Presentation of BLP Unit -3

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FINANCIAL ANALYSIS

- The performance of a company or business enterprise can be measured by looking into the financial results of the company over a period of time. A comparative study of the financial statements would assist the analyst to assess the results.
- Two important financial statements commonly used for financial analysis are P & L account, and balance sheet.

Advantages of analysis of financial statements:

- The financial results in the form of P&L accounts and balance sheets are readily available.
- These financial statements are drawn as per the accounting standards and as per the regulatory and legal frame work.
- Depending upon the requirement of the analyst (investors, bankers, credit rating agencies etc.,) the figures and data available on these statements can be easily grouped and interpreted.

Limitations of analysis of financial statements

- The balance sheet numbers are available as on a particular date hence may not reveal the correct position of the financial health for over a period of one year.
- Since both profit and loss account and balance sheet are in the form of numerical statements, these statements would not reveal the overall picture about the performance of the concern or business unit.
- The methods of valuation of assets, writing off depreciation, amortization of costs, large expenses etc. may vary from business unit to business unit.
- Further, these financial statements depict the performance of the business enterprise. Therefore, any meaningful interpretation of these statements, will depend upon the projections of the future trend.

P&L Account

- A profit and loss account is an account into which all income and expenses are collected, in order to ascertain the excess of gains over the losses or vice-versa.

- Need
  - To ascertain the Net Profit and Net Loss
  - Comparison with previous years profits
  - Control on expenses
  - Helpful in the preparation of Balance Sheet

Preparation of P&L Acount

- Items written in debit side P&L Account
  - Gross Loss
  - Office & Administrative Expenses
  - Selling and Distribution Expenses
  - Miscellaneous Expenses

Items written in credit side P&L Account
  - Gross Profit
  - Other Incomes and Gains

- **In case of Gross Loss**

Profit and Loss A/c Dr.
To Trading A/c

- **In case of Gross Profit**

Trading A/c Dr.
To Profit and Loss A/c

Balance Sheet

Liabilities	Assets
Current Liabilities Bank Overdraft Bills Payable Sundry Creditors Outstanding Expenses Unearned Income **Non current liabilities** Long Term Loans **Reserves** **Capital** *Add*: Net Profit *Less*: Drawings *Less*: Income Tax *Less*: Life Insurance Premium	**Current Assets** Cash in Hand Cash at Bank Bills Receivable Short Term Investments Sundry Debtors Closing Stock Prepaid Expenses Accrual Income **Non Current Assets:** Furniture Loose Tools Motor Vehicles Long term Investments Plant and Machinery Land and Buildings Patents Goodwill

TECHNIQUES USED IN ANALYSIS OF FINANCIAL STATEMENTS

- Funds Flow Analysis:

The total sources of funds are categorized as 'Long term' and 'Short term'. Similarly, the total uses are also categorized as 'Long term' and 'Short term'. If the short term sources are more than the short uses, it indicates diversion of working capital funds and needs to be probed further. Sometimes, it may be a desirable thing e.g., in case of companies with very high current ratio, it may be desirable to use the idle funds for creating additional capacity. The guiding principle is that this diversion should not affect the liquidity position of the company to unacceptable level.

Trend Analysis

- (a) The items, for which trend is required to be seen, are arranged in horizontal form and percentage increase (decrease) from the previous year's fig is indicated below it. Generally, this is used to see the trends of sales, operating profit, PBT, PAT etc. from P& L account. Similarly, the balance sheets, arranged in horizontal order give the trends of increase or decrease of various items.
- (b) Common size statements are prepared to express the relationship of various items to one item in percentage terms. For example, consumption of raw materials is expressed as a percentage of sales for different years and comparison of these figures gives indication of trend of operating efficiency.

Ratio Analysis

- Liquidity ratio: Current Ratio and quick Ratio
- Profitability Ratio
- Leverage Ratio
- Efficiency ratio
- Market Valuation ratio
- https://corporatefinanceinstitute.com/resources/knowledge/finance/financial-ratios/

https://hbr.org/1982/03/how-to-negotiate-a-term-loan

DU PONT MODEL

- The Du Pont identifies that the earning power of a firm is represented by (Return on Capital Employed) ROCE. ROCE shows the **combined effect** of the **profit margin and the capital turn over**. A change in any of these ratios would change the company's earning power.
- ROCE = Turn Over x Profit Margin =Net Profit/Capital Employed
- Turn over = Sales/ Capital Employed
- Capital Employed = Working Capital + Fixed Assets
- Working Capital = Stock + Bills Receivable + Debtors + Cash
- Profit Margin= Net Profit/ Sales
- Net Profit = Sales – (Manufacturing costs + Selling costs + Administrative costs)

Special issues in financial analysis – Banking Industry

- Safety and security is the concern of a lending and investing banker, since he also acts as trustee for the depositor's money.
- While lending as well as investing, banks are exposed to many a risks.
- Banks needs to balance their assets and liabilities, and also ensure proper liquidity management.
- Banks should carefully handle their assets portfolio to ensure that their NPA levels remain at minimum possible levels.

FINANCIAL ANALYSIS BY BANK AS A LENDER

- Net Worth of the borrower
- Viability
- Repayment Capacity
- Assessment of Performance and Financial Position
- Financial Health Indicators
- Assessment of Credit Requirements
- Cross Verification

BANKERS AS INVESTOR

- These investments are made by banks for the following reasons:
- To comply with SLR requirements
- To optimally deploy surplus funds
- To manage the gap between assets and liabilities (mismatch)
- To diversify risks

While investing funds in Non–SLR securities, the following need to be taken into account:

- They should adhere to exposure limits and counter-party limits.
- The financial statements of banks and corporate clients, where the funds would be invested, need to be properly analyzed.
- Like a lending banker, the investing banker also needs to verify all the important parameters to cover various risks.
- If the investments are in market related instruments, banks also need to do a proper analysis of the market risks and their impact
- Banks should ensure that all such investments are properly valued by practicing the mark-to-market concept.
- Apart from trend ratio and other analysis, banks should also carry out PESTEL analysis (Political, Economic, Social, Technological, Environmental and Legal) and impact of the PESTEL factors on their investments

- Sales/Revenue
- - VC
- Contribution
- -Fixed Cost
- PBDIT (Gross Profit)
- -Dept.
- PBIT (Operating Profit)
- -I
- PBT
- -T
- PAT (Net Profit)

-Div Preference shares
EATESH