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Financial Statement Analysis and Bank Lending in Nigeria

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Abstract:
The purpose of this paper is to examine impact of financial statement analysis on bank lending in Nigeria. It highlights the importance of financial ratios as they affect lending decision taking into consideration principles of good lending by bankers. The paper relied essentially on secondary data and employed descriptive analytical approach. The study found out that credit analysis plays a crucial role in lending decision by bankers. In order to solve the problems of bad lending, there is need for bank to ensure virile Credit Department to reduce incidence of non-performing facilities and to enhance banks' profitability.

Keywords: *Bank lending, credit analysis, financial statement and profitability*

1. Introduction

One of the many functions of a bank is to give credit facilities to its customers. Credit is defined as the financial assistance given by a bank to its customer for the purpose of financing the customer's trade or business. Agbada (2010) stated that several types of credit facilities are available to Banking Service Provider (BSP) for financing business projects and investments. These credit facilities are obtained by means of financial documents or credit instruments and the credit facilities commonly obtained include overdraft, bill discounting, equipment leasing, factoring or loan will be assessed using financial statements submitted by the customer to the bank. Whether a credit facility will be approved or declined by the bank is a function of the analysis made from the financial statements as analyzed by Credit Analyst of the bank. While the Credit Analyst analyzed and recommends the facility, approval of the facility is the responsibility of the bank management. Banks are in business for profit; therefore, banks management are very careful in granting credit facilities to borrowers as bad lending will reduce the profit or affect adversely the fortune of the bank.

Financial statements are periodical financial reports and accounts and other related documents that highlight the financial position of an enterprise as well as profitability. They also reveal the providers of resources available to an enterprise and the extent to which such resources have been effectively utilized (Anyaduba, 1996).
Financial statement analysis is a process which examines past and current financial data for the purpose of evaluating performance and estimating future risks and potential (Pandey, 2010). Financial statement analysis is used by investors, creditors, security analysts, bank lending officers, managers, taxing authorities, regulatory agencies, labor unions, customers, and many other parties who rely on financial data for making economic decisions about a company.

1.1. Group Financial Statements

Group financial statements are documents that present the parent or holding company's shareholders' accounts, its assets, liabilities and revenue and expenses, together with those of its subsidiaries as those of a single company.

1.2. The Qualitative Characteristics of Financial Statements

Oduware (2010) stated that the qualitative characteristics of financial information are the qualities that make the information useful to the users. The qualitative characteristics are:

- It must be objective: The report must be purposeful to the users.
- It must be relevant: Information to be contained in the financial statement must be relevant to the years under consideration.
- It must be comparable: The report should be comparable to the previous one for easy understanding
- It must be complete: The financial statement must be complete and detailed.
- It must be easily understood: The users of the financial statements should be able to understand what is contained in the financial statement.
- It must be reliable: The report should be relied upon by people making use of it.
- It must be timely: Timeliness means that time has not passed before the report was published.
- It must be comprehensive: All the necessary details are incorporated into the report.
- It must be consistent: The pattern of reporting must be the same for the years under consideration

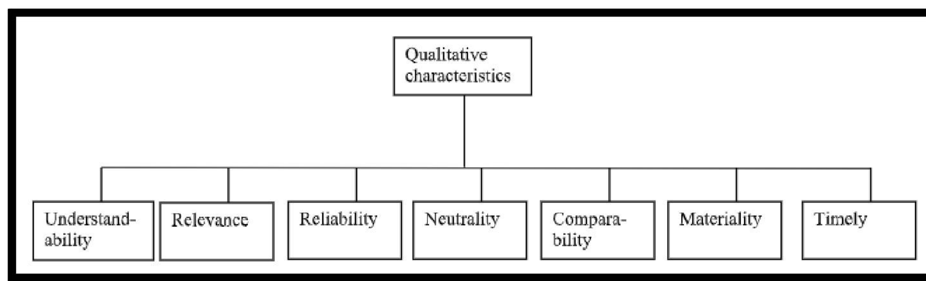

Figure 1

1.3. Users of Financial Statement

Olowe, (2018), stated that there are various interest groups in a firm and each of them are interested in financial statements of the firm. They all undertake financial ratio analysis that varies according to their specific interest. The various users of a firm's financial statement and their interest are as follows:

- Management: To access past performance, their own performances, decide on dividend to recommend and to present the financial statements to future buyers of the business.
- Shareholders: Their interested in the company's profitability, stability, potential for growth, dividend policy and performance of management.
- Potential Buyers of the Business: Financial statement will enable them to decide on whether the business should be bought or not and to access the reasonableness of purchase price of the business (Adebayo, 2005).
- Suppliers of the Business: Will uses financial statement to decide whether to sell goods on credit to the business and to assess how long it will take the business to pay suppliers.
- The Government: Will be interested in business profit to assess tax liabilities.
- Employees: Are interested in long-term stability of the company, security of their job and ability of the company to meet wage demands.
- Customers: Are interested in ability of the company to maintain supplies.
- Competitors: They are interested in comparative performance of the business.
- Financial Analysis and Advisers: To advise their clients.
- Banks and other Lenders: They are interested in the ability of the business to interest and repay the principal sum on a due date, to decide whether to lend to the business, determine the terms and condition of lending and assess the management performance of the would-be borrower.

1.4. Credit Granting Strategies

Strategies for granting credits and other financial strategies that focus on customer must take care of different customer groups of the bank. Accordingly, it is necessary to develop new credit product and instrument for different customer segments. Listed below are some of the credit instruments used by bank

- Agricultural credit
- Working capital financing
- Discounting of promissory notes
- Commercial papers
- Local Purchase Order (LPO) Financing
- Bills discounting
- Export stimulation credit
- Loans syndication etc.

1.5. Principles of Bank Lending

In order to extend credit, the banker must evaluate the project, promoters and prevailing economic situations. In evaluating credit, Onyeagocha (2001) recommended three (3) basic principles as follows:

- Safety
- Profitability and
- Suitability

1.5.1. Safety

This is of paramount importance to the bank. For the advance to be secured, the character, integrity and reliability of the borrower must be sound. The source of repayment proposed by the borrower must be proved and ensured to be certain (Ajayi, 2015).

1.5.2. Profitability

Banks are businesses established mainly to make profit, therefore, any facilities granted are expected to yield some profit to the bank. What determines the amount of profit is the rate of interest charged. In most developing

countries, interest rates on advances are controlled by the Central Bank and are generally higher than the interest paid to depositors. Thus, banks are able to make profit relatively easily (Adekanye, 2010).

1.5.3. Suitability

The lending banker should also satisfy himself about the suitability of an advance. The purpose of the loan must not conflict with the economic and monetary policies of the government. A banker is not expected to lend to finance gambling, betting and other speculative activities (Ajayi, 2015).
Other things to be taking into consideration by the lending banker are:

1.6. The Borrower

The borrower will be examined based on character, capital/contribution and capacity

1.6.1. Character

The character of the borrower is very important in bank lending. Character borders on integrity, honesty and reliability of the would-be borrower. Character can be assessed through a consideration of the previous relationship of the customer with the bank, the quality of guarantor the borrower brings forward. Is he the type that is trustworthy and willing to liquidate the loan with minimum trouble? Infants or anybody under the age of 18 years should not be given credit facility by a bank (Doyle Vs White City Stadium). Infants can only borrow for the purpose or buying necessaries and for the payment of fees for apprenticeship.
When lending to corporate bodies either registered under Companies and Allied Matters Act (CAMA) 2004 as amended or by a specific law, the law should be carefully studied to ensure that such company can borrow.

1.6.2. Capital/Contribution

Capital is required for a business. Banks should always be concerned about ensuring that their investment bears a reasonable relationship to the amount of the proprietor’s stake (Adegbie, 2010). To made the borrower to be committed to the project, banks may require that the borrower should contribute certain percentage of the amount to be used for the project. The borrower’s stake in the project must be substantial in terms of financial commitment. The borrower’s stake in the business helps the bank to determine the level of the borrower’s commitment and the amount of risk they will be willing to take (Nwude, 2007).

1.6.3. Capacity

This has to do with the ability to use the funds being requested for efficiently and effectively. A customer is said to use funds efficiently if the customer is able to generate adequate profit from the facility granted. Effective utilization of funds can be assessed by reference to the level of operations. The usual expectation is that repayment should come from the normal business operation proceeds. Based on these proceeds, what would guarantee repayment is adequate sales of the products or services on a continuous basis. If there are no diversion of sales proceeds and all the sales proceeds are lodged into the bank account with the lending banker, it should be possible to obtain sales figure from the banks statement of account. Otherwise, sales figure could be confirmed from the customer’s book or the suppliers showing average purchase per month or per annum (Nwude, 2007).

1.7. Amount of Borrowing

Ajiboba (2018), stated that the amount of the facility must match the purpose. If the purpose is clear, it will help to determine the magnitude of loan that is required. The amount of the loan is important to both the lender and the borrower because if the amount is not in tune with what is required, the bank may either under lend or over-lend. If the bank over-lends, it is taking a major risk because the borrower is likely to divert whatever remains as excess over and above what is required for the purpose. If the bank under lend, at the end of the day, the borrower will not be able to accomplish the purpose and that may cause some delays and total disruption to the payback arrangement. It is important for the amount to just be right for the purpose of the loan.

1.8. Purpose of the Credit

The facility to be granted should be for the purpose of the business. Lending banker can know the purpose of the business through information contained in the memorandum and article of association. The purpose of the facility should be consistent with the business for which the customer is known. It should be legal and capable of performance and monitoring.

For corporate borrowers, the purpose should be in consonance with the object clause to avoid the harsh reality of the doctrine of ultra vires. If a bank lends money for a purpose for which a company was not registered, the court. If dispute arises, will rule that the lending was void ab initio.
These were the facts of the case of Ashbury Carriage Co. Vs Riche (1875). A purpose stated as “to expand business” should not be accepted. The expansion and the extent anticipated should be explicitly stated and backed up with documentary evidence. Lending for speculative purposes should be avoided.

1.9. Duration of the Facility

The question, “for how long is the facility required”? is commonly asked in relation to lending.

Great care is required in matching of most deposits payable on demand with tenor of advances in order to avoid inability to meet drawings.

A bank taking short term deposits should avoid lending on long term as this will amount to poor risk management. For this reason, the period for which the advance is required should be carefully scrutinized. Where a cash budget was tendered, the tenor of utilization and eventual payment would be stated.

Tenors in excess of short term should be examined in line with added security like life insurance policy of the borrower with substantial surrender value and the bank's interest noted on it and perhaps with an executed mandate to pay all future premiums as and when due.

1.10. Conditions

By this, we mean the totality of the conditions of the environment in which the banker and the customer operate. These could be economic, business, political and social conditions. There are occasions when the economic policies could discourage banks from lending to certain sectors of the economy. The political environment may similarly not be conducive for business. It will be foolhardy to want to lend to someone trading in a war-torn country (Olusemore, 2009).

1.11. Repayment Programme

The credit analyst's accounting and finance skills are crucial and displayed in determining the ability of the borrower to repay a loan from cash flow projection.

In general, cash flow from business operations is the most dependable source of loan repayment. If the advance is an overdraft, the question to ask is will it be paid back on a reducing balance method, if so by how much and when will the repayment start? (Adekanye, 1993).

A loan will already have such a programme that can be monitored, where the purpose is for the acquisition of a capital asset, new venture or business, the customer should be told to approach a financial manager who would appraise the project and critically examine the payback method using any of the following methods in financial management.

1.12. Financial Standing of the Business Firm

If the borrowing customer of the bank is a business firm, the lending banker would be interested in its financial strength and ability to generate funds to meet installment repayments as they fall due. Information regarding the firm's financial strength could be obtaining from the Financial Statements published by the company, e.g. Trading and Profit and Loss Account, and the Balance Sheet of the firm for the past two or three years. Also, an estimated cash-flow analysis of the firm, using its cash budget, could be done to assess its liquidity and ability to generate funds regularly (Omolumo, 2001).

1.13. Importance of Financial Analysis in Bank Lending

Adegbie (2010), stated that financial analysis is the process taking accounting and other financial data and organizing them into a form which reveals a firm's strengths and weaknesses. The primary concern of the bank is the ability of the customer to repay the facility in terms of principal and the interest charges on the facility. This is where financial analysis comes in (Omolumo, 2001). Financial ratios are the tools used by lending bankers to assess the ability of the borrower in repaying the facility granted. Important financial ratios used by bankers are:

- Profitability ratio
- Liquidity ratio and
- Risk/gearing ratio

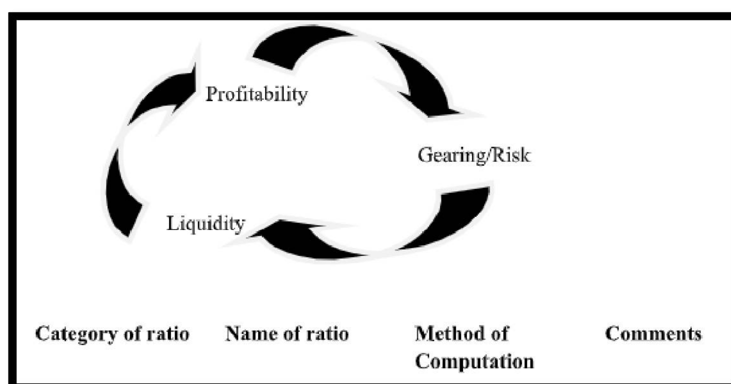

Figure 2

Profitability	a. Gross profit ratio	$\frac{\text{Gross profit}}{\text{Sales}} \times \frac{100}{1}$	Measures the amount of gross profit on sales. The higher the rate the better. A low ratio indicates selling price too low or cost of sales too high.

	b. Net profit ratio	$\frac{\text{Net profit}}{\text{Sales}} \times \frac{100}{1}$	Measures the amount of profit earned on each Naira of sales value. The higher the rate the better. A low ratio indicates low selling price or high cost of sales.
	c. Return on capital employed (ROCE)	$\frac{\text{PBIT}}{\text{Capital employed}} \times \frac{100}{1}$	Measures the ability of the management to earn return from the total resources of the business. A low return on capital employed is caused either by a low profit margin or a low asset turnover or both.
Liquidity ratio	a. Current ratio	$\frac{\text{Current Assets}}{\text{Current liabilities}}$	Measures the firm's ability to meet its maturing short-term obligations. The ideal ratio is 2:1.
	b. Acid test/ Quick ratio	$\frac{\text{Current assets less stock}}{\text{Current liabilities}}$	Measures the firm's ability to meet its short-term debt in the absence of stock. The ideal ratio is 1:1.
	c. Cash position ratio	$\frac{\text{Cash + Bank}}{\text{Current liabilities}}$	Measures the firm's ability to meet debt obligation based on cash position.
Risk/gearing ratio	a. Interest coverage	$\frac{\text{Profit before interest \& Tax}}{\text{Financial charges}}$	Measures the ability of the firm to meet financial charges
	b. Debt ratio	$\frac{\text{Total debt}}{\text{Shareholders fund}}$	Measures percentage of debt to shareholders fund
	c. Gearing	$\frac{\text{Fixed Interest Loan + Pref. share capital}}{\text{Equity}}$	Measures total debt capital to equity capital

1.14. Security Available

It is just a fallback. It is not the very reason for lending no matter how good the security is, unless it is cash; it is not a good reason to lend. Security is put in place so that in the event that the unexpected happens and since the bank is not in a position to give away money that does not belong to it. The money must just come back irrespective of the reason for the failure of that particular project or business. Therefore, security is taken in the event of the unexpected. The loan, of course, is paid back from cash flow not from security (Ajiboba, 2018).

2. Functions of Credit Department of a Bank

2.1. Understand the Legal and Regulatory Framework Guiding Bank Credits

Credit department of a bank should understand and apply the various aspects of the legal system to credit applications and approval. Many banks have been penalized by the Regulatory Authorities for non-compliance with the relevant legal and regulatory requirements.

2.2. Credit Department Should Have Knowledge of the Customer

It is expected that financial institutions should not carry out or agree to carry out financial business or provide advice to a customer or potential customer unless they are certain as to who that person actually is "know your customer" concept summarizes the importance of an effective and proactive relationship management by credit officers and relationship managers, to forestall the occurrence of bad loans, fraudulent transactions, fictitious borrowing and other unethical practices (Majekodunmi, 2003).

2.3. Formulation and Implementation of Bank's Credit Policy

Majekodunmi (2003) stated that bank's credit policy is a broad statement of its basic philosophy and concept of lending which includes standards, guidelines and limitations to guide the decision-making process. Credit department of a bank should be actively involved in the formulation and implementation of the bank's credit policy. An effective credit department should therefore ensure that a quality credit policy is in plate, in order to direct and enhance the quality of their functions.

2.4. Credit Department Should Also Understand the Principles of Lending

Credit department should ensure investment of the bank is safe and sound. The department should ensure that credit granted is fully repaid by the borrower.

2.5. Credit Documentation

A sound credit department should be able to understand the appropriate documentations that are required for every credit. It should also be conversant with how such vital documents should be handled.

2.6. Credit Department Should Know the Sources of Credit Information

An effective credit department should know the sources through which independent information on credit requests could be obtained.

2.7. Credit Review and Supervision

The bank's credit department must periodically review all credits until they reach maturity. In addition, after facility has been advanced to customer, it is very important for credit officer who was assigned to the customer, to regularly monitor the facility and ensure that customer is making proper use of the facility.

3. Recommendations

For banks to reduce poor risk assets in their portfolio and to improve on profitability, it is recommended that efficient Credit Risk Department should be put in place with professional bankers and accountants to be saddled with the responsibility of credit risk analysis. It is by doing this that banks we reduce incidence poor risk assets, be more functional with the responsibility of granting facility to the various sector of the economy in other to improve the performance of the Nigeria ailing economy.

4. Conclusion

The basic principles of safety, profitability and suitability are very crucial to a lending banker in arriving at a good lending decision. The lending banker should also be guided by the principles of good lending in term of ascertainment of the amount, purpose, security, repayment terms, character of the borrower and the financial standing of the borrower in deciding whether to lend or not.

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