

RELEVANCE OF FINANCIAL REPORTING TO CREDIT INSTITUTION DECISIONS

Abstract

To many organizations financial reporting is aimed at internal users only, that is, management and shareholders. Perhaps the only external users considered are the tax authorities who for obvious reasons are interested parties. For quoted companies the financial statements also address the needs of potential investors by supplying them with relevant information for decision making. Credit institutions, in particular banks utilize financial statements in making lending decision. Of great importance to a lender is the risk of the borrower not being able to pay the principal as well as interest on the borrowed amount. This article looks at the critical information contained in the financial statements that credit institutions hold in great regard.

Introduction

Decision making is an every day affair for any organisation. The quality of decisions made depends on the quality of the underlying information that forms the basis of that decision making. Of great importance is the information supplied by financial statements, which generally provides a summary of all the other activities of the organisation. To be of importance to decision makers, financial reporting has to be exhaustive both in content and quality. Sufficient guarantee has to be provided to make the information reliable and reduce uncertainty.

In this respect a number of regulations exist defining the content and form of financial reporting. International Financial Reporting Standards (IFRSs) define the recognition and measurement of accounting transactions and the mandatory disclosures to be made in the financial statements. Various acts of parliament like the Companies Act, Banking Act, Insurance Act, etc also put regulations on the content of financial statements. The Companies Act Cap 486 puts a requirement that an independent auditor's opinion be expressed as a guarantee of compliance with the act's requirements, by the company.

Credit institutions which are important financiers of many a company's activities can be considered major users of financial statements. The objective of this paper is to look at what financial information is most relevant to credit institutions. The paper also enumerates some of the limitations of the financial statement information to this particular user group.

Indebtedness

Financial institutions are interested in the capacity of the borrower to generate future cash flows to permit repayment of debt and interest. For this purpose, the borrower's current level of indebtedness is considered, taking into account the cash inflows available to repay the current and any additional debt. The balance sheet reveals the extent of obligations to lenders in form of bank loans and overdrafts, debentures and owing to related parties (holding companies, subsidiaries, group members, directors etc).

Hernandez and Lopez (2004) in their study of relevance of financial reporting to credit institutions found indebtedness to be of greatest importance. They also found clear preference by credit institutions of information that is budgetary in nature. In this regard, the balance sheet will be of little use as it can only classify borrowings in terms of short term and long term obligations, without a clear analysis of how repayments will be made. A cash budget giving monthly expected expenditure supplies this information. Financial statements included in a company's annual report, however, do not include cash budgets.

Liquidity

Liquidity refers to an organisation's ability to meet short term obligations as they fall due. It is the ability of an organisation to sell an asset quickly without having to make a substantial price concession (Sharp et al, 1999). From the above definitions, it can be concluded that the mark of an organisation's liquidity is the value of easily disposable assets held, vis-à-vis the value of its short term obligations. Easy to dispose assets include inventories, trade debtors, bills receivable and treasury bills. Immediate obligations are those falling due within the next twelve months, e.g. trade creditors, taxes due, salaries and outstanding staff benefits and the portion of borrowings (bank loans, hire purchase loans etc) repayable within the next twelve months.

The balance sheet can readily provide this information. A strong liquidity position provides a margin of safety to lenders. Various liquidity ratios are computed by lenders using the information provided by the balance sheet, for instance, current ratio (current assets divided by current liabilities) and the quick ratio (current assets less stock, divided by current liabilities). The cash flow statement on its part provides information of the cash flows provided by operations (as well as financing activities e.g. borrowings, or investing activities e.g. disposal of property and equipment). The balance of cash flow from operations indicates the excess (deficit) amount of cash derived from operations after funding working capital needs.

A major limitation of assessing liquidity from the balance sheet is that it provides historical information which is not always a good indicator of future organisational prospects. It is also a measure at a given period in time; the fact that the position was good 'as at' the balance sheet date does not necessarily mean that the same was true throughout the year. To mitigate against this, lenders require borrowers to prepare a cash budget as well as projected income statements over the next, say, three years. These two statements, which lenders hold in high regard, are a management's assessment of where the firm is heading. They clearly show the firm's expected sales and the way cash from those sales will be received, and the budgeted expenses and how they will be paid for. These statements are, however, not included in the financial statements attached to the company's annual report.

Performance

Perhaps the best indicator of the firm's performance over the financial period is its income statement. The statement, also known as the profit and loss account, shows how much revenue the firm generated over the period and how much it cost the firm to generate that income and run its operations. Lenders are interested with high performing firms as it minimizes their risk of default in loan and interest repayment. Measures such as the gross margin, sales to staff cost ratio, sales to administrative costs ratio and similar measures show how efficiently the firm is able to generate that revenue.

Limitations of financial statements

The level of utility of financial statements to credit institutions, and in some cases other users, is subject to some limiting factors. Firstly, financial statements, no matter how comprehensively prepared, may not in all aspects address the needs of each specific user. This means that different users will require of the firm further information in addition to those financial statements.

Secondly, accounting principles offer some flexibility in preparing financial statements thereby giving financial managers some freedom to select among accounting policies and alternatives. Though financial reporting requires disclosure of all significant accounting policies adopted, such disclosures, sometimes, like the bikini, are too scanty or like rocket science, too complex or, like the politician, vague and ambiguous. Earnings management which involves manipulation of earnings to achieve a desired target e.g. report higher profit where managers get commissions based on earnings, or defer income to postpone payment of taxes are not uncommon.

Timeliness in preparation of financial statements is also an issue. Some organizations prepare financial statement only when faced with tax or other regulatory deadlines or when the banks ask for them when approached for lending. In many of such firms where timely financial reporting is not valued, even the underlying accounting and other management information system are not reliable to guarantee accuracy and completeness of the financial statements. In addition to that, financial statements are mainly historical; history is not always a good indicator of the future.

Mitigating Factors

Financial statement analysis is just but one of the factors considered by lenders in credit risk evaluation. Lenders are interested in other qualitative and quantifiable aspects in commercial credit requests. Firstly, borrower's character including honesty, integrity, work ethic and business commitment are considered. Secondly, the purpose of borrowing is evaluated. For instance, borrowing to finance speculative asset purchase, or for debt substitution or to finance illegal or unprofitable ventures is likely to be rejected by lenders. Thirdly, the secondary source of repayment, known as collateral is considered, though loan risk is mainly determined by the primary source of repayment i.e. the use to which the proceeds are put.

Conclusion

Financial statements are an important source of information for credit risk analysis. They however suffer from several limitations and are thus only partially reliable in making lending decisions. The onus is on the lender to determine what additional information to use in the lending process.

The lender's main concern is to avoid two judgmental errors: lending to an undeserving borrower, thus risking repayment default, or refusing to lend to a deserving one, thereby incurring an opportunity cost.

References

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