

# SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

## MBA 921

Q. 1. Investment vs. Speculation

Ans.1.

Investment and speculation both involve the purchase of assets such as shares and securities, with an expectation of return. However, investment can be distinguished from speculation by risk bearing capacity, return expectations, and duration of trade. The capacity to bear risk distinguishes an investor from a speculator. An investor prefers low risk investments, whereas a speculator is prepared to take higher risks for higher returns. Speculation focuses more on returns than safety, thereby encouraging frequent trading without any intention of owning the investment.

The speculator's motive is to achieve profits through price change, that is, capital gains are more important than the direct income from an investment. Thus, speculation is associated with buying low and selling high with the hope of making large capital gains. Investors are careful while selecting securities for trading. Investments, in most instances, expect an income in addition to the capital gains that may accrue when the securities are traded in the market.

Investment is long term in nature. An investor commits funds for a longer period in the expectation of holding period gains. However, a speculator trades frequently; hence, the holding period of securities is very short.

Q.2. What is security analysis?

Ans. 2.

For making proper investment involving both risk and return, the investor has to make a study of the alternative avenues of investment— their risk and return characteristics and make proper projection or expectation of the risk and return of the alternative investments under consideration. He has to tune the expectations to his preferences of the risk and return for making a proper investment choice. *The process of analyzing the individual*

*securities and the market as a whole and estimating the risk and return expected from each of the investments with a view to identifying undervalued securities for buying and overvalued securities for selling is both an art and a science and this is what is called security analysis.*

Security Analysis in both traditional sense and modern sense involves the projection of future dividend, or earnings flows, forecast of the share price in the future and estimating the intrinsic value of a security based on the forecast of earnings or dividends. Thus, security analysis in traditional sense is essentially an analysis of the fundamental value of a share and its forecast for the future through the calculation of its intrinsic worth of the share.

Modern security analysis relies on the fundamental analysis of the security, leading to its intrinsic worth and also risk-return analysis depending on the variability of the returns, covariance, safety of funds and the projections of the future returns. If the security analysis is based on fundamental factors of the company, then the forecast of the share price has to take into account inevitably the trends and the scenario in the economy, in the industry to which the company belongs and finally the strengths and weaknesses of the company itself- its management, promoters' track record, financial results, projections of expansion, diversification, tax planning etc. all these studies are only a part of the total security analysis that the investor should aim at.

Q.3. Explain portfolio management.

Ans.3.

A combination of such securities with different risk-return characteristics will constitute the portfolio of the investor. Thus, a portfolio is a combination of various assets and/or instruments of investments. The combination may have different features of risk and return, separate from those of the components.

The portfolio is also built up out of the wealth or income of the investor over a period of time, with a view to suit his risk or return preferences to that of the portfolio that he holds. The portfolio analysis is thus an analysis of the risk-return characteristics of individual securities in the portfolio and changes that may take place in combination with other securities due to

interaction among themselves and impact of each one of them on others. As referred earlier, portfolios are combinations of assets held by the investors. These combinations may be of various asset classes like equity and debt and of different issuers like Government bonds and corporate debt or of various instruments like discount bonds, warrants, debentures and Blue chip equity or scrip of emerging blue chip companies. The traditional Portfolio Theory aims at the selection of such securities that would fit in well with the asset preferences, needs and choices of the investor. Thus, a retired executive invests in fixed income securities for a regular and fixed return. A business executive or a young aggressive investor on the other hand invests in new and growing companies and in risky ventures. Modern Portfolio Theory postulates that maximisation of return and or minimisation of risk will yield optimal returns and the choice and attitudes of investors are only a starting point for investment decision and that rigorous risk return analysis is necessary for optimisation of returns.

Q.4. Write a note on capital market.

Ans.4.

Capital markets exchange both long-term fixed claim securities and residual/equity claim securities. The main economic role of a capital market is to match players who have excess funds to players who are in need of funds. Capital markets also provide liquidity to financial instruments. In this exchange process, there is a valuation of the instruments done by the market for the specific risk assumed by the investors. Risk is prevalent in the capital market since the market valuation process is subject to change. For example, deviation in return is one type of risk prevalent in the instruments traded in the capital market. Besides, the instruments could also have economic risk, liquidity risk, default risk, trading risk, and so on. There are two forms of returns from instruments. One is the claim on the instrument; the other form of return is due to trade. The claim on the instrument could be fixed or residual. The return through claim is either nil or positive. While fixed claim instruments hardly show any variation in returns, residual claim instruments display fluctuating returns thus exposing the holders to greater risk.

The capital gain/loss in buying/selling the security is the trade return from the security. Given the risk-return characteristic of the capital market, the expectations of the market participants play a major role in the market price determination of the securities traded. This risk return characteristic of the instruments necessitates a subdivision of the capital market into debt market and equity market.

Q.5. Discuss relevance of primary market.

Ans.5.

The primary market is the doorway for corporate enterprises to enter the capital market. The issues of new securities are offered to the public through the primary market. The issue is thus an open public offer to sell the securities. The sale is made at a value predetermined by the firm issuing the security. Sometimes a road show is conducted to feel the pulse of the public in fixing the value for a security.

The securities have a face value, which is the denomination in which it is divided. For instance, an instrument could have a face value of Re 1, Rs. 5, Rs. 10, or Rs. 100 in India. This denomination determines the number of units of the security that are offered to the public. The price at which the security is offered to the public is the offer price of the instrument. This price could be equal to or greater or lesser than the face value. When the offer price is greater than the face value, the offer is said to be at a premium. When the offer price is less than the face value, the offer is at a discount. When the two prices are equal, the offer is at par.

Several intermediaries have sprung up to help corporate entities to offer their debt and equity instruments to the public. Merchant bankers and underwriters are the major intermediaries who help to match the fund requirement of corporate entities with the surplus fund position of public. The public is represented by both individual investors and institutional investors. Sometimes, when the market is dominated by institutions, the market is said to be institutionalised.

Once the offer process of the securities to the public is complete, the securities are listed in the markets. The corporate then has to comply with the specific regulations of each local market in which its securities are listed.

Q.6. What are various sources of systematic and unsystematic risks?

Ans.6.

As discussed, the main constituents of systematic risk include- market risk, interest rate risk and purchasing power risk.

**Market risk:** The price of a stock may fluctuate widely within a short span of time even though earnings remain unchanged. The causes of this phenomenon are varied, but it is mainly due to a change in investors' attitudes towards equities in general, or toward certain types or groups of securities in particular. Variability in return on most common stocks that is due to basic sweeping changes in investor expectations is referred to as market risk.

The reaction of investors to tangible as well as intangible events causes market risk. Expectations of lower corporate profits in general may cause the larger body of common stocks to fall in price. Investors are expressing their judgement that too much is being paid for earnings in the light of anticipated events. The basis for the reaction is a set of real, tangible events– political, social, or economic.

Intangible events are related to market psychology. Market risk is usually touched off by a reaction to real events, but the emotional instability of investors acting collectively leads to a snowballing overreaction. The initial decline in the market can cause the fear of loss to grip investors, and a kind of herd instinct builds as all investors make for the exit. These reactions to reactions frequently culminate in excessive selling, pushing prices down far out of line with fundamental value. With a trigger mechanism such as the threat of war, or an oil shortage, virtually all stocks are adversely affected.

**Interest-rate risk:** The risk of variations in future market values and the size of income, caused by fluctuations in the general level of interest rates is referred to as interest-rate risk. The basic cause of interest-rate risk lies in the fact that, as the rate of interest paid on Indian government securities rises or falls, the rates of return demanded on alternative investment vehicles, such as

stocks and bonds issued in the private sector, rise or fall. In other words, as the cost of money changes for risk-free securities, the cost of money to risk-prone issuers will also change.

People normally regard government securities like treasury bills risk free. The interest rates demanded on these securities are thought to approximate the “pure” rate of interest, or the cost of hiring money at no risk. Interest rates on gilts shift with changes in the supply and demand for government securities. For example, a large operating deficit experienced by the Indian government will require financing.

Issuance of added amounts of Indian government securities will increase the available supply. Potential buyers of this new supply may be induced to buy only if interest rates are somewhat higher than those currently prevailing on outstanding issues. If rates on gilts advance from, say, 8 percent to 8¼ percent, investors holding outstanding issues that yield 8 percent will notice a decline in the price of their securities. Because the 8 percent rate is fixed by contract on these “old” gilts, a potential buyer would be able to realize the competitive 8¼ percent rate only if the current holder “marked down” the price. As the rate on gilts advances, they become relatively more attractive and other securities become less attractive. Consequently, bond purchasers will buy governments instead of corporates. This will cause the price of corporates to fall and the rate on corporates to rise. Rising corporate bond rates will eventually cause preferred and in turn common stock prices to adjust downward as the chain reaction is felt throughout the system of security yields. Thus the direct effect of increases in the level of interest rates is to cause security prices to fall across a wide span of investment vehicles. Also there are indirect effects on common stocks. First, lower or higher interest rates make the purchase of stocks on margin (using borrowed funds) more or less attractive. Higher interest rates, for example, may lead to lower stock prices because of a diminished demand for equities by speculators who use margin. Second, many firms, such as public utilities finance their operations quite heavily with borrowed funds. Others, such as financial institutions, are principally in the business of lending money. Advancing interest rates can bring higher earnings to lending institutions whose principal revenue source is interest received on loans. For these firms, higher earnings could lead to increased dividends and stock prices.

**Purchasing-power risk:** Purchasing-power risk refers to the uncertainty of the purchasing power of the money to be received. In simple terms, purchasing-power risk is the impact of inflation or deflation on an investment. When we think of investment as the postponement of consumption, we can see that when a person purchases a stock, he has foregone the opportunity to buy some goods or service for as long as he owns the stock. If, during the holding period, prices on desired goods and services rise, the investor actually loses purchasing power. Rising prices on goods and services are normally associated with what is referred to as inflation. Falling prices on goods and services are termed deflation. Both inflation and deflation are covered in the all-encompassing term purchasing-power risk. Generally, purchasing-power risk has come to be identified with inflation (rising prices); the incidence of declining prices in most countries has been slight. The anticipated purchasing power changes manifest themselves on both bond and stocks.

### **Unsystematic risk**

Market, purchasing-power, and interest-rate risks are the principal sources of systematic risk in securities; but we should also consider another important category of security risks—unsystematic risks. The portion of total risk that is unique or peculiar to a firm or an industry, above and beyond that affecting securities markets in general is called unsystematic risk. Factors such as management capability, consumer preferences, and labour strikes can cause unsystematic variability of returns for a company's stock.

### **Examples of unsystematic risks**

(i) *Business risk:* Business risk relates to the variability of the sales, income, profits etc., which in turn depend on the market conditions for the product mix, input supplies, strength of competitors, etc. The business risk is sometimes external to the company due to changes in government policy or strategies of competitors or unforeseen market conditions. They may be internal due to fall in production, labour problems, raw material problems or inadequate supply of electricity etc. The internal business risk leads to fall in revenues and in profit of the company, but can be corrected by certain changes in the company's policies.

(ii) *Financial Risk*: This relates to the method of financing, adopted by the company; high leverage leading to larger debt servicing problems or short-term liquidity problems due to bad debts, delayed receivables and fall in current assets or rise in current liabilities. These problems could no doubt be solved, but they may lead to fluctuations in earnings, profits and dividends to share holders. Sometimes, if the company runs into losses or reduced profits, these may lead to fall in returns to investors or negative returns. Proper financial planning and other financial adjustments can be used to correct this risk and as such it is controllable.

(iii) *Default or insolvency risk*: The borrower or issuer of securities may become insolvent or may default, or delay the payments due, such as interest instalments or principal repayments. The borrower's credit rating might have fallen suddenly and he became default prone and in its extreme form it may lead to insolvency or bankruptcies. In such cases, the investor may get no return or negative returns. An investment in a healthy company's share might turn out to be a waste paper, if within a short span, by the deliberate mistakes of Management or acts of God, the company became sick and its share price tumbled below its face value.

Q. 7. Explain the Functions of New Issues Market (NIM).

Ans.7.

Main functions of NIM are:

1. Facilitates transfer of resources from savers to entrepreneurs establishing new companies;
2. Helps raising resources for expansion and/or diversification of activities of existing companies;
3. Helps selling existing enterprises to the public as going concerns through conversion of existing proprietorship/partnership/private limited concerns into public limited companies.

In operational terms NIM performs above functions by providing three services: (1) origination, (2) underwriting, and (3) distribution.

Q8. Discuss the Mechanism for New issues.

Ans.8.

New issues can be made in any of the following ways:

1. Public issue through prospectus,
2. Through offer for sale,
3. Through placement of securities— private placement and stock exchange placing,
4. Issue of bonus shares,
5. Book-building, and
6. Stock option.

### **1. Issue through prospectus**

Application forms for shares of a company should be accompanied by a Memorandum (abridged prospectus). In simple terms a prospectus document gives details regarding the company and invites offers for subscription or purchase of any shares or debentures from the public. The draft prospectus has to be sent to the Regional Stock Exchange where the shares of the company are to be listed and also to all other stock exchanges where the shares are proposed to be listed. The stock exchange scrutinises the draft prospectus. After scrutiny if there is any clarification needed, the stock exchange writes to the company and also suggests modification if any. The prospectus should contain details regarding the statutory provisions for the issue, programme of public issue-opening, closing and earliest closing date of the issue, issue to be listed at, highlights and risk factors, capital structure, board of directors, registered office of the company, brokers to the issue, brief description of the issue, cost of the project, projected earnings and other such details. The board, lending financial institutions and the stock exchanges in which they are to be listed

should approve the prospectus. Prospectus is distributed among the stock exchanges, brokers, underwriters, collecting branches of the bankers and to the lead managers.

## **2. Bought out deals (Offer for sale)**

Under this method, the company does not directly offer its shares to the public, but through intermediaries, such as, issuing houses or a firm or firms of stock-brokers. A prospectus with prescribed minimum contents is distributed to applicants on a nondiscriminatory basis. The issue is also underwritten to avoid the possibility of the issue largely remaining with the issue houses.

## **3. Private placement of securities**

Under this method the securities are acquired by the issuing houses directly from the issuing company at an agreed price, and then these are placed only with their investor-clients, both individual and institutional investors, at a higher price. The difference, i.e., turn, represents their remuneration out of which they bear various expenses relating to placement. In this case no underwriting is required as issue houses guarantee cent per cent placement.

However, sometimes, though rarely, issue houses may agree to arrange placement of shares for a fee. In this case they act only as an agent of the issuing company. Placing of unquoted securities is called private placing, and that of newly quoted securities is called stock exchange placing.

## **4. Issue of bonus shares**

Issue of bonus shares is merely a conversion of existing reserves and surpluses into share capital. It does not result in raising fresh capital. It represents just a book entry subject to certain rules and regulations. Total resources base of the company does not change due to issue of bonus shares. Moreover, such issue does not result in the entry of new investors.

## **5. Book-building**

Book building is also a method of issue of shares based on floor price which is indicated before the opening of the bidding process. The issue price is fixed after the bid closing date. Under book-building scheme the issuer company does not directly issue shares to the public but invites bids from the merchant bankers to take up full responsibility for the issue. One of the lead merchant bankers to the issue is nominated by the issuer company as a Book Runner at an agreed price.

### **6. Employees stock option**

Employees Stock Option Plan (ESOP) is a voluntary scheme on the part of the company to encourage employees' participation in the company. The scheme also offers an incentive to the employees to stay in the company. The scheme is particularly useful in case of companies whose business activity is dominantly based on the talent of the employees, as in case of software industry.

Q.9. What are the factors to be considered by the investors in selecting a public issue?

Ans.9.

In this context, the investor has to be alert and careful in his investment. He has to analyse several factors. They are given below :

- 1) Promoters' past performance with reference to the companies promoted by them earlier.
- 2) The integrity of the promoters should be found out with enquiries and from financial magazines and newspapers.
- 3) The managing directors' background and experience in the field.
- 4) The composition of the Board of Directors is to be studied to

find out whether it is broad based and professionals are included.

5) The credibility of the project appraising institution or agency.

6) The stake of the appraising agency in the forthcoming issue.

7) Availability of raw materials, government norms regarding it and the tax concessions, if any.

8) Reliability of the demand and supply projections of the product.

9) Competition faced in the market and the marketing strategy.

10) If the product is export oriented, the tie-up with the foreign collaborator or agency for the purchase of products.

11) Accounting policy and Revaluation of the assets, if any.

12) Analysis of the data related to capital, reserves, turnover, profit, dividend record and profitability ratio.

13) Possibilities for achieving the financial projections as indicated by the appraising institution.

14) Pending litigations and their effect on the profitability of the company. Default in the payment of dues to the banks and financial institutions.

15) A careful study of the general and specific risk factors should be carried out.

16) A thorough reading of the auditors' report is needed especially with reference to significant notes to accounts, qualifying remarks and changes in the accounting policy. In the case of letter of offer the investors have to look for the recent un-audited working results at the end of letter of offer.

17) Investor should find out whether all the required statutory clearance has been obtained if not what is the current status. The clearances used to have a bearing on the completion of the project.

18) Promptness in replying to the enquiries of allocation of shares, refund of money, annual reports, dividends and share transfer should be assessed with the help of past record.

Q.10. Write a note on rolling settlement?

Ans. 10.

On December 17, 1997, the SEBI announced that transactions on dematerialised shares should be settled on rolling basis on the fifth day after the respective transaction. Accordingly, trading in demat shares commenced on the basis of T+5 rollign settlement cycle w.e.f. January 15, 1998 on optional basis.

Rolling settlement on T + 5 basis was kicked off initially with 10 scrips on January 10, 2000. the system allows settlement of each day's trade at the end of five days. The system was introduced in those exchanges which were connected to a depository. Rolling system was first introduction at Bombay Stock Exchange while the National Stock Exchange was next to follow. Initial ten selected scrips for rolling settlement were: BFL Software, Citicorp Securities, Cybertech Systems and Software, Hitech Drilling Services, Lupin Laboratories, Maars Software International, Morepen Lab, Sri Adhikari Brothers, Tata Infotech, and Visual Soft (India).

Q.11. What are various investment alternatives available in India?

Ans.11.

### **Investment alternatives in India**

- **Non marketable financial assets:** These are such financial assets which gives moderately high return but can not be traded in market.
  - \* Bank Deposits
  - \* Post Office Schemes
  - \* Company FDs
  - \* PPF
  
- **Equity shares:** These are shares of company and can be traded in secondary market. Investors get benefit by change in price of share and dividend given by companies. Equity shares represent ownership capital. As an equity shareholder, a person has an ownership stake in the company. This essentially means that the person has a residual interest in income and wealth of the company. These can be classified into following broad categories as per stock market:
  - \* Blue chip shares
  - \* Growth shares
  - \* Income shares
  - \* Cyclic shares
  - \* Speculative shares
  
- **Bonds:** Bonds are the instruments that are considered as a relatively safer investment avenues.
  - \* G sec bonds
  - \* GOI relief funds

- \* Govt. agency funds
- \* PSU Bonds
- \* RBI BOND
- \* Debenture of private sector co.

- **Money market instrument:** By convention, the term "money market" refers to the market for short-term requirement and deployment of funds. Money market instruments are those instruments, which have a maturity period of less than one year.

- \* T-Bills
- \* Certificate of Deposit
- \* Commercial Paper

- **Mutual Funds-** A mutual fund is a trust that pools together the savings of a number of investors who share a common financial goal. The fund manager invests this pool of money in securities, ranging from shares, debentures to money market instruments or in a mixture of equity and debt, depending upon the objective of the scheme. The different types of schemes are

- \* Balanced Funds
- \* Index Funds
- \* Sector Fund
- \* Equity Oriented Funds

- **Life insurance:** Now-a-days life insurance is also being considered as an investment avenue. Insurance premiums represent the sacrifice and the assured sum the benefit. Under it different schemes are:

- \* Endowment assurance policy
- \* Money back policy
- \* Whole life policy
- \* Term assurance policy

- **Real estate:** One of the most important assets in portfolio of investors is a residential house. In addition to a residential house, the more affluent investors are likely to be interested in the following types of real estate:
  - \* Agricultural land
  - \* Semi urban land
  - \* Farm House
  
- **Precious objects:** Investors can also invest in the objects which have value. These comprises of:
  - \* Gold
  - \* Silver
  - \* Precious stones
  - \* Art objects
  
- **Financial Derivatives:** These are such instruments which derive their value from some other underlying assets. It may be viewed as a side bet on the asset. The most important financial derivatives from the point of view of investors are:
  - \* Options
  - \* Futures

Q.12. What are the various economic forecasting techniques?

Ans. 12.

# Techniques for Economic forecasting

- (1) GNP
- (2) SAVINGS AND INVESTMENT
- (3) INFLATION
- (4) AGRICULTURE
- (5) RATES OF INTEREST
- (6) GOVT. REVENUE, EXPENDITURE & DEFICITS
- (7) INFRASTRUCTURE
- (8) MONSOON
- (9) POLITICAL STABILITY

## Forecasting techniques

There are basically five economic forecasting techniques:

**Surveys:** It is a method of short term forecasting. It is broadly used to convey the future course of events in the economy. The method to do this is approximate "because it is based on beliefs, notions and future budgeting of the government. It, however, broadly indicates the future of events in the economy.

**Economic Indicators:** It gives indication of the economic process through cyclical timings. These projections are a method of getting indications of the future relating to business depressions and business prosperity. This method although has its advantages of giving the future indications of the economy is not an exact method of finding out the economic activity. It gives results approximately and is at best an estimation of the future of the economic conditions.

**Diffusion Indexes:** The diffusion index is a method which combines the different indicators into one total measure and it gives weaknesses and strength of a particular time series of data. The diffusion index is also called a census or a

composite index.

**Economic Model Building:** This is a mathematical and statistical application to forecast the future trend of the economy. This technique can be used by trained technicians and it is used to draw out relation between two or more variables. The technique is to make one independent variable and independent variable and to draw out a relationship between these variables. The answer of drawing these relationships is to get a forecast of direction as well as magnitude.

**Opportunistic Model Building:** This method is the most widely used economic forecasting method. This is also sectoral analysis of Gross National Product Model Building. This method uses the national accounting data to be able to forecast for a future short-term period. It is a flexible and reliable method of forecasting. The method of forecasting is to find out the total income and the total demand for the forecast period. To this are added the environment conditions of political stability, economic and fiscal policies of the government, policies relating to tax and interest rates.

Q. 13. Explain the Industry Life Cycle with suitable illustrations.

Ans. 13.

An insightful analysis when predicting industry sales and trends in profitability is to view the industry over time and divide its development into stages similar to those that humans progress through. The number of stages in the industry life cycle analysis can be based on a five stages model, which includes:

1. Pioneering Development
2. Rapid accelerating growth
3. Mature growth during this period is very small or negative profit margins and profits.
4. Stabilization and market maturity
5. Deceleration of growth and decline.

Besides being useful when estimating sales, the analysis of an industry's life cycles also can provide insights into profit margins and earnings growth. The profit margin series typically peaks early in the total cycle and then levels

off and declines as competition is attracted by the early success of the industry.

1. ***Pioneering Development:*** During this start up stage, the industry experiences modest sales growth and very small or negative profit margins and profits. The market for the industry's product or service during this time period is small, and the firms involved incur major development costs.

2. ***Rapid Accelerating Growth:*** During this stage a market develops for the product or service and demand becomes substantial. The limited number of firms in the industry faces little competition and individual firms can experience substantial backlogs. The profit margins are very high. The industry builds its productive capacity as sales grow at an increasing rate as the industry attempts to meet excess demand. High scales growth and high profit margins that increase as firms become more efficient cause industry and firm profits to explode. During this phase profits can grow at over 100% a year as a result of the low warning base and the rapid growth of scales and net profit margins.

3. ***Mature Growth:*** The success in stage two has satisfied most of the demand for the industry goods or service. Thus, future scales growth may be above normal but it no longer accelerates for example, if the over all economy is growing at 8% scale for this industry might grow at an above normal rate of 15% to 20% a year. Also the rapid growth of scales and high profit margins attract competitors to the industry which causes an increase in supply and lower prices which means that the profit margins begin to decline to normal levels.

4. ***Stabilization And Market Maturity:*** During this stage which is probably the longest phase the industry growth rate declines to the growth rate of the aggregate economy or its industry segment. During this stage investors can estimate growth easily because scales correlate highly with an economic series. Although scales grow in line with the economy profit growth varies by industry because the competitive structure varies by industries and by individual firms within the industry because the ability to control costs differs among companies.

**5. Declaration of Growth and Decline:** At this stage of maturity the industry sales growth declines because of shifts in demand or growth of substitutes. Profit margins continue to be squeezed and some firms experience low profit or even losses. Firms that remain profitable may show very low rates of return on capital. Finally, investors begin thinking about alternative uses for the capital tied up in this industry.

Q. 14. What is Financial Analysis? Explain the components of it.

Ans. 14.

The financial management of a company is concerned with management of its funds which reflects how efficiently the company is managing its funds.

The overall objective of all business is to secure funds at low cost and their effective utilization in the business for a profit. The funds so utilized must generate an income higher than the cost of procuring them. Here it is to be noted that all companies need both long-term and short-term capital. The finance manager must therefore keep in view the needs of both long-term debt and working capital and ensure that the business enjoys an optimum level of working capital and that it does not keep too many funds blocked in inventories, book-debts, cash, etc. The capital structuring and average cost of capital for the company should also be examined.

### **Components of Financial Statements**

The term 'financial statements' as used in modern business refers to the balance sheet, or the statement of financial position of the company at a point of time and income and expenditure statement, or the profit and loss statement over a period. To this is added, the profit allocation statement which reconciles the balance in this account at the end of the period with that at the beginning. Thus, the financial statements provide a summary of the accounts of a company over a period of one year, and the balance sheet reflecting the assets, liabilities and capital as at a point of time say at the end of the year.

***Analysis and Interpretation:*** With a view to interpret the financial statements, it is necessary to analyse them with the object of formation of an opinion with respect to the financial condition of that company.

This Analysis involves the following steps:

- (a) Comparison of the financial statements, over two to five years.
- (b) Ratio analysis, for two to three years.
- (c) Cash Flow analysis, over a short period.
- (d) Trend analysis, over a period of 5 to 10 years.

### ***Comparison of the Financial Statements***

Comparison is the precondition for a meaningful interpretation. It may be in the nature of:

- (a) Figures of one year with that of another year;
- (b) Inter-firm comparison of figures, within the same industry;
- (c) Comparison of one product figures with that of another product; and
- (d) Comparison of budgeted figures with the actual figures.

### ***RATIO ANALYSIS***

Ratios, are probably the most frequently used tool to analyse a company, and are popular because they are readily understood and can be computed with ease. In addition, the information used in ratio analysis is easy to obtain, for many ratios employ data available in a firm's annual report and quarterly reports. Ratios are used not only by investors but also by a firm's management and its creditors. Creditors use the analysis to establish the ability of the borrowers to pay interest and retire debt. Management use ratios to plan, control, and to identify weaknesses within the firm. Shareholders use ratios to measure firm's profitability. The ratio is a statistical yardstick that provides a measure of relationship between any two variables.

#### **Cash Flow Analysis**

Analysis of a firm's income statement and balance sheet with special emphasis on profitability and net earnings available to the shareholder is important. However, increased interest has developed among financial analysts in a firm's operational income and cash flow. Since net

earnings may be affected by non recurring items for example profit on sale of fixed assets, some financial analysts place more emphasis on cash flow. The argument is that the cash flow generated by a firm's operations is a better indication of its profitability and value. Thus the use of cash flow is greatly increasing. This statement determines the changes in the firm's holdings of cash and cash equivalent (i.e. short term liquid assets, treasury bills etc). The emphasis is not on the income or the firm's assets and liabilities but on the inflow and outflow of cash from the firms operations, investments, and financing decisions. By placing emphasis on cash, the statement permits the individual to see where the firm generated cash and how these funds were used.

### ***Trend Analysis***

In trend analysis, regression technique is used and the dependent variable says sales are regressed over time, say months or years. Similarly, earnings can be regressed over time to know the short term and long-term trend of earnings. These techniques require a good deal of data of the past and analysis for a length of time for experimentation. Trend Analysis refers to comparison of some important ratios and rates of growth over a time period of a few years. These trends in the case of GPM or Sales Turnover are useful to indicate the extent of improvement or deterioration over a period of time in the aspects considered. The trends in dividends, E.P.S., asset growth or sales growth are some examples of the trends used to study the operational performance of the companies. Any temporary rise in inventories to sales would indicate sluggish demand for the products of the company.

### **Books:**

- Reily and Brown, Investment Analysis and Portfolio Management, Cengage, New Delhi
- Bodie, Kane, Marcus and Mohanty, Investments, Tata McGraw Hill, New Delhi
- Fisher DE and Jordon RJ, Security Analysis and Portfolio Management, PHI, New Delhi
- Hirt and Block, Fundamentals of Investment Management, Tata McGraw Hill, NewDelhi
- A. Avdhani 'Security Analysis and Portfolio Management' Himalaya Publications