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Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: International Trade
Level: Third year Bachelor

Lecture 08: Financial Analysis of Banks

After reading this lesson the student would be able to:
– Understand the types of financial statements and their role in financial analysis
– Appreciate the various aspects of financial analysis and their significance

Like any other lender and / or as an investor, a banker also needs to carry out many a type of analysis. The main source of Financial analysis is the financial statements viz., the balance sheet, profit and loss account, cash flow and funds flow statements. Analysis of financial statements helps banks in knowing the financial health, performance and viability of an enterprise, and in assessing its credit requirements

1-Analysis of Balance Sheet

The balance sheet is the most important financial statement prepared annually. It shows the assets and liabilities of a business concern as on a particular date (For example as on 31st March). The assets indicate what the company owns and its receivables, and the liabilities indicate what the company owes and its payables.

Assets:

Assets are classified into: (a) Current Assets (b) Fixed Assets (c) Intangible Assets Please note that in the vertical form of balance sheet, most of these items are appearing as part of application of funds or deployment of funds

Current Assets:

Current assets are those assets which are to be liquidated into cash in the near future. These assets are also known as 'circulating assets'.

Composition of Current Assets:

Cash and bank balances, marketable securities, inventories, bills receivables and debtors (book debts) are examples of Current Assets. Debts and bills receivable which are outstanding for not more than 12 months are treated as current assets. Inventories and Receivables are two important components of current assets. As already indicated while interpreting the financial statements, care should be taken to bifurcate these assets into two categories as current and noncurrent assets. A close review of the inventory and receivables would give better results of the efficiency of the management in managing these two assets, and clearly indicate the liquidity management skills of the business concern.

Fixed Assets:

The next important classification of assets is fixed assets. The fixed assets usually consist of Land and buildings, Plant and Machinery, fixtures and fittings, etc. These assets are used by the company for carrying on the business and are not meant for sale in the near future. While analyzing the fixed assets, care should be taken to verify the book value as well as market value (re-saleable value and necessary precautions to be taken to verify whether such assets are charged to any bank or financial institutions and the impact of the borrowings against such fixed assets). The depreciation and amortization policies should also be reviewed. For example, the valuation of the fixed assets varies from type of assets. Land should be valued according to ownership pattern like free hold or lease hold, and the location of the land, etc., As regards valuation of building, the age of the building, location and other factors need to be given appropriate weightage.

Intangible Assets:

With the changing pattern of integration of global business environment, a lot of changes are taking place in the analysis of financial statements as well. Importance is being given to the intangible assets, and their valuation is an important part of financial analysis.

Generally, the following items are classified as intangible assets; goodwill, copy right, patents, trade mark, designs, brand value etc. These are also called as fictitious assets. These assets do not represent any tangible assets like land and building, raw materials, stocks etc; These intangible assets in a way represent the reputation earned by the company. Apart from the above, certain other items which can also be classified as intangible assets are: preliminary expenses, debit balance in profit and loss account, which are either deferred revenue expenses or are actual losses to be written off over a period of time.

Liabilities:

The liabilities mainly represent sources of funds and can be broadly classified into: (i) Net Worth – Owned funds and share capital and free reserves (ii) Current liabilities and (iii) the term liabilities

Current liabilities: Those items which are repayable within one year are treated as current liabilities..

Borrowings from banks: Business units avail bank finance in the form of overdraft, / cash credit (working capital finance). An analyst should be interested to know the details of such bank borrowings like amount under different categories, security charged to the banks in the form of hypothecation and pledge of inventories and receivables etc.,

Contingent Liabilities or Off Balance Sheet Items:

Contingent liabilities are those liabilities which do not exist as on the date of balance sheet, however they may arise in future Unlike other items, which are classified as On balance sheet items, the contingent liabilities are classified as Off balance sheet items. On balance sheet items are part of the balance sheet as historical items, whereas the contingent liabilities are future items. In case these items become payable, it would distort the liquidity position of the company, hence a careful review as to the terms and conditions of such contingent liabilities, possible repayment amount and time etc., need to be given importance

2-Analysis of Profit and Loss account

It is a statement of income and expenditure of an entity for the accounting period. Every P&L account must indicate the accounting period for which it is prepared. The items of a P&L account are:

Gross and Net sales
Cost of goods sold
Gross profit
Operating expenses
Operating profit
Non-operating surplus/deficit
Profit before interest and tax
Interest
Profit before tax
Tax
Profit after tax (Net Profit)

Gross and Net Sales:

The total price of goods sold and services rendered by an enterprise, including excise duty paid on the goods sold, is called Gross sales. Net sales are gross sales minus excise duties.

Cost of Goods Sold:

This is the sum of costs incurred for manufacturing the goods sold during the accounting period. It consists of direct material cost, direct labour cost, and factory overheads. It is different from the cost of production, which represents the cost of goods produced in the accounting year, not the cost of goods sold during the same period.

Gross Profit:

This is the difference between net sales and cost of goods sold. Most companies show this amount as a separate item. Some companies, however, show all expenses at one place without making gross profit a separate item.

Operating Expenses:

These consist of general administrative expenses, selling and distribution expenses, and depreciation. Some companies include depreciation under cost of goods sold as a manufacturing overhead rather than under operating expenses.

Operating Profit:

This is the difference between gross profit and operating expenses. As a measure of profit, it reflects operating performance and is not affected by non-operating gains/losses, financial leverage, and tax factor.

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This is the difference between gross profit and operating expenses. As a measure of profit, it reflects operating performance and is not affected by non-operating gains/losses, financial leverage and the tax factor.

Non-operating Surplus: This represents gains arising from sources other than normal operations of the business. Its major components are income from investments and gains from disposal of assets. Likewise, non-operating deficit represents losses from activities unrelated to the normal operations of the firm.

Profit before Interest and Taxes:

This is the sum of operating profit and non-operating surplus/deficit. Referred to also as earnings before interest and taxes (EBIT), this represents a measure of profit which is not influenced by financial leverage and the tax factor.

Interest:

This is the expenses incurred for borrowed funds, such as term loans, debentures, public deposits, and working capital advances etc.

Profit before tax:

This is obtained by deducting interest from profits before interest and taxes.

Tax:

This represents the income tax payable on the taxable profit of the year.

Profit after tax:

This is the difference between the profit before tax and tax for the year.

3-Analysis of Funds flow/ cash flow statements

Each item in the balance sheet represents either source of funds or use of funds. All items on the liabilities side represent the funds provided to the enterprise and all items on the assets side (except cash) represent use of these funds. When we compare two balance sheets of different dates, change in each item (or introduction of a new item) in the balance sheet of later date, as compared to that item in the balance sheet of earlier date, will represent either addition of funds or additional use of funds in the intervening period. Any increase in any item on the liabilities side means additional funds available. Please note that additional funds are also available if there is decrease in any item on the assets side. Similarly, any increase in any item on the assets side or decrease in any item on the liabilities side means additional use of funds. A statement of these additional sources of funds and additional uses of funds is called Funds flow statement for the intervening period.

If we have to prepare the cash flow statement, we start with the cash in the first balance sheet as opening balance, add all the additional sources, excluding cash (cash is also a source of funds if it is at a reduced level in the subsequent balance sheet), and deduct all additional uses (excluding cash), thus arriving at the closing balance, which will be equal to the cash shown in the second balance sheet. In practice, the statement is prepared perceiving cash as a use or source of funds.