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Credit policy and credit appraisal of canara bank using ratio analysis

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Abstract
Credit appraisal is an important activity carried out by the credit department of the bank to determine whether to accept or reject the proposal for finance. The article deals in banking such as working capital and its management, working capital methods of assessment, compilation of credit reports. The study included working capital, working capital cycle and working capital management of Canara Bank. The methods that are used by the banks in order to calculate the loan limits are Turnover method, MBPF system and Cash budget system. The financial statements were taken for a period of five years from 1st April 2007 to 31st March 2012. The Profit and loss account and Balance sheet were analyzed. The firm's financial performance is analyzed through ratio analyses. The study shows Canara bank has sound system for credit appraisal and the bank has good parameters to appraise the project.

Keywords: Credit appraisal, Ratio analysis, Working capital and Financial performance.

INTRODUCTION

Credit appraisal is a holistic exercise which starts from the time a prospective borrower walks into the branch and culminates in credit delivery and monitoring with the objective of ensuring and maintaining the quality of lending and managing credit risk within acceptable limits.

There are two types of proposals that are received by the bank for funds. The first types of proposals are for starting a new project or for setting up a new company, also known as project financing and the other proposals are for additional funds requirements (working capital).Financial requirements for project finance and working capital purposes are taken care of at the credit department. Companies that intend to seek credit facilities approach the bank. Primarily, credit is required for following purposes:-

1. Working capital finance
2. Term loan for mega projects
3. Non fund based limits like letter of guarantee, letter of credit

Objectives

1. To study the credit policy of the bank and the credit appraisal process as a whole.
2. To study the credit rating methods followed by the bank for different credit ranges.
3. To study a credit appraisal report of a firm.

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Limitations of the study

1. The period is five year. Hence the data cannot be compared to the longer life of the bank.
2. There is no information regarding the total amount of credit available to a particular industry thus the inclusion of industry analysis is limited.
3. Matters related to Bank's asset classification / income recognition procedures, investment are not given by the bank.

OVERVIEW OF LITERATURE.

Banks have credit policies that guide them in the process of awarding credit. The policy sets the rules on who should access credit, when and why one should obtain the credit including repayment arrangements and necessary collaterals. The method of assessment and evaluation of risk of each prospective applicant are part of a credit control policy (Payle, 1997).

A firm's credit policy may be lenient or stringent. In the case of a lenient policy, the firm lends liberally even to those whose credit worthiness is questionable. This minimizes costs and losses from bad debts but might reduce revenue earning from loans, profitability and cash flow (Bonin and Huang, 2001).

Simonson and Hempel (1999), Hsiu-Kwang (1969) and IMF (1997) observe that sound credit policy would help improve prudential oversight of asset quality, establish a set of minimum standards, and apply a common language and methodology (assessment of risk, pricing, documentation, securities, authorization, and ethics), for measurement and reporting of nonperforming assets, loan classification and provisioning.

Chen and Shimerda (1981) review 26 articles that classify 100 financial indicators, 65 of them financial ratios. They report that 41 financial ratios are considered important, given citation in one more of the 26 articles. In identifying bankrupt firms: Their final model, however, includes only seven financial indicators, namely, return on investment, debt ratio, the current ratio, cash position, net working capital turnover, inventory turnover and accounts receivable turnover. The bankruptcy model for industrial companies developed by Gombola and Ketz (1983) adds to these factors a cash flow measure.

Sun and Li (2006) have developed a model to predict companies' financial distress, testing 35 financial ratios for 135 pairs of listed companies. Their final distress prediction model includes net profit growth rate, liabilities to tangible net assets, accounts receivable turnover, liabilities to cash flow, liabilities to equity market value, total asset turnover and gross profit margin.

Giacomino and Mielke (1993) propose nine cash flow ratios to evaluate a company's performance and use than to evaluate US companies in the chemical, food and electronic industries, calculating three-year averages per industry. The industries were chosen had the largest number of companies among the Fortune 500.

The extensive research on financial ratios reveals their importance in many important decisions, including financing and investment decisions. For example, Ezzamel et al. (1987) find that in a study of bankrupt British firms in 1973, 1977 and 1981 that no single model can be used in each year studied, even when the methodology is the same.

METHODS AND MATERIALS

The study is based on secondary source of data. Secondary data have been mainly obtained from reports, records and books of M/s. XYZ CNC PRODUCT P LTD. The data also collected from audited financial statements periodicals and other records maintained by M/s. XYZ PRODUCT P LTD. The financial statements were taken for a period of five years from 1st April 2007 to 31st March 2012.

A tool used by individuals to conduct a quantitative analysis of information in a company's financial statements. Ratios are calculated from current year numbers and are then compared to previous years, other companies, the industry, or even the economy to judge the performance of the company. Ratio analysis is predominately used by proponents of fundamental analysis.

RATIO ANALYSIS

LIQUIDITY RATIOS

Current ratio

Year	Current assets (In lakhs)	Current liabilities (In lakhs)	Current ratio
2007-2008	191.21	98.71	1.94
2008-2009	260.55	163.04	1.60
2009-2010	301.63	177.10	1.70
2010-2011	334.00	197.00	1.70
2011-2012	365.00	214.00	1.71

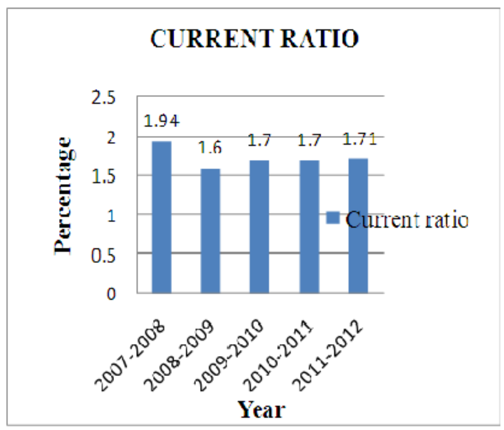

Table 1 and Fig 1.

This ratio indicates the extent to which short term creditors are safe in terms of liquidity of the current assets. Thus, higher the value of the current ratio, more liquid the firm is and more ability it has to pay the bills. However a current ratio of 2:1 is considered generally satisfactory. The ratio was high during the period 2007-2008 and it was low during the period 2008-2009 which is shown in (Table.1 & Figure.1). The ratio was satisfactory during the year 2007-2008.

Quick ratio

Year	Quick assets (In lakhs)	Current liabilities (In lakhs)	Quick ratio
2007-2008	144.98	98.71	1.47
2008-2009	166.55	163.04	1.02
2009-2010	205.63	177.10	1.16
2010-2011	228.00	197.00	1.16
2011-2012	249.00	214.00	1.16

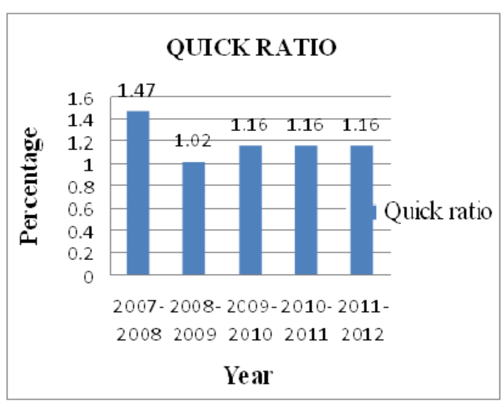

Table 2 and Fig 2.

The quick ratio of 1:1 is considered satisfactory. The quick ratio was high during the period 2007-2008 and it was satisfactory during 2007-2008 and it started to decrease from 2008-2009 and again it is increased from 2009-2010 and it is maintained in same position till 2012. (Table 2 & Figure.2)

Super quick assets ratio

Year	Super quick assets (In lakhs)	Super quick liabilities (In lakhs)	Super quick assets ratio
2007-2008	1.89	53.71	0.04
2008-2009	2.00	38.04	0.05
2009-2010	5.00	52.10	0.10
2010-2011	6.00	59.00	0.10
2011-2012	6.00	63.00	0.10

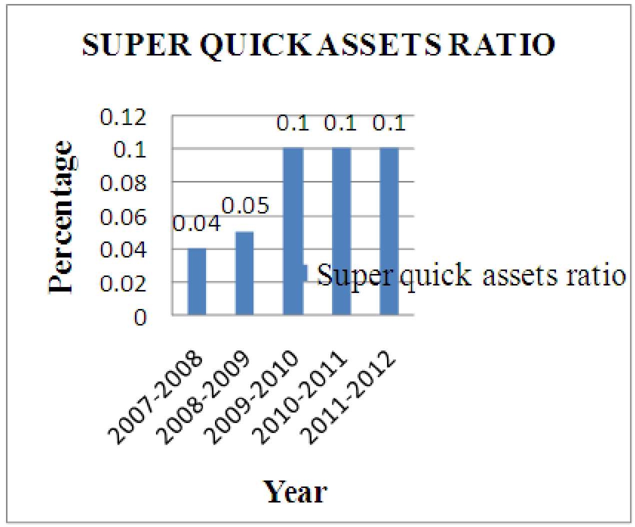

Table 3 and Fig 3.

The firm keeps more liquid assets than that of the specified norm means that excessive liquid assets are held by the firm than the requirement in the form of idle not productive in utility. The ratio was low during the period 2007-2008 and it was high from the period 2009-2012. It shows an increasing trend so it is good for the company (Table 3 & Figure.3).

CAPITAL STRUCTURE RATIOS
Leverage ratio
Debt-equity ratio

Year	Term loans (In lakhs)	Shareholder's fund (In lakhs)	Debt-equity ratio
2007-2008	3.50	289.14	0.01
2008-2009	3.40	294.25	0.01
2009-2010	2.35	297.57	0.01
2010-2011	3.00	328.00	0.01
2011-2012	3.00	360.00	0.01

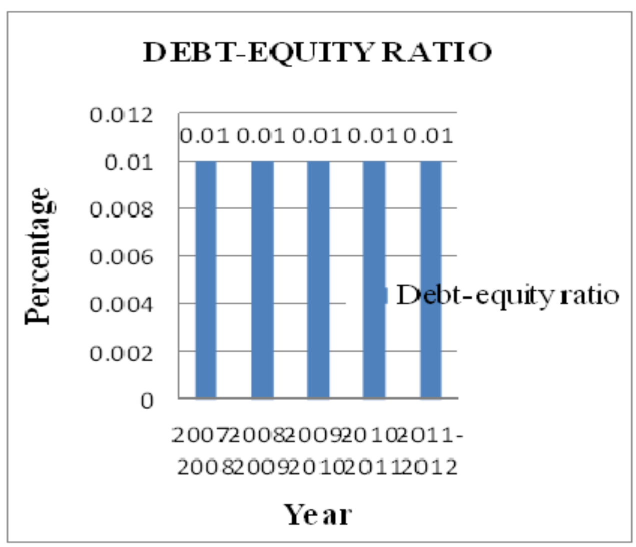

Table 4 and Fig 4.

Higher ratio indicates the riskier financial status of the firm which means that the firm has been financed by the greater outsiders fund rather than that of the owners fund contribution and vice versa. The firm should have a minimum of 50% margin of safety in meeting the long term financial commitments. The ratio was maintained in the same position from 2008-2012. There was no fluctuation, so it is good for the company (Table.4 & Figure.4).

Total debt-equity ratio

Year	Short term debt (In lakhs)	Long term debt (In lakhs)	Shareholder's fund (In lakhs)	Total debt-equity ratio
2007-2008	45.00	19.91	289.14	0.22
2008-2009	125.00	19.81	294.25	0.49
2009-2010	125.00	18.51	297.57	0.48
2010-2011	138.00	21.00	328.00	0.48
2011-2012	151.00	23.00	360.00	0.48

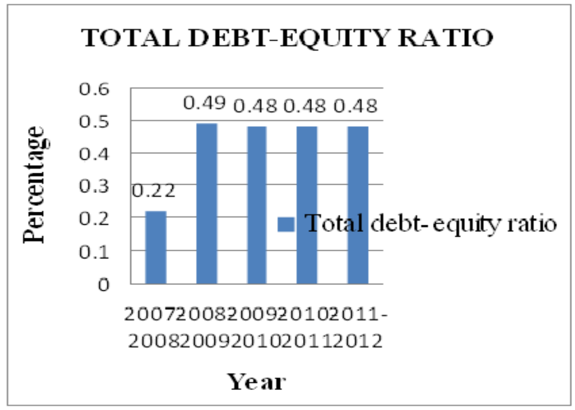

Table 5 and Fig 5.

The ratio was low during the period 2007-2008 and it was high during the period 2008-2009 then again is start to decrease from the period 2009-2010. The ratio was maintained in same position from 2010-2012. It shows a fluctuating trend (Table.5 & Figure.5).

Proprietary ratio

Year	Shareholder's fund (In lakhs)	Total assets (In lakhs)	Proprietary ratio
2007-2008	289.14	407.76	0.71
2008-2009	294.25	477.10	0.62
2009-2010	297.57	493.18	0.60
2010-2011	328.00	546.00	0.60
2011-2012	360.00	597.00	0.60

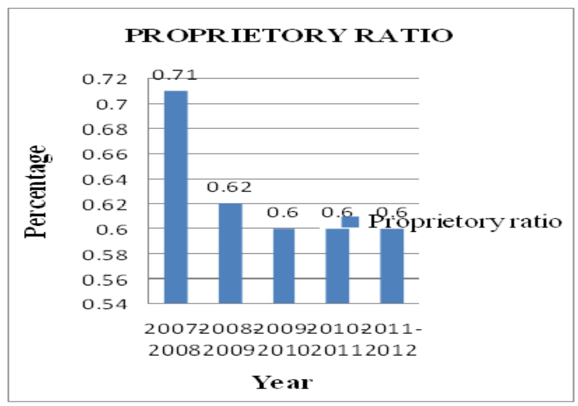

Table 6 and Fig 6

The ratio was high during the period 2007-2008 and it started to decrease from 2008-2012. It shows a decreasing trend so the firm has to improve (Table.6 & Figure.6).

Fixed assets ratio

Year	Share holder's fund(In lakhs)	Outsider's fund (In lakhs)	Net fixed assets (In lakhs)	Fixed assets ratio
2007-2008	289.14	16.41	216.55	1.41
2008-2009	294.25	16.41	216.55	1.43
2009-2010	297.57	16.16	191.55	1.64
2010-2011	328.00	18.00	212.00	1.63
2011-2012	360.00	20.00	232.00	1.64

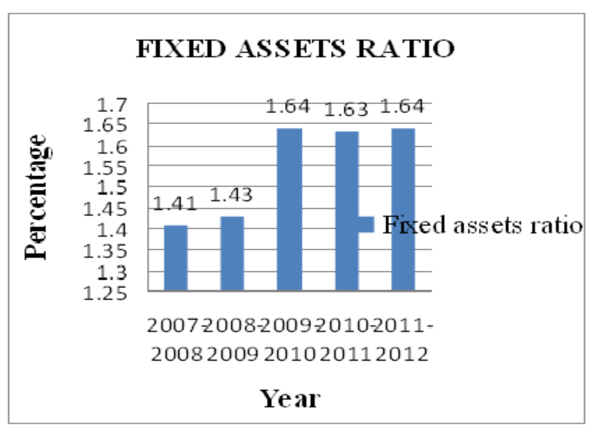

Table 7 and Fig 7.

The ratio was low during the period 2007-2008 and it start to increase from 2008-2010 then it decrease during 2010-2011 then again is increase from 2011-2012. It shows a fluctuating trend (Table.7 & Figure.7).

Coverage ratio

Interest coverage ratio

Year	EBIT (In lakhs)	Interest (In lakhs)	Interest coverage ratio
2007-2008	23.37	2.50	9.35
2008-2009	31.55	3.00	10.52
2009-2010	37.00	12.00	3.08
2010-2011	41.00	13.00	3.15
2011-2012	45.00	15.00	3.00

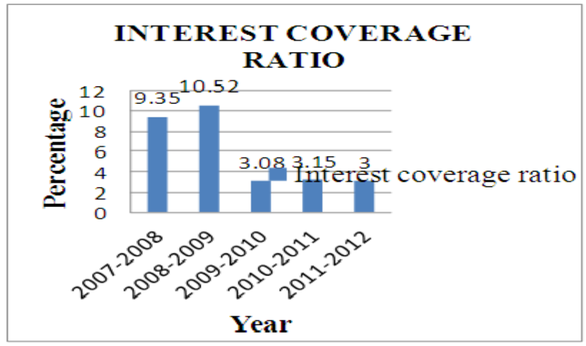

Table 8 and Fig 8

The ratio shows an increasing trend from 2007-2009 and it decrease during 2009-2010 and again it increase during 2010-2011 and then it decrease during 2011-2012. It shows a fluctuating trend (Table.8 & Figure.8).

PROFITABILITY RATIOS

Gross profit ratio

Year	Gross profit (In lakhs)	Sales (In lakhs)	Gross profit ratio
2007-2008	262.70	500.00	52.54
2008-2009	290.00	540.00	53.70
2009-2010	410.00	700.00	58.57
2010-2011	451.00	770.00	58.57
2011-2012	496.00	847.00	58.56

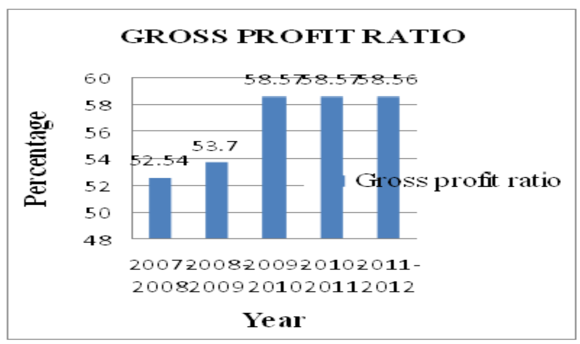

Table 9 and Fig 9

The ratio was low during the period 2007-2008. The ratio was high during the period 2009-2011 and the ratio was better during this period. The ratio start to increase form 2007-2011 it shows an increasing trend and the firm earns more profit during this period (Table.9 & Figure.9)

Net profit ratio

Year	Net profit (In lakhs)	Sales (In lakhs)	Net profit ratio
2007-2008	14.14	500.00	2.83
2008-2009	19.25	540.00	3.56
2009-2010	22.57	700.00	3.22
2010-2011	25.00	770.00	3.25
2011-2012	27.00	847.00	3.19

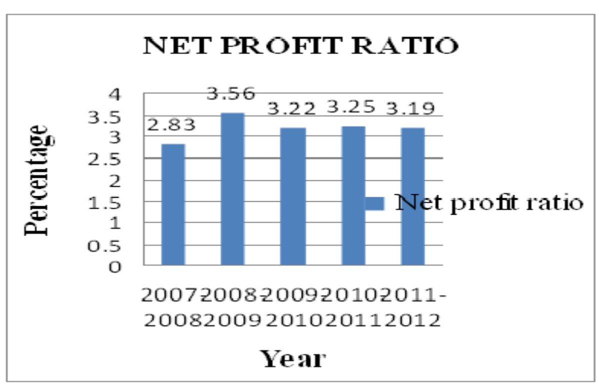

Table 10 and Fig 10.

The ratio was low during the period 2007-2008 and it increased during 2008-2009 and it decreased during the period 2009-2010 and again it increased during 2010-2011 and again in 2011-2012 it decreases. It shows a fluctuating trend (Table.10 & Figure.10).

Operating profit ratio

Year	Cost of goods sold (In lakhs)	Operating expenses (In lakhs)	Net sales (In lakhs)	Operating profit ratio
2007-2008	237.3	459.74	500.00	139.41
2008-2009	250.00	535.45	540.00	145.45
2009-2010	290.00	586.00	700.00	125.14
2010-2011	319.00	645.00	770.00	125.19
2011-2012	351.00	710.00	847.00	125.27

Table 11 and Fig 11

The ratio was high during the period 2008-2009 and it was low during the period 2009-2010. The ratio shows increasing trend from the year 2008-2009 then again it shows a decreasing trend so it is good for the company (Table.11 & Figure.11).

Return on assets

Year	Net profit after taxes (In lakhs)	Average total assets (In lakhs)	Return on assets
2007-2008	14.14	407.76	3.47
2008-2009	19.25	442.43	4.35
2009-2010	22.57	485.14	4.65
2010-2011	25.00	519.59	4.81
2011-2012	27.00	571.50	4.72

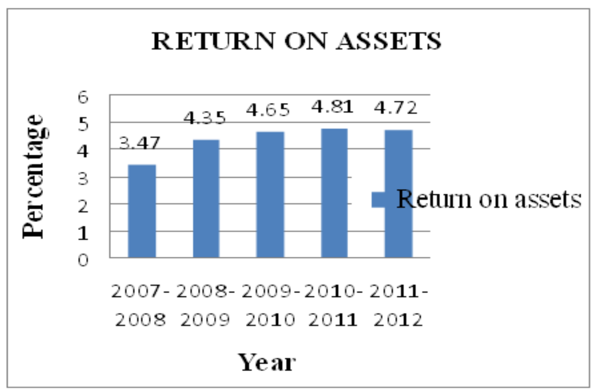

Table 12 and Fig 12

The ratio shows an increasing trend from 2007-2011 and it shows slight decrease in 2011-2012. The ratio shows that the firm earned better profit during the period 2007-2011. It shows the good position of the firm (Table.12 & Figure.12).

Return on capital employed

Year	Net profit (In lakhs)	Interest (In lakhs)	Tax (In lakhs)	Average capital employed (In lakhs)	Return on capital employed
2007-2008	14.14	2.50	9.23	316.12	8.18
2008-2009	19.25	3.00	12.30	323.69	10.67
2009-2010	22.57	12.00	14.43	327.37	14.97
2010-2011	25.00	13.00	16.00	361.50	14.94
2011-2012	27.00	15.00	17.00	396.50	14.88

Table 13 and Fig 13

The ratio shows the increasing trend during the period 2007-2010 and it shows the decreasing trend during the period 2010-2012 so the firm has to utilize the long term funds properly to earn more profits (Table.13 & Figure.13).

Activity turnover ratios
Stock turnover ratio

Year	Sales (In lakhs)	Closing stock (In lakhs)	Stock turnover ratio
2007-2008	500.00	43.00	11.63
2008-2009	540.00	90.00	6.00
2009-2010	700.00	90.00	7.78
2010-2011	770.00	99.00	7.78
2011-2012	847.00	109.00	7.77

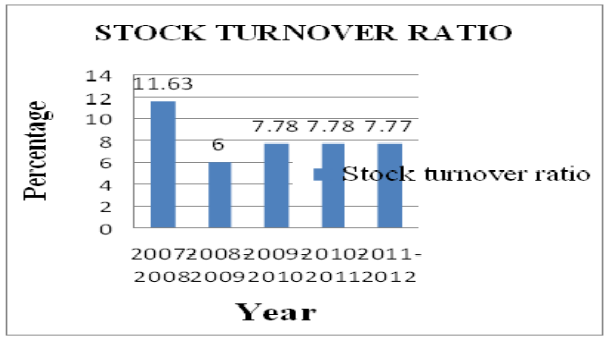

Table 14 and Fig 14

The ratio was high during the period 2007-2008 and it was low during the period 2008-2009 and again slightly it increases during 2009-2011 then again it decrease during 2011-2012 so the decreasing trend has to change to get better position(Table.14 & Figure.14).

Debtors turnover ratio

Year	Net credit sales (In lakhs)	Average debtors (In lakhs)	Debtors turnover ratio
2007-2008	320.00	130.54	2.45
2008-2009	360.00	145.27	2.48
2009-2010	500.00	175.00	2.86
2010-2011	550.00	200.00	2.75
2011-2012	605.00	220.00	2.75

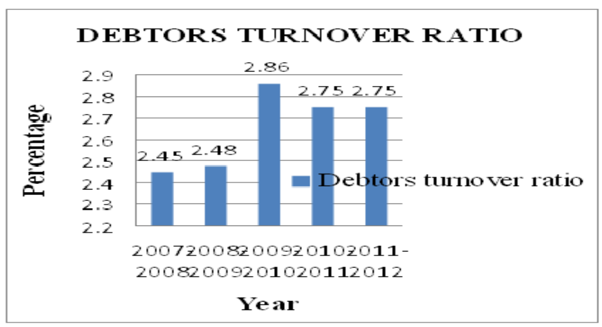

Table 15 and Fig 15

The ratio was low during the period 2007-2008 and it was high during the period 2009-2010. The ratio during 2009-2010 was satisfactory (Table.15 & Figure.15)

Debtor’s velocity

Year	Days	Debtors turnover ratio	Debtors velocity
2007-2008	365	2.45	148.98
2008-2009	365	2.48	147.18
2009-2010	365	2.86	127.62
2010-2011	365	2.75	132.73
2011-2012	365	2.75	132.73

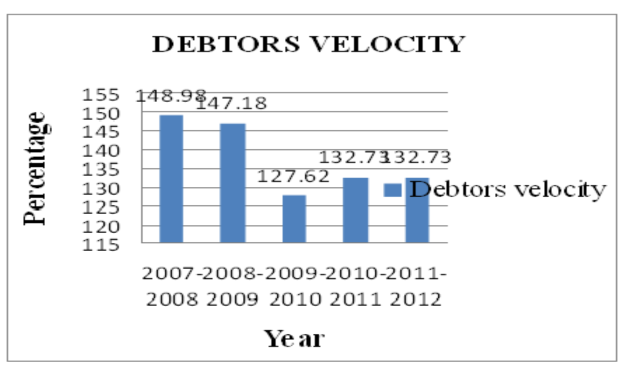

Table 16 and Fig 16

The ratio shows decreasing trend from 2007-2010 and it shows an increasing trend from 2010-2012. The ratio during 2009-2010 was satisfactory (Table.16 & Figure.16)

Creditor's turnover ratio

Year	Credit purchase (In lakhs)	Average creditors (In lakhs)	Creditors turnover ratio
2007-2008	224.24	36.67	6.12
2008-2009	272.00	28.73	9.47
2009-2010	304.00	26.90	11.30
2010-2011	334.00	35.00	9.55
2011-2012	368.00	38.50	9.56

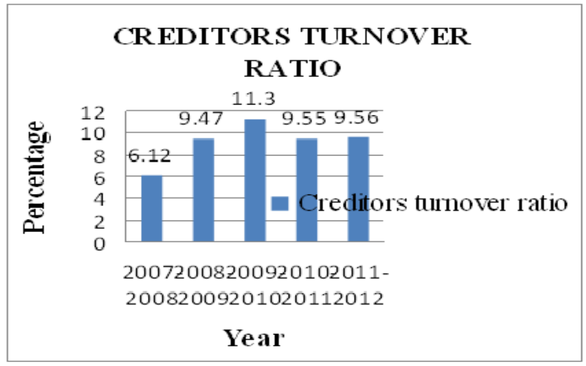

Table 17 and Fig 17.

The ratio was low during the period 2007-2008 and it started to increase during the period 2008-2010 and it was high during the period 2009-2010 then again it decreased during 2010-2011 then it increased during 2011-2012. It shows a fluctuating trend and the ratio was satisfactory during the year 2007-2008 (Table.17 & Figure.17).

Credit velocity

Year	Days	Creditors turnover ratio	Credit velocity
2007-2008	365	6.12	59.64
2008-2009	365	9.47	38.54
2009-2010	365	11.30	32.30
2010-2011	365	9.55	38.22
2011-2012	365	9.56	38.18

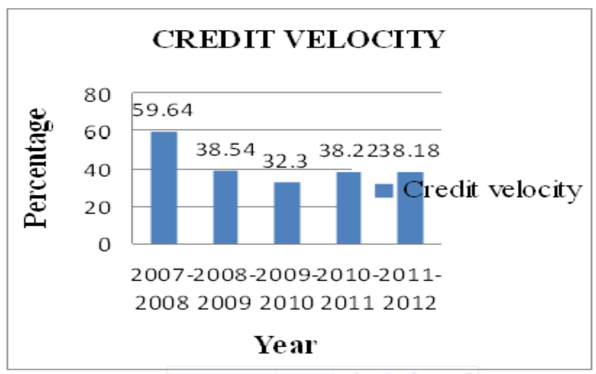

Table 18 and Fig 18.

The ratio was high during the period 2007-2008 and it starts to decrease during the period 2009-2012.The ratio shows the decreasing trend (Table.18 & Figure.18)

Fixed turnover ratio

Year	Sales (In lakhs)	Net fixed assets (In lakhs)	Fixed turnover ratio
2007-2008	500.00	216.55	2.31
2008-2009	540.00	216.55	2.49
2009-2010	700.00	191.55	3.65
2010-2011	770.00	212.00	3.63
2011-2012	847.00	232.00	3.65

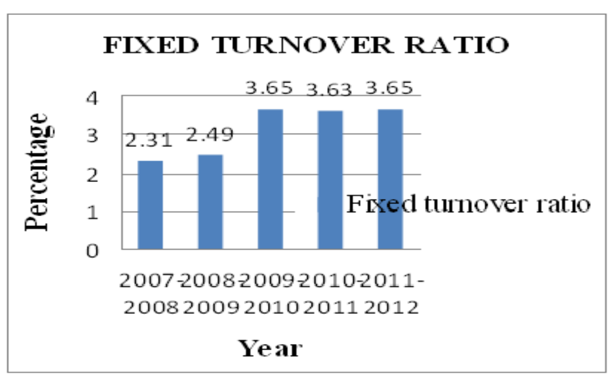

Table 19 and Fig 19

The ratio shows an increasing trend during the period 2007-2010 and it decrease during 2010-2011 and again it increase during 2011-2012. The ratio shows the fluctuating trend. The ratio was better during the year 2009-2010 and during 2011-2012(Table.19& Figure.19)

FINDINGS, RECOMMENDATIONS AND CONCLUSION

Findings.

From this study the credit policy of the bank and the credit appraisal process was found.

(i)The firm's financial performance is analyzed through ratio analyses. From the analyze it shows that the current ratio was high during the period 2007-2008 and it was low during the period 2008-2009.The quick ratio was high during the period 2007-2008 and it was satisfactory during 2007-2008 and it started to decrease from 2008-2009 and again it is increased from 2009-2010 and it is maintained in same position till 2012.The super quick assets was low during the period 2007-2008 and it was high from the period 2009-2012. It shows an increasing trend so it is good for the company. The debt-equity ratio was maintained in the same position from 2007-2012. There were no fluctuations so it is good for the company.

(ii)The total debt equity ratio was low during the period 2007-2008 and it was high during the period 2008-2009 then again is start to decrease from the period 2009-2010. It shows a fluctuating trend. The proprietary ratio was high during the period 2007-2008 and it started to decrease from 2008-2012. It shows a decreasing trend so the firm has to improve. The fixed assets ratio was low during the period 2007-2008 and it start to increase from 2008-2010 then it decrease during 2010-2011 then again is increase from 2011-2012. It shows a fluctuating trend.

The interest coverage ratio shows an increasing trend from 2007-2009 and it decrease during 2009-2010 and again it increase during 2010-2011 and then it decrease during 2011-2012. It shows a fluctuating trend.

(iii)The gross profit ratio was low during the period 2007-2008. The ratio was high during the period 2009-2011 and the ratio was better during this period. The net profit ratio was low during the period 2007-2008 and it increased during 2008-2009 and it decreased during the period 2009-2010 and again it increased during 2010-2011 and again in 2011-2012 it decreases. It shows a fluctuating trend. The operating profit ratio was high during the period 2008-2009 and it was low during the period 2009-2010. It shows a decreasing trend and it is good for the company. The return on asset shows an increasing trend from 2007-2011 and it shows slight decrease in 2011-2012. The ratio shows that the firm earned better profit during the period 2007-2011. It shows the good position of the firm. The return on capital employed shows the increasing trend during the period 2007-2010 and it shows the decreasing trend during the period 2010-2012 so the firm has to utilize the long term funds properly to earn more profits.

(iv)The stock turnover ratio was high during the period 2007-2008 and it was low during the period 2008-2009 so the decreasing trend has to change to get better position. The debtors velocity shows decreasing trend from 2007-2010 and it shows an increasing trend from 2010-2012.The creditors turnover ratio was low during the period 2007-2008 and it was high during the period 2009-2010.The creditors velocity was high during the period 2007-2008 and it start to decrease during the period 2009-2012. The ratio shows the decreasing trend. The fixed turnover ratio shows an increasing trend during the period 2007-2010 and it decrease during 2010-2011 and again it increase during 2011-2012. The ratio shows the fluctuating trend. Based on turnover method the sales is analyzed from that it is projected that the domestic and global sales for the year 2011-2012 will be 242 and 605 lakhs, so the total projection is 847 lakhs from that 20% will be contributed on projected sales.

Recommendations.

1. All the documents required to appraise the project should be asked at the time of application only rather than later by the bank
2. The bank must bring more transparency in appraisal of the project there should be explanation for a appraisal of the project that was sanctioned by higher authority.
3. The bank must not rely on software or information provided by the client the bank should dig in for other sources in order to draw a real picture for the company.
4. Credit scoring allows lenders to determine whether or not you fill the profile of the type of customers they are looking for.
5. Banks concerned should continuously monitor loans to identify accounts that have potential to become non-performing.
6. At the time of projections due to lack of documents, the projections are done.

CONCLUSION

In Canara bank the credit appraisal is done by the study involves the Evaluation of management, Technical feasibility, Financial viability, Risk analysis and Credit rating.

It is on the basis of the credit risk level, collateral securities to be given by the borrower are determined. The credit department thoroughly analyses the credit requirement of the company and the capacity to service the debt. The bank has conservative norms to appraise the project the bank at the max. Allows a 20% hike in projections. The credit appraisal passes through various stages and evaluations before it is appraised.

The financial and banking system has placed before the SME sector a fully dressed up and it is the appreciation of the efforts and also as an incentive to work hard. The sector should avail of the opportunities and scale new heights. With this the sector will be benefited and the society too. This shows Canara bank has sound system for credit appraisal. The credit appraisal process carried out at Canara bank has good parameters to appraise.

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