How Creditors Evaluate Financial Statements?

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ABSTRACT

Analysts, investors, borrowers and other stakeholders are interested to know how creditors evaluate financial statements in general. The first part of this article covers how creditors analyze a company’s asset quality, capital structure, profitability, cash flow and repayment ability, and off balance sheet items. The latter part will discuss the additional information that creditors may look for such as disclosure of inter-company/related party transactions, segment information breakdown by business activities and observations about a company’s internal control in auditors’ report, so that a more complete, accurate and reliable view on a company’s state of financial health can be established.

INTRODUCTION

The balance sheet of a company has variously been described as a snapshot at a specific moment in time and the window of the financial health of the business. From a viewpoint of a creditor, the balance sheet should serve as a valuation statement and the critical tool for evaluation so that they can gain insight into the financial risks attached to a company. It would also act as a springboard for intelligent questioning. The following discussion on financial statements excludes those specified industries, such as insurance companies, banks, securities firms and other non-profit organizations.

ASSET QUALITY

In order to evaluate the financial health of a company, the quality of assets is one of the primary concerns. What is the timing and likelihood of current assets’ turning into cash? What is the state of the fixed assets? Is the plant in need of large scale renovation? Are land and buildings undervalued on the balance sheet? Clearly some real-world questions have to be asked here and first of all they have to consider separately the quality of inventories and accounts receivable.

INVENTORIES

Regarding inventories, creditors can evaluate their quality by asking themselves what the actual state of finished goods, raw materials, and work-in-progress is behind the numbers on the balance sheet. They need to find out whether there has been any prior period inventories write-down or devaluations, to reflect the fact that in the past some inventories could not be disposed of their full balance sheet valuation. Another quality indicator is inventories turnover period. This is calculated by dividing inventories over cost of sales times 365 days. This ratio expresses the number of days required to turnover the inventories levels shown on the balance sheet. The real usefulness of this indicator is serving as a comparative tool. If they derive the turnover figures for a number of years, then they can see the trend. Has the turnover period slowed down or accelerated over the years? If it has slowed down what is the reason? Perhaps the company is carry stale inventories on its books, rather than writing it off. Or the company may be
building inventories to counteract the effect of an anticipated raw materials shortage. Creditors are concerned about a company’s liquidity being tied up in excessively high level of inventories.

**Accounts Receivable**

Accounts receivable or trade receivables are amounts due from customers for credit sales (Wild, Shaw and Chiappetta, 2009). Regarding accounts receivable, they can evaluate their quality by asking similar questions. What is the company’s stated credit terms? To whom is the company selling its products? If the company sells goods to companies which have financial problems, some of its receivable may never be collected. If it is selling to top rated companies, the picture may be brighter. The diversity of its market could be a factor too. Selling to a large number of unrelated customers mitigates the effect of any one customer’s inability to repay.

The balance sheet itself may give us some useful data. The item “provisions on bad and doubtful debts” is the company’s reserve for collection losses. If it is growing as a percentage of sales, this may indicate increasing collection problems. Or conversely it may indicate that the company has over-reserved for expected losses that did not materialize. They can also derive a receivable turnover figure from the financial statements. The formula is accounts receivable over net sales times 365 days. Current year’s receivable turnover can again be compared with prior’s years’ to see if there is an apparent trend developing. A faster turnover period is better, since creditors clearly prefer to see an improving cash conversion cycle; one that will ease a company’s liquidity requirements.

Both stocks and accounts receivable have discussed in such detail because arriving at an evaluation of the quality of the current assets is an important step in assessing a borrower’s financial strength as far as creditors are concerned. As regards to long term fixed assets, in particular land and buildings, the current market value from a chartered surveyor or appraiser can be ascertained as a second opinion in view of the volatile nature of the property market.

**CAPITAL STRUCTURE**

The primary indicators for analysis are tangible net worth, gearing, debt-to-equity ratio and interest cover. Large variations in tangible net worth should be investigated and accounted for. Increases are predominantly due to retained earnings or share issues. Decreases in tangible net worth normally indicate losses absorbed, in which case should be provided an estimate as to how long the company can continue at present levels.

**Gearing**

Gearing is defined as the percentage of long-term debt to equity (Alexander, Britton and Jorissen, 2011). It is a very useful indicator in determining the general health of a company. Levels may vary from industry to industry, but any company with a gearing in excess of one hundred percent should be investigated with particular reference to the following points, namely, utilization of borrowings, ability to service interest on debt, repayment ability and impact of interest expenses on liquidity and cash flow. Excessively high percentage of gearing may indicate the imminent collapse of a business and usually recommendations would be made to protect the creditor’s interests in this event.

One has to be careful because financial statements often do not distinguish between trade or accounts payable and other payable. Furthermore, in some cases trade finance liabilities may be put under accounts payable. In these cases it is helpful for auditors to provide a breakdown of the balance sheet.
figures. On a conservative and prudent basis, creditors usually treat bills discounted with recourse as interest-bearing debts to reflect the real gearing level which is higher.

Highly geared companies are more vulnerable to business downturns than low geared ones because their interest burden becomes heavier as profits decline. Their scope for further borrowings is usually restricted too. Increases in gearing could be caused by a number of reasons, namely, the company making losses which reduces the company’s tangible net worth; the company expanding sales at the expense of profit margin and it is not able to increase tangible net worth via profit accumulation, or the assets of the company expanding so fast that current resources cannot accommodate. In such cases the company could be overtrading. Other signs of this are poor liquidity, working capital falling and possibly profit margins falling. The company thus requires further funding via new capital injection.

**Debt-to-Equity Ratio**

Debt-to-equity ratio provides a means for assessing the proportion of a company’s debt in relation to shareholders’ equity. According to Wild, Shaw and Chiappetta (2009), a measure to assess the risk of a company’s financing structure is the debt-to-equity ratio. In this context, debt not only relates to bank borrowings but also accounts payables and other payables. Generally speaking, the higher the ratio, the higher is the likely exposure for the unsecured creditor. It also indicates the worsening of the company’s financial health. If the trend indicates a deteriorating position creditors will consider enhancing collateral. Companies with low debt-to-equity ratios generally are able to obtain additional finance more easily. If gearing is increasing while the debt-to-equity ratio remains static or declining, then the creditor is taking the place of other forms of non-shareholder finance within the business. If gearing decreases, but debt-to-equity ratio increases, then the reverse is true.

Interest cover can be defined as the number of times the profit before interest and tax covers the company’s interest costs. Creditors use this indicator to assess trends with particular reference to debt servicing ability. A company can carry a huge debt as long as its profits are high and interest rates are low, a factor ignored by the capital gearing ratios. Analysis of this ratio must be tied back to analysis of fixed rate and floating rate structure of the company’s external debt. A falling interest cover ratio could be the result of falling sales volume or margins on sales; creditor financed expansion or rising interest rates. A falling ratio is a warning signal and the company could become a loss maker if the trend continues.

All in all, a company is well capitalized when it has a total debt structure that it can support. When it can meet the cash calls associated with the liabilities recorded on its balance sheet such as short term debt, accounts payable or other long term obligations and also maintain its ongoing operations. If it can be seen that this company could support an even higher ongoing debt structure with no financial strain, then it is under-leveraged. If the company is having trouble meeting its financial obligations as they now stand, then it is over-leveraged. Creditors expect a company’s financial statements to reveal its leverage position.

**PROFITABILITY**

Profitability ratios are keys to assessing the viability of a company. According to Elliott and Elliott (2011), profitability ratios permit a more detailed analysis of profit margin such as expressing individual expenses as a proportion of cost of sales or sales. Specific questions will need to be asked depending upon the particular ratio being looked at but, there are a number of questions that reader should ask himself in looking at all ratios: Has the ratio change significantly? Does the change represent the continuation of a trend? Is the ratio’s size and trend similar to other companies within the industry/market?
A company must make profits to survive in the long run. Creditors and shareholders alike expect a company to provide an acceptable return on sales and capital invested in the company. A company should be able to withstand short term losses as long as cash flow is positive. Continual losses will ultimately erode the capital structure of the company until such time as the balance sheet is no longer healthy.

If the company continues to make losses at this point then the survival of the company will be called into question. Obviously the time it takes for a company to change from a healthy company to an insolvent one will depend upon the size of losses that the company makes, and the willingness of its owners to take remedial action such as injecting fresh capital or selling surplus assets. Creditors should be aware of the profitability and performance trends of a company. Continually declining returns should be investigated to establish cause and possible solutions. For example, the decline may be the direct result of a cyclical downturn in the industry; management may have other more profitable interests to concentrate on or management may be incapable of, or unwilling to reverse the trend.

**Gross Profit Margin**

Gross profit margin can be derived from the financial statements. The formula is profit before deducting distribution, selling and administrative costs as a percentage of sales. Pike, Neale and Linsley (2012) defined gross profit margin as gross profit divided by sales. This ratio provides a measure of profitability of the company’s core business. When considering the gross profit margin, questions could be asked by the creditors of the company to ensure they know the exact reasons behind any material changes. A falling ratio could signify cost of raw materials &/or production labor have increased, and these increases have not been passed on to the customer. It could be the weakening of the local currency has caused imported raw materials costs to increase and this has not been passed on to the customer or competition within the market has increased, forcing the company to accept lower margins on its sales.

A company may change its strategy to increase market share, by under-cutting its competitors’ prices which could lead to overtrading, or change its product-mix. Different margins on different product lines could alter the gross profit margin. Finally, changes in the method of stock valuation may result in the over- or under-valuation of stock, but in any event will impact on the company’s tangible net worth. A rising ratio could signify the opposite of the above along with increased efficiency; alternatively, cheaper sources of raw materials used; or production moved offshore to take advantage of cheaper labor costs.

**Operating Profit Margin**

Operating profit margin can also be derived from the financial statements. The formula is profit after deducting distribution, selling and administrative costs as a percentage of sales. Operating profit is affected by sales pricing policy and the control of overheads. Different industries operate satisfactorily at different margins. For example, manufacturing sector requires higher margins than food retailing, which is a high volume and low margin industry. The company may be vulnerable to downturn in the market if it margins are below industry norms. If this ratio is changing in line with the gross profit margin, then the change is being caused by the changes in the gross profit margins and may not need further investigation. If the ratio changes out of line with the gross profit margin, this is because overheads have increased and decreased in relation to sales. In the latter case creditors must find out why the company’s overheads are more and less significant. Creditors would focus for such expenditure items such as housing, travel and entertainment, where increases could mask payments to directors. They may watch out for manipulation of depreciation charges resulting from changes in depreciation policy.
CASH FLOW

An effective cash flow analysis should analyze why net operating cash flow was not sufficient to meet debt service such as financing charges; evaluate the sustainability of cash flow with respect to one-time, temporary or fundamental changes; provide insight into how cash flowed historically through business; and emphasize risks to future cash generation. The cash flow statement is a record of net cash inflows and outflows by accounts or group of accounts during the period reviewed. There is either a net inflow or outflow per account group and the net difference between inflows and outflows for the period. It is a record of cash provided by cash sources, and of cash consumed by cash uses. Cash inflows and outflows are derived from changes in the balance sheet and information from the corresponding income statement. It is helpful to group the cash flows of a business into three distinctive activities, namely, cash flow from operations, that is, the company’s ability to generate cash from regular operations, its primary purpose for being; cash flow from investing which means the cash demands of investing activities; and cash flow from financing, that is, the level of reliance on financing either from borrowing or capital access in order to meet any shortfalls.

A business has to be able to generate positive operating cash flow on a sustainable basis to survive. In the short run cash sourced from financing may be used to meet a cash deficit from operations and a cash deficit caused by heavy investment activities. In the long run, however, it should be clearly demonstrable that cash flow from operations is able to meet the future cash demands generated by financing. The sustainable cash-generating ability of a business can be derived only from past trends and projections of future performance. A single cash flow statement is unable to provide this insight.

The survival and success of any business is determined by its ability over time to generate cash income in excess of cash outgoings. The cash flow statement has been designed to report these cash movements. Although the information historical, it should help readers form an opinion as to the company’s future ability to generate cash and therefore meet its interest, dividend and tax liabilities and thereafter its ability to service principal repayments. Transactions which do not result in cash flows of the reporting entity should not be reported in the cash flow statement such as depreciation and deferred taxation.

Take the case of a company requesting financing facilities for a future project that it would like to undertake. Creditors will most likely be involved in granting the usual working capital facilities, and possibly facilities of a longer term nature, should the company wish to borrow to finance the purchase of fixed assets. This calls for a closer look at the effect of future operations on cash flow. Cash flow forecasts, both for the individual projects and for general future operations allow creditors to do so. A cash flow forecast shows the cash position of a company over future months and years; whether the company will have a surplus or shortage of cash, say next month or next year. It provides the creditor and the company a guide in designing mutually acceptable repayment terms.

It is not uncommon to hear companies making good profits getting into difficulties due to the lack of cash. A cash flow forecast is therefore important to a company as it gives an indication of whether adequate cash will be available to meet the trading needs of the business. It is a view ahead on which managers make their decisions. Creditors need to understand and assess the cash position of the company in order to work out the facility requirement; provide a budget against which the creditor can monitor the account; and provide a basis on which the creditors can advise the company on matters such as increase in equity participation such as issue of new shares to strength capital structure; securing more prompt
payment by trade receivables; getting more trade credit from suppliers; and adjusting optimum stock level. In preparing a cash flow statement the following are the data normally required.

For cash inflow, the company has to estimate monthly or yearly sales according to present business activities. Sales forecast to cover cash sales and credit sales. The period of credit given must be taken into account since no cash will be received until the end of the credit period. Other sources include income from investments. For cash outflow, the following are items that generally make up the outflows: cash purchases, payment for purchases on credit, salaries and wages, interest and bank charges, sales commission, rent, tax, dividends, capital expenditure and sundry expenses. Assumptions underlying projections must be articulated and critically assessed using robust sensitivity analysis. The assumptions underlying cash item should be carefully checked. Cash flow should provide a comfortable margin of debt service including principal and interest coverage. A cash flow forecast shows the cash position of a company over future months or years; whether the company will have a surplus or shortage of cash, say next month or year. It provides the creditors and the customers a guide in designing mutually acceptable repayment terms.

**REPAYMENT ABILITY**

Repayment means the ability of the company to repay the debt out of cash flow or from other sources. What are the sources of repayment? There must be at least two sources of repayment. Will it be repaid within the time frame allowed? These are the mandatory questions creditors ought to know. The company’s cash flow and realization of security including enforcement of personal guarantee supported by tangible security can answer some of these questions. Creditors should reject a “pawn-broking” mentality, and always evaluate credit proposals in terms of the company’s ability to generate cash to repay debts. Extending credit to companies must not be contemplated purely on the basis of the security offered. Security, therefore, should only ever be a second way out.

The ability of the company to service its debt is fundamental to the analysis of its financial strength. In particular its ability to generate sufficient cash flow to meet its debt service obligations; whether the company can continually meet the conditions of its long term debt agreements; and refinance its short term debt. Detailed analysis is required of annual obligations to service and repay its debts; the availability of committed finance facilities from other sources; and the relationship with short and long term debt providers. The strength of the company’s financial position as measured by these factors will determine the extent of financial risk.

**OFF BALANCE SHEET ITEMS**

Off balance sheet items contain potential liabilities that have not materialized by the date of the balance sheet. It is not an actual liability at the time of the balance sheet but, if some specific future event occurs, then it will become so. Creditors would evaluate significant off balance sheet items having a potential financial impact on the company. Of more consequence, answer what is the probability of a drawn down on any contingent liabilities. Include such items can be guarantee of a loan or contract; non-discretionary commitments for capital goods or investments which cannot be cancelled; operating leases especially with retailers and capital intensive companies such as airlines; any lawsuits, pending litigation, or tax disputes; warranties on investment and goods sold; outstanding standby letters of credit; negative pledges and options or hedging instruments.
Due regard must be paid to the existence of inter-company guarantees in support of borrowing facilities, particularly from holding companies. The calling of such guarantees can often escalate to significant proportions, turning these off balance sheet items into unsustainable cash outflows and triggering cross-default clauses in borrowing facilities, bond and loan documentation which can in a worse scenario lead to insolvency of a company.

Another major off balance sheet item is capital commitments. This represents projected expenditure of a capital nature. It is usually broken down in the notes to the accounts between that which has been authorized for where the company has actually ordered the goods and work and that which has been authorized by the directors but not contracted for as at the balance sheet date. Contingent liabilities and capital commitments thus represent possible and definite future expenditure. As such, they are of interest because the company will need to finance them and may be looking to its creditors as providers.

**INTER-COMPANY AND RELATED PARTY TRANSACTIONS**

A company can be a net provider of funds to other members of the group or a net user of funds provided by them. Creditors are particularly aware of situations where material sums are being diverted into intra-group assets and these funds are being granted by the creditor(s). If this is the case, then in effect creditors are acting as funding vehicles to related companies without the necessary control. In such situations, creditors could be better off extending credit to related companies directly and, taking necessary precautions. Intra-group balances are likely to arise from normal trading activity between group companies. Creditors would expect these balances to show a healthy movement in both directions and the resultant flow of funds to swing between funds in and funds out. If funds appear to be flowing in one direction only and the amounts involved are material, then creditors must request a detailed breakdown of the balances to see if there is any hardcore element.

If a company has material amounts here, ask for a breakdown of them and determine why they exist. Are they due to trading balance, or funding for fixed assets? Creditors are aware that funds may be moved around between related companies without any indication of the use to which they are being put. Also, to strengthen their position, if these debts are long term in nature, it is worth trying to have them subordinated to other creditor facilities. This area has more serious implications for the creditors since, if the company funds are being applied to related companies on a long term basis, they need to ascertain just who is providing the company with funds to do this and precisely why it is being done. If it represents the diversion of the creditors' funds, then they need to take corrective action. If it is a diversion of funds out of working capital, it could cause the company to become badly structured and weaker since short term assets are being replaced by long term assets with resultant implications for liquidity.

**SEGMENT INFORMATION BREAKDOWN BY BUSINESS ACTIVITIES**

Where a company undertakes a mix of activities, it is important to secure segment information breakdown by business activities and calculate separate ratios for each section of business activity wherever possible. Particular care must be taken when interpreting financial ratios calculated for seasonal business. Consideration should be given to variations in commercial patterns when assessing the significance of financial ratios computed for particular companies. For example, supermarkets have a lower rate of return than a jewelry company, or a financial institution has a much higher gearing than a manufacturing company. Financial ratios only show the results of carrying on business; they do not indicate the causes of poor ratios. Further investigation is required. Ratios can only be used to compare like-with-like.
AUDITORS’ REPORT

An auditors’ report is compiled by external auditors contains their opinions on the company’s financial statements, as a result of their examination of the company’s affairs. In the report, the auditors have to state whether in their opinion the income statement, the balance sheet and other published accounts have been properly prepared in accordance with statute and international and/or domestic accounting standards; the financial statements give a true and fair view or present fairly of the profit and state of affairs of the company. In looking at an auditors’ report, the main concern is to find out whether it is a clean report or a qualified report and in the latter case, the type of qualification.

A clean report shows in the opinion paragraph that, in the auditors’ opinion, the financial statements give a true and fair view or present fairly in conformity with the Generally Accepted Accounting Principles without any qualification. A qualified report contains qualifications which are divided into two categories, namely, uncertainty, and disagreement. Uncertainty means where there is an uncertainty which prevents the auditors from forming an opinion. Disagreement means where the opinion formed by the auditors contradicts the view given by the financial statements. Uncertainties and disagreements can either material or fundamental. A material uncertainty or disagreement has a significant effect on one or more items in the financial statements, but does not determine the reliability of the accounts as a whole. For this type of qualification, the auditors will state that the accounts show a true and fair view or presents fairly subject to or except for the matter(s) referred to.

CONCLUSIONS AND REMARKS

Although financial ratios are very useful as an indication of trends and in interpreting the strength of a company’s financial position, there are a number of limitations which should be borne in our mind. Ratios do not provide explanations for observed changes. A deterioration cannot be necessarily be interpreted as poor management, for example a deterioration of inventories turnover appears undesirable but further investigation might reveal the accumulation of scarce raw materials which enable the plant to continue working when competitors are forced to suspend production. Too much significance should not be attached to individual ratios, for example, rate of return on total assets is high might indicate all is well, but this conclusion would be unjustified if further analysis revealed a tight liquidity ratio. Company financial statements are usually based on historical cost and during an inflationary period, financial ratios based on these figures would be expected to improve, irrespective of efficiency. Ratios can be distorted by one-off large transactions such as profit on sale of fixed assets, or window dressing to conceal a deteriorating financial position.

The accuracy of ratios depends upon the quality of the information from which they are calculated. Financial ratios tend to ignore the time factor in seasonal businesses such as inventories levels and trade receivable levels which are widely fluctuating. Long term creditors who extend project financing are concerned with the long term viability of the business of the project. Short term creditors who extend short term credit facilities may be interested in the ability of the company to repay the amounts owing currently. As a result the liquidity ratios should be of interest. The Chairman’s Report gives details of what has happened in the past and why, as well as what is likely to happen in the future. Specifically, it comments on overall trading conditions during the year, the performance achieved by each major activity, covering both current trading and future prospects; special items of interest such as closures, new ventures; acquisitions and company strategy and plans for the future. The information contained in the
Chairman’s Report provides indications as to the company’s future profits and growth. The Chairman’s Report and Auditors’ Report that accompany the financial statements submitted by a company reveal important information about the company’s operating and financial risk profile, management capability, potential profits and credibility of the financial statements themselves.

REFERENCES