Corporate Governance in Loan Appraisal: A Case Study

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Introduction

Lenders in present business environment are heavily depending on the audited financial statements and do very little to gain the maximum from cross-verification through formal and informal sources. The primary objective of appraisal is to ensure safety of the bank's money and its customers through market, management, technical, and financial evaluation. Thus, much needs to be done on Corporate Governance, because poor governance of the borrower can contaminate financial statements, and hence annul the entire credit appraisal exercise. In this background, the important issues relating to the appraisal of term loan has been presented with the help of a case study in this article focusing on corporate governance and due diligence in term loan appraisal.

A Case Study - Synopsis

A registered partnership firm was established on 20th October 2014 by five Gen-Y partners in the age group of 35-40 years. Promoters have experience of trading in rice for different brands and now ventured to set up a manufacturing plant with their own brand 'Gramin Basmati'. The firm has appointed a supplier & consultant M/s Johan Engineering Ltd on turnkey basis for the supply of rice mill plant. Bank Branch has opened current account in March 2015 and received loan application for term loan of ₹25 Million (Mn) and working capital limit for ₹6 Mn. Promoters have stock of 87 acres agriculture land in their personal names and in names of their family members for growing paddy and other agriculture produce. Raw material (paddy) is available in nearby agricultural market and also from Food Corporation of India. Family members and close relatives of promoters, all put together eleven individuals having aggregated worth of ₹38 Mn, of which promoters have ₹12 Mn; have joined hands to infuse funds in the projects as their own contribution and also agreed to mortgage their properties to secure banks loans.

Bank's empanelled TEV consultant has considered the project viable from technical & economical angle. The firm proposes to commence its trial run from April 2016 and in the initial year of operation i.e. 2016-17, it proposes to achieve sale of ₹135 Mn at 50% capacity utilization. As there is no rice mill in the nearby areas, the firm will be able to supply the finished products to hotels, bakeries, and also to retailers in local market in addition to other big markets of the country. Proposed exposure is secured by equitable mortgage of factory land belonging to firm valued for ₹2 Mn which was purchased a year before in ₹0.20 Mn. Also the loan shall be secured by equitable mortgage of ten properties in name of partners & guarantors valuing ₹24 Mn. The valuation and legal opinion reports have been obtained by SME Loan Hub of the Bank at request of branch, from empanelled valuer & advocate respectively. Accordingly, original reports of valuation & legal opinion were sent to the Branch for doing needful with the directions that branch to get photocopy documents, based on which non-encumbrance certificate (NEC) obtained, verified from the original documents by bank's empanelled advocate. The project outlay of ₹43.70 Mn is depicted in table -1 and proposed credit facilities have been rated in 'investment grade' under Bank's internal rating system. Thus, credit facilities requested by the firm were sanctioned. Branch had disbursed term loan facility partly and also released cash credit limit fully to credit current and saving bank account of the firm and promoters.

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Table – 1: Project Outlay			(₹in Mn.)
Cost of Project	**Amount**	**Means of Finance**	**Amount**
Freehold land	0.40	Capital	13.70
Building & civil works	12.00	Unsecured Loan	5.00
Plant & Machinery	27.36	Term Loan	25.00
Other fixed assets	0.10		
Electric security	0.04		
Escalation & Contingencies	0.80		
IDCP	1.00		
Margin for working capital	2.00		
Total	43.70	Total	43.70

Term Loan is repayable in 20 quarterly equal installments commencing from June 2016 with gestation period of one year. However, interest amount at rate of 12% per annum will be served on monthly basis and average utilization of term loan reported ₹15 Mn. during the period. The repaying capacity assessed based on the cash flow presented in Table -2.

Table – 2: Internal Accruals, Liquidity and Repayment Schedule					(₹ in Mn)
Year – 31st March	**2017**	**2018**	**2019**	**2020**	**2021**
Profit After Tax	2.00	5.00	7.00	9.00	11.00
Depreciation	5.00	5.00	4.00	3.00	3.00
Interest on term loan	3.00	3.00	2.00	1.00	0.50
Term Loan installment	5.00	5.00	5.00	5.00	5.00
Net Current Assets	3.00	7.00	12.00	18.00	25.00

The factory site was visited by Branch Manager and found it easily accessible & adequate to set up the plant. Branch Manager also found the partners capable and thus recommended the proposal for sanction to SME Loan Hub (SMELH) on 01.06.15. Processing Manager of SMELH visited the factory site and also all the properties mortgaged to the Bank. During the physical visit, properties found marketable and their value observed realistic except of five properties which were taken at higher value thus their lesser value reported by the Processing Manager was considered for security coverage ratio. Branch Manager has also accompanied while visited all the properties including factory site with Processing Manager on 11th June 2015, through report was signed by Processing Manager only. SMELH has therefore, advised the branch to make pre disbursement visit and keep the satisfactory inspection report on its records. After a year when borrower had failed to repay bank's dues and account turned to non- performing asset; the properties were visited and four properties mortgaged to the bank found fake during the inspection process. The owner of one property was reportedly passed away in year 2010.

Findings of Case

The observations from the case study are discussed herein the article from the angle of exercising due diligence in appraisal of term loan.

01. Land: It is the fundamental requirement of setting up a project to have adequate land in light of the plant size and its capacity. Land can be owned and rented for the project. In the given case it was purchased a year before in ₹0.20 Mn which is having market value of ₹2.00 Mn but shown in the project cost at ₹0.40 Mn. The higher amount of land by ₹0.20 Mn taken in cost of project shall inflate promoters fund for the equivalent amount without actual flow of funds into business. Thus, acquisition cost of land

should be taken in the project cost to accept realistic project outlay and also to avoid fabricated source of finance submitted by the entrepreneur.

02. **Building & Civil Work:** It is to be ascertained from plant layout whether proposed building is sufficient and building design is approved by the competent local bodies. Cost estimates of the proposed building need to be compared with the unit cost of construction notified by the government department of the area concerned such as Public Works Department (Bridges & Roads) apart from peer comparison of similar building & civil work. Higher amount of cost shall require justification in terms of quality of construction and building material proposed to be used; by the Bank's Architects in their report. This may cause over-financing with less or nil promoters' contribution if estimated cost is not compared with notified rates.

03. **Plant & Machinery:** Project implementation largely depends on the quality and timely supply of the machines to be commissioned at the plant. It thus obligatory on the part of the appraisal officer that reasonableness of the cost estimates should be cross checked by competitive quotations and independent verifications from reputed manufacturers. The credibility, experience and standing of machinery suppliers have to be examined. The prices quoted in the respective supply contracts have to be fixed. In case price is subject to escalation clause, adequate contingency provision must be made in cost of project. Contract between the borrower and supplier should be thoroughly examined with respect to warranty and damage clause. Illustratively, in the extant case when services of a turnkey vendor is hired following issues to be fully addressed before accepting the project cost –

a) Relationship, if any between turnkey vendor and promoters?

b) Expenses of training for Indian technical staff & also foreign technicians involved in turnkey supply?

c) Track records of the vendor to commission project in time from other users?

d) Provision of compensation clause in agreement if delay caused in commissioning the plant?

It can be observed from the case that no provision of preliminary & preoperative expenses has been made towards training expenses for technical know-how that signifies understatement of project cost leading to less provision of margin by promoters toward the project. Besides, failing in due diligence on other vital issues narrated in the case may lead to accept unrealistic Date of Commencement of Commercial Operation (DCCO) causing to the turning the loan as NPA on technical grounds and also un-warranted modification in sanctioned proposal to accept new DCCO.

04. **Electricity Security:** Power being the pre-requisite to run a project successfully should be adequate and uninterrupted. It is therefore inevitable to verify that power connection for required power load is applied and security amount for the applied power load has been adequately provided. In the given case security amount required to be deposited with state electricity board for required power load connection was found to be ₹0.10 Mn as against actual amount provided in project cost of ₹0.04 Mn. It leads to the inferences that power load for which security deposited shall not be adequate to achieve projected level of production which may cause short supply of power at later stage for which no provision is made in the project report. Also the receipt produced in support of depositing the security amount to be verified from the amount reflected in audited financials of the borrower or bank statement submitted by the client.

05. **Escalation & Contingencies :** Provision towards contingencies depend on the economic factors of the country and thus it should be worked out in light of the expected increase in cost due to rise in prices, sales tax, excise duty, transportation charges, fluctuation in foreign exchange rates, inflation rate etc. Besides the time involved in commissioning the project shall be another determinant as longer implementation period require higher amount of contingencies. As such no standard norms have been set for contingencies; the accepted practice is to keep 10-15% of the project cost as contingency requirements. The amount provided towards contingencies in the given case is merely ₹0.80 Mn against the project cost of ₹43.70 Mn which is much

lower than the required amount that caused to funds deficit because of cost escalation and hence, delays in project commission or failure of the project.

06. **Interest During Construction Period (IDCP):** Interest on term loan during the construction period need to be serviced by the borrowers for which adequate provision of funds to be made by them. Moratorium period, applicable rate of interest and average amount of withdrawal in sanctioned limit are the key determinant to accept realistic amount of IDCP. In the extant case at given amount of average utilization of ₹15 Mn of term loan at 12% p.a. rate of interest for a period of one year the IDCP works out ₹1.80 Mn as against the amount provided in the project cost of ₹1.00 Mn that will result non-serving of interest payable to the Bank during construction period, thus account may turn into NPA before a year period which was observed in the case too.

07. **Margin for Working Capital:** Borrower has to finance a part of its current assets through long term sources. Also cash margins on any LC/ BG / DPG to be issued should be arranged by the client. Generally margin requirements for working capital for the first full year of commercial production are taken in total project cost. It can be observed from the given case that year 2016-17 shall be first year of its commercial production for which required margin i.e. net working capital (NWC) projected for ₹3.00 Mn while the actual provision made by the borrower in cost of project is merely ₹2.00 Mn resulting liquidity crisis and may also cause of turning the account under stress due to disbursement of facilities without adequate margin from promoters; which observed to be one of the reasons of becoming account NPA.

08. **Capital and Unsecured Loans (USL):** After accepting cost of project, the next step is to find out the sources of funds that may include contribution by the promoters themselves and also raising loans from others including term loans from financial institutions and also unsecured loans from friends & relatives. The norms for minimum promoter's contribution to be followed by financial institutions which varies but in most of the cases it is 25% of the project cost, of which 'core promoters' contribution should not be less than 15% of the project cost. In this context, core contribution is ₹13.70 Mn which constitutes 31.35% of project cost apart from unsecured loan of ₹5.00 Mn. with project leverage ratio of 1.33 which is considered to be financially sound. However, a credit officer should satisfy upon the sources of promoters to raise projected funds.

09. **Physical Verification of Assets:** Bank officials need to make personal visit of properties proposed to be mortgaged to verify their marketability, valuation and genuineness. In the extant case all properties visited by bank officials and found them marketable with realistic value except the five properties which were valued on higher side thus their lesser / realistic value reported by the Processing Manager was considered for security coverage ratio. Besides, SMELH has advised the branch to make pre disbursement visit to its satisfaction on the valuation and enforceability of the properties. However, four properties found fake during the process of initiating actions under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) 2002. This could have been avoided by the branch to observe not only laid down guidelines in routine but also to exercise due diligence with respect to proper KYC of depositors of title deeds, opening their accounts and sending them letter by registered post confirming the creation of mortgage on their properties.

Learning from the Case

Based on the empirical observations of case, following important learning are emerged from the study.

01. **Technical Due Diligence (TDD)** – Compliance and due diligence are assumed to be synonym by the lenders as against the fact that due diligence is beyond laid down guidelines which is expected from a lender to exercise for safeguarding bank's interest. Illustratively, in the given case acquisition cost mentioned in the purchase agreement of the land to be commensurate with rates of legal / registration charges to ensure the genuineness of the title deeds and proper stamping on the deed of the properties. Similarly, amount of fee paid to the architect by the prospective borrower to be commensurated with the market rates of professionals. The genuineness of properties mortgaged need to be assured by getting its lien noted with respective state revenue

authorities, sending a letter by registered post to the depositors of title deeds having confirmed that properties in their name is charged to the Bank and keep its acknowledgement with memorandum of entry of title deeds as part of KYC compliance by lenders in addition to other formalities like obtaining title clearance report from empanelled advocate of the Bank, getting them vetted by bank's law officer and making physical verification of properties. The incidence of creating ineffective mortgage on the properties of owner expired in year 2010 could have been avoided by adopting the suggestive measure of sending a letter by registered post to the depositor by the bank branch which was found missing in the case.

02. **Moderating Project Cost (MPC)** - Project outlay is to be viewed in integration with audited / projected financials considered for assessment of bank finance to avoid any kind of trumped-up presentation in accounts. Illustratively, the acquisition cost of the land in the given case was ₹0.20 Mn as against its cost shown of ₹0.40 Mn taken in project outlay that inflate the promoters 'contribution to the extent of ₹0.20 Mn without actual infusion of margin by promoters. Also working capital margin envisaged ₹3.00 Mn in year 2016-17 for proposed working capital but the actual margin provided by the promoters' in project outlay is merely ₹2.00 Mn that may cause release of working capital limit without raising projected margin from the borrower.

03. **Know Your Customer (KYC)** – KYC should not be limited to the verification of photo copies of identity and address proof of the client but this need to be explored beyond this point to assess prospective business risk and measures of their mitigation. KYC from lender perspective include establishing genuineness of documents submitted by the borrower such as worth report, valuation report, legal opinion report and sales / purchase order of buyers and suppliers of the client. Cost estimates of building and civil work should be compared with the rates notified by the government department of concerned area and justification of abnormal hike in prices to be asked from architect who certifies the cost estimates. The capacity of suppliers also to be verified during KYC process to ensure uninterrupted supply of raw material and appetite of buyers to absorb projected product supply on the estimated price to be fully examined for realistic revenue projected to assess project viability.

04. **Financial Closure (FC)** – It is a process of completing all project-related financial transactions to release work site. Among others, promoters' contribution is also one of the activities of financial closure wherein funds are arranged by the borrower through equity and sub ordinate debt to commercialize the project in time. It symbolize the promoters interest to set up the project and achieve its commercialization in scheduled time, thus bankers need to discreetly verify the source of equity and also un-secured loan. Promoters in the case under reference have their worth of ₹12 Mn then it would be unrealistic to accept capital of ₹13.70 Mn from their available worth. Thus, the available liquid worth of individuals should always be higher than amount expected to be raised from them. Similarly, the liquid worth of the unsecured lenders with the conditions of raising funds from them should be fully ascertained before fixing financial closure to ensure timely achievement of DCCO.

05. **Charter of Governance (COG)** – The success of an advance proposal meticulously and carefully appraised largely depends on the effective post-disbursement control, follow up and monitoring of loan accounts. Good credit governance observed to be missing in carrying out due diligence in the given case study such as poor KYC, accepting realistic project outlay, promoters contribution, releasing working capital facility without completion of the project and disbursing the term loan to credit bank accounts of promoters etc. It is therefore, suggested to document Best Business Practices (BBP) in credit for introducing good credit governance in branches. Each loan officer should be given Charter of Governance for its adherence.

06. **Loan Arranger Diligence (LAD)** – Engaging the professionals like Chartered/Cost Management Accountants, retired bankers etc. as loan arranger by

entrepreneurs has become a regular and legitimate activity to avail finance from banks. However, instances of collusion are being frequently noticed in sanctions of loan proposal for which regulators and investigating agency are expressing their concern. Since the loan arrangers are found to be involved in preparing loan application and project report of borrowers to appraisal note for bankers. Such types of outsourcing resulting poor quality of appraisal and becoming cause of corporate financial frauds. It is therefore, suggested that besides the KYC of borrower it is to be satisfactorily established of loan arrangers too along with obtaining an appointment letter with detailed scope of mandate given by the borrower to loan arranger. Dealing credit bankers should maintain arms length without getting influenced by the present / past position of arranger. The reference of loan arranger to be mentioned in appraisal note together with past experience for other accounts sponsored and dealt by the concerned arranger.

Conclusion

Appraisal of term loan aims to ascertain whether the proposal is commercially viable taking into consideration the technical, economical, financial and managerial aspects of the project. It is strongly suggested that the appraisal should go beyond Financial Statement Analysis and to address this deeper issue of corporate governance or lack of it, encourage further research for a timely detection of falling corporate governance standards. Towards this end, the case study under reference presents significance of corporate governance on appraisal of term loan.

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यूनियन बजट 2015-16 में मुद्रा लि. की स्थापना की घोषणा की गई, जो कि विनिर्माण, कारोबार और सेवा क्रियाकलापों में संलग्न सूक्ष्म/लघु कारोबारी संस्थाओं को ऋण देने के व्यवसाय में लगी सभी सूक्ष्म वित्त संस्थानों के विनियमन और पुनर्वित्तीयन के लिए उत्तरदायी होगी, और यह लघु/सूक्ष्म व्यवसायी उद्यमों को वित्त प्रदान करने वाले अंतिम वित्तपोषकों को वित्त प्रदान करने वाले राज्य स्तरीय/क्षेत्रीय स्तर के समन्वयकर्ताओं के साथ काम करेंगी। सरकार द्वारा प्राथमिकता क्षेत्र को उधार देने से बची रही गई रकम में से ₹200 बिलियन की रकम मुद्रा को आबंटित की जाएगी ताकि अंतिम वित्त पोषकों को पुनर्वित्त प्रदान करने के लिए पुनर्वित्त निधि का सृजन हो सके। मुद्रा को बजट में से ₹300 बिलियन की रकम भी दी। जाएगी ताकि सूक्ष्म उद्यमों को प्रदत्त ऋणों की गारंटी हेतु क्रेडिट गारंटी कोष का सृजन हो सके।

मुद्रा की स्थाना के लिए केन्द्र सरकार द्वारा समुचित विधान का प्रारूप तैयार किया जा रहा है। विधान का अनुमोदन होने तक लघु/सुक्ष्म उद्यमों के विकास और वित्त पोषण से संबंधित क्रियाकलापों के लिए भारतीय लघु उद्योग विकास बैंक (सिडबी) के पूर्ण स्वामित्व वाली सहायक इकाई के रूप में 18 मार्च, 2015 को कम्पनी अधिनियम, 2013 के तहत मुद्रा लि. की स्थापना की गई, और इसे 6 अप्रैल, 2015 को जमाराशि स्वीकर नहीं करने वाली गैर बैंकिग वित्तीय कम्पनी के रूप में पंजीकृत किया गया। सिडबी को अन्य बैंको/वित्तीय संस्थानों द्वारा पूंजी की क्रॉस-होल्डिंग के लिए मुद्रा में ₹7.5 बिलियन के निवेश से छूट प्रदान की गई है।

स्रोत : भारतीय रिज़र्व बैंक वार्षिक रिपोर्ट के माध्यम से