cell rules, at least 75% of creditors (by value) should approve the resolution plan, which would make it binding on the remaining 25%.

The reason for CDR's failure can be attributed to the inability of promoters to infuse equity capital and non-compliance with the CDR agreement in pledging shares in favour of lenders' consortia. The cell also prescribed a shorter interest payment moratorium of two years for all types of loans including infrastructure projects, which typically take a long time to develop and pay back.

According to Siby Antony, chairman of Edelweiss Asset Reconstruction Co., CDR was one of the best restructuring schemes introduced by RBI. Antony was previously the executive director of IDBI Bank, and was responsible for setting up the CDR cell. "The success rate of CDR during the initial period up to 2009 was more than 90%. In fact, gross NPA of the banking system during this period which was as high as 15%, came down to less than 2%. But the problem started post Lehman crisis and the global meltdown, when stress began to build up in the system. At the same time, CDR went through regulatory changes which required that net present value of a loan after restructuring should be retained. This led to ballooning of debt which ultimately led to the collapse of the CDR framework," said Antony.

SARFAESI ACT, 2002

The financial sector has been one of the key handlers in India's efforts to achieve success in rapidly developing its economy. Since our existing legal framework relating to commercial transactions has not kept pace with the changing commercial practices and financial sector reforms. This ensures the slow pace of recovery of defaulting loans and escalating levels of non performing assets of banks and financial institutions.

Narasimham Committee I and II and Andhyarujina Committee was constituted by the Central Government for the purpose of examining banking sector reforms have considered the need for changes in the legal system in respect of these areas. Amongst the other committees, these Committees have made suggestions to form new legislation for securitization and empowering banks and financial institutions to gain possession of the securities and to sell them without any intervention of the court here.

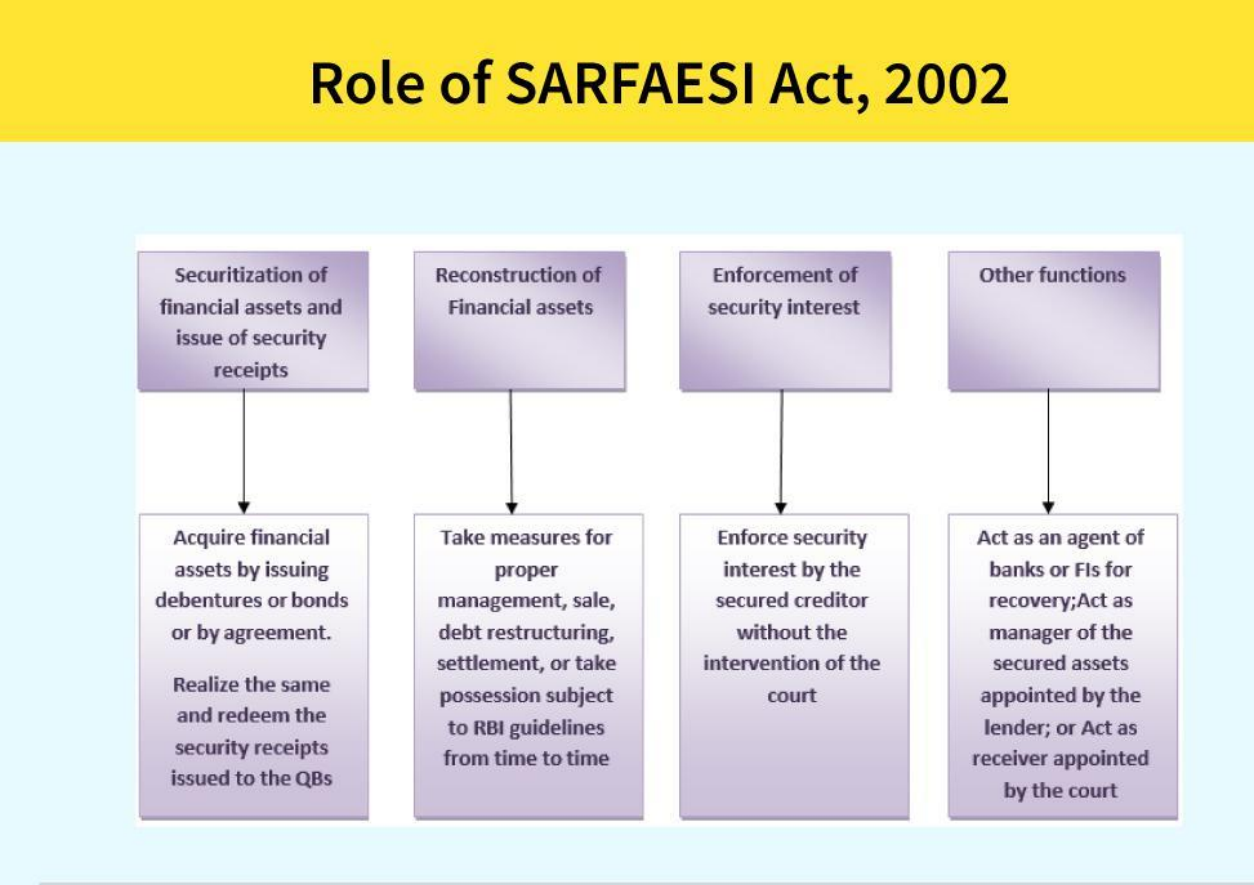
Applicability Of SARFAESI Act, 2002

The amendment to this Act is "an act to regulate securitization and reconstruction of financial assets and enforcement of security interest and to provide for a central database of security interests created on property rights, and for matters connected therewith or incidental thereto."

The Act deals with the following:

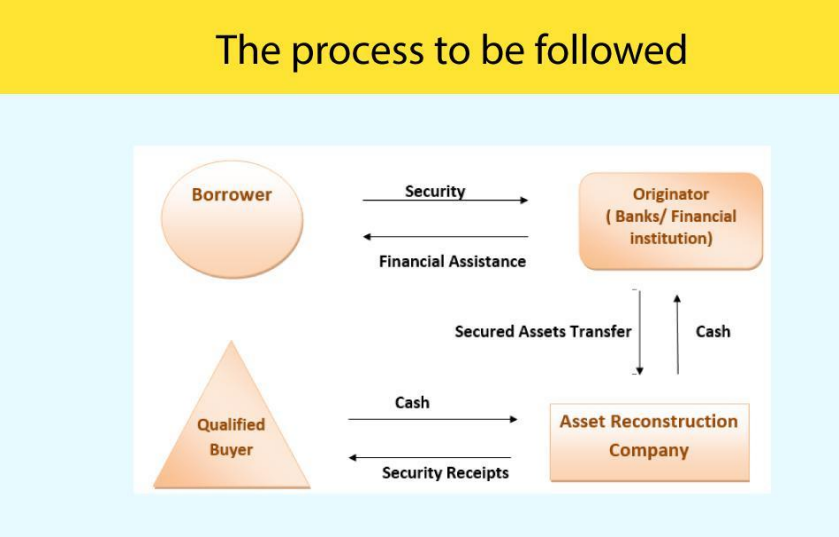
- Registration and regulation of Asset Reconstruction Companies (ARCs) by the Reserve Bank of India
- Facilitating securitization of financial assets of banks and financial institutions with or without the benefit of underlying securities
- Promotion of seamless transferability of financial assets by the ARC to acquire financial assets of banks and financial institutions through the issuance of debentures or bonds or any other security as a debenture
- Entrusting the Asset Reconstruction Companies to raise funds by issue of security receipts to qualified buyers
- Facilitating the reconstruction of financial assets which are acquired while exercising powers of enforcement of securities or change of management or other powers which are proposed to be conferred on the banks and financial institutions
- Presentation of any securitization company or asset reconstruction company registered with the Reserve Bank of India as a public financial institution
- Defining 'security interest' to be any type of security including mortgage and change on immovable properties given for due repayment of any financial assistance given by any bank or financial institution

- Classification of the borrower's account as a non-performing asset in accordance with the directions given or under guidelines issued by the Reserve Bank of India from time to time
- The officers authorized will exercise the rights of a secured creditor in this behalf in accordance with the rules made by the Central Government
- An appeal against the action of any bank or financial institution to the concerned Debts Recovery Tribunal and a second appeal to the Appellate Debts Recovery Tribunal
- The Central Government may set up or cause to be set up a Central Registry for the purpose of registration of transactions relating to securitization, asset reconstruction and creation of the security interest
- Application of the proposed legislation initially to banks and financial institutions and empowerment of the Central Government to extend the application of the proposed legislation to non-banking financial companies and other entities
- Non-application of the proposed legislation to security interests in agricultural lands, loans less than rupees one lakh and cases where eighty per cent, of the loans, is repaid by the borrower



Objectives of SARFAESI Act, 2002

- Efficient or rapid recovery of non-performing assets (NPAs) of the banks and FIs.
- Allows banks and financial institutions to auction properties (say, commercial/residential) when borrower fail to repay their loans.



Documents Required

e-Form CHG-1 or e-Form CHG-9 is required to be filed for application of

a. Registration of creation

b. Modification of charge (other than those related to debentures) including particulars of modification of charge by Asset Reconstruction Company in terms of Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 [SARFAESI]

The documents in this context are as follows:

i. Particulars of charge

ii. Certificate of registration

iii. An Instrument created for the charge

iv. Copy of the instrument – creating or modifying the charge

v. Hypothecation Deed

vi. Sanction Letter

In case of any e-Form to be digitally signed, either of the following is required-

a. DSC of the charge holder

b. Director Identification Number [DIN]of the Director

c. Permanent Account Number [PAN] of the manager, CEO, CFO

d. Membership Number of the Company Secretary

Formation of SARFAESI Act, 2002

Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) was circulated –

i. To regulate securitization and reconstruction of financial assets

ii. Enforcement of the security interest for

iii. Matters connected therewith or incidental thereto

It extended to the whole of India.

Amendment in the (SARFAESI) Act, 2002 vide the enforcement of the Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016.

The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisional information in the Official Gazette, s (Amendment) Act, 2016 was published

It is an Act further to amend four laws:

1. Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI)
2. Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDDBFI)
3. Indian Stamp Act, 1899
4. Depositories Act, 1996, and for matters connected therewith or incidental thereto

Non-Performing Asset

What Is a Non-Performing Asset (NPA)?

A nonperforming asset (NPA) refers to a classification for loans or advances that are in default or in arrears. A loan is in arrears when principal or interest payments are late or missed. A loan is in default when the lender considers the loan agreement to be broken and the debtor is unable to meet his obligations.

KEY TAKEAWAYS

- Nonperforming assets (NPAs) are recorded on a bank's balance sheet after a prolonged period of non-payment by the borrower.
- NPAs place financial burden on the lender; a significant number of NPAs over a period of time may indicate to regulators that the financial health of the bank is in jeopardy.
- NPAs can be classified as a substandard asset, doubtful asset, or loss asset, depending on the length of time overdue and probability of repayment.

- Lenders have options to recover their losses, including taking possession of any collateral or selling off the loan at a significant discount to a collection agency.

How Non-Performing Assets (NPA) Work

Nonperforming assets are listed on the balance sheet of a bank or other financial institution. After a prolonged period of non-payment, the lender will force the borrower to liquidate any assets that were pledged as part of the debt agreement. If no assets were pledged, the lender might write-off the asset as a bad debt and then sell it at a discount to a collection agency.

In most cases, debt is classified as nonperforming when loan payments have not been made for a period of 90 days. While 90 days is the standard, the amount of elapsed time may be shorter or longer depending on the terms and conditions of each individual loan. A loan can be classified as a nonperforming asset at any point during the term of the loan or at its maturity.

For example, assume a company with a $10 million loan with interest-only payments of $50,000 per month fails to make a payment for three consecutive months. The lender may be required to categorize the loan as nonperforming to meet regulatory requirements. Alternatively, a loan can also be categorized as nonperforming if a company makes all interest payments but cannot repay the principal at maturity.

Carrying nonperforming assets, also referred to as nonperforming loans, on the balance sheet places significant burden on the lender. The nonpayment of interest or principal reduces the lender's cash flow, which can disrupt budgets and decrease earnings. Loan loss provisions, which are set aside to cover potential losses, reduce the capital available to provide subsequent loans to other borrowers. Once the actual losses from defaulted loans are determined, they are written off against earnings. Carrying a significant amount of NPAs on the balance sheet over a period of time is an indicator to regulators that the financial health of the bank is at risk.

Types of Non-Performing Assets (NPA)

Although the most common nonperforming assets are term loans, there are other forms of nonperforming assets as well.

- Overdraft and cash credit (OD/CC) accounts left out-of-order for more than 90 days
- Agricultural advances whose interest or principal installment payments remain overdue for two crop/harvest seasons for short duration crops or overdue one crop season for long duration crops
- Expected payment on any other type of account is overdue for more than 90 days

NPA recovery

1. Amendment in banking law to give RBI more powers

The Banking Regulation Act may be amended to give RBI more powers to monitor bank accounts of big defaulters.

The amendment in the banking law will enable setting up of a committee to oversee companies that have been the biggest defaulters of loans.

RBI wants stricter rules for joint lenders' forum (JLF) and oversight committee (OC) to curb NPAs.

While the present law allows the government to direct RBI to carry out inspection of a lender, there is no provision for setting up oversight committees.

Also, there could be changes in the laws, which will bar a bank to extend loans to a defaulting company that has failed to repay to other banks.

2. Stringent NPA recovery rules

The government has over the years enacted and tweaked stringent rules to recover assets of defaulters.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act or Sarfaesi Act of 2002 was amended in 2016 as it took banks years to recover the assets.

Experts have pointed out that the NPA problem has to be tackled before the time a company starts defaulting. This needs a risk assessment by the lenders and red-flagging the early signs of a possible default.

3. RBI's loan restructuring schemes

RBI has over the past few decades come up with a number of schemes such as corporate debt restructuring (CDR), formation of joint lenders' forum (JLF), flexible structuring for long-term project loans to infrastructure (or 5/25 Scheme), strategic debt restructuring (SDR) scheme and sustainable structuring of stressed assets (S4A) to check the menace of NPAs.

In many cases, the companies have failed to make profits and defaulted even after their loans were restructured.

4. Present NPA scenario

According to the latest information collated by the government, stressed assets which includes both non-performing assets as well as restructured loans of banks stood at Rs 9.64 lakh crore as on December 31, 2016.

In December, RBI's financial stability report said the gross non-performing advances (GNPAs) ratio of all banks increased to 9.1% by September 2016 from 7.8% in March 2016. The amount of stressed loans was up at 12.3% of total loan given out by banks by September, up from 11.5% in March 2016.

RBI's stress test of the banking sector indicated that GNPA ratio may increase from 9.1% in September 2016 to 9.8% by March 2017, and further to 10.1% by March 2018.

PSU banks are worst hit as their GNPA may increase to 12.5% by March 2017 and then to 12.9% in March 2018, from 11.8% in September 2016.

5. Banks may need to take a "hair cut"

In the past few quarters, most of the banks especially PSU lenders, have reported a sharp fall in profits as they set aside hefty amounts for losses on account of NPAs, which eroded their profits.

Given the gravity of the problem, the government may ask banks to go for more "hair cut" or write offs for NPAs.

The government and RBI may also come up with a one-time settlement scheme for top defaulters before initiating stringent steps against them.

The finance ministry and RBI are also considering setting up of a "bad bank" to deal with the problem of non-performing loans, as it has been suggested by chief economic adviser Arvind Subramanian in the Economic Survey.

Reserve Bank deputy governor Viral Acharya has also floated the twin concept of Private Asset Management Company (PAMC) and National Asset Management Company (NAMC) for resolution of stressed assets.

With rule changes and strict regulations, banks may be asked to restructure about 50 large NPA accounts by December, 2017.