NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: BHM745

COURSE TITLE: SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

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CONTENT

INTRODUCTION

You are holding in your hand the course guide for ENT432 (International Accounting System). The purpose of the course guide is to relate to you the basic structure of the course material you are expected to study as an Accounting Student in National Open University of Nigeria. Like the name 'course guide' implies, it is to guide you on what to expect from the course material and at the end of studying the course material.

COURSE CONTENT

The course content basically focuses on International Accounting System. The course material tends to portray accounting with global dimension of its implication in modern realities. As the world becomes a global village, the need to harmonize accounting standards becomes more intense, so as to facilitate mutual understanding and cooperation among nations.

Multinational corporations have become the vehicles of global drives. The course material has successfully dealt with issues relating to multinational corporations. In the light of that, the course material has richly dealt with issues such as performance evaluation, foreign currency issues, international taxation and transfer pricing.

COURSE AIM

The aim of the course is to bring to your cognizance the practice of accounting with its international dimension in recent times.

COURSE OBJECTIVES

At the end of studying the course material, among other objectives, you should be able to:

1. Discuss how accounting is shaped by its environment.
2. Explain the international market in relation to accounting services.
3. State the various possible forms of organization that international aspects have been integrated into financial management.
4. Discuss external finance as a factor influencing accounting development.
5. Discuss legal system as a factor influencing accounting development.
6. Discuss political and economic ties with other countries as a factor influencing accounting development.
7. Discuss the levels of inflation as a factor influencing accounting development.
8. Discuss size and complexity of business enterprises, sophistication of management and financial community and general levels of education as factors that influence accounting development.
9. List and describe the three accounting models.

10. Discuss some existing financial accounting practice differences using goodwill, income smoothing and asset valuation.
11. Explain the opinion of corporate management, investors, stock markets and regulators and accounting professionals and standard setters regarding international accounting diversity.
12. Distinguish between financial and nonfinancial disclosure.
13. Explain the bases used for ensuring disclosure.
14. Discuss the following:
    a. Segment disclosure
    b. Financial forecast disclosures
    c. Information about shares and shareholders disclosure
15. Explain the purposes of accounting and auditing standards and how they are related.
16. List and explain the benefits of accounting harmonization.
17. List and explain the barriers to accounting harmonization
18. State the objectives of IASC.
19. State the obligations member countries of IASC are expected to do to support the objectives of IASC.
20. List and discuss the operating structure of IASC.
21. Describe the operating procedures of IASC for setting up accounting standards.
22. Describe how the approval for the IASC restructuring was obtained.
23. Explain what the key responsibilities of IASB are.
24. State the specific objectives of IASB
25. Explain the IASB due process.
26. Discuss the qualification of IASB members.
27. Discuss the Standard Advisory Council.
28. Discuss the International Financial Reporting Interpretations Committee
29. State the benefits of global accounting standards.
30. State the justification for having international standard setters.

31. State the recent trends in International Financial Reporting Standards
32. Define transnational financial reporting and explain what has caused the phenomenon.
33. Discuss problems confronting users of foreign financial statements.
34. State and explain what multinational corporations do to accommodate foreign readers of their financial reports.
35. Discuss what it means to translate a financial statement item at the historical exchange rate.
36. Discuss what it means to translate items in the financial statement at the current exchange rate.

COURSE MATERIAL

The course material package is composed of:

The Course Guide

The study units

Self-Assessment Exercises

Tutor Marked Assignment

References/Further Reading

THE STUDY UNITS

The study units are as listed below:

MODULE 1: INTERNATIONAL ACCOUNTING

Unit 1: Financial Accounting with International Perspective

Unit 2: Factors Influencing Accounting Development

Unit 3: Diversity in Financial Accounting Practices

MODULE 2: **ACCOUNTING HARMONIZATION**

Unit 1: Promotion of International Accounting Harmonization

Unit 2: International Accounting Standards Committee

Unit 3: Financial Reporting in the International Environment

Unit 4: Global Assessment of Disclosure Practices

MODULE 3: **ISSUES WITH MULTINATIONAL CORPORATIONS**

Unit 1: The Multinational Corporations

Unit 2: International Financial Statement Analysis

Unit 3: Information Systems for Multinational Planning and Control

Unit 4: Multinational Budgeting

MODULE 4: **EVALUATION AND TRANSLATION**

Unit 1: Performance Evaluation in MNCs

Unit 2: Issues to Consider when Developing MNC Evaluation Systems

Unit 3: Foreign Currency Translation

Unit 4: Translation Methods

ASSIGNMENTS

Each unit of the course has a self assessment exercise. You will be expected to attempt them as this will enable you understand the content of the unit.

TUTOR MARKED ASSIGNMENT

The Tutor Marked Assignments (TMAs) at the end of each unit are designed to test your understanding and application of the concepts learned. Besides the preparatory TMAs in the course material to test what has been learnt, it is important that you know that at the end of the course, you must have done your examinable TMAs as they fall due, which are marked electronically. They make up 30 percent of the total score for the course.

SUMMARY

International accounting system as a course in accounting is a giant stride towards actualizing the global demand of understanding and cooperating on financial matters in recent times. The world is no doubt a global village with the technological advancement we celebrate today. Financial transactions have equally played a crucial role in these global realities. Therefore, it is very important that you commit adequate effort to the study of the course material for maximum benefit.

INTERNATIONAL ACCOUNTING SYSTEM

ENT432

MAIN CONTENT

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TABLE OF CONTENT

Module 4: **EVALUATION AND TRANSLATION**

Unit 1: Performance Evaluation in MNCs

Unit 2: Issues to Consider when Developing MNC Evaluation Systems

Unit 3: Foreign Currency Translation

Unit 4: Translation Methods

MODULE 1: INTERNATIONAL ACCOUNTING

UNIT 1: FINANCIAL ACCOUNTING WITH INTERNATIONAL PERSPECTIVE

CONTENT

1.0 INTRODUCTION

Financial accounting information is oriented primarily toward those users external to the business enterprise who provided capital used in establishing the business. Hence, financial accounting is defined as the classification and recording of the monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation by means of profit and loss account, balance sheet and cash flow statements during and at the end of an accounting period (CIMA). Those who have money to invest or lend may decide where to invest such resources based on the financial accounting information available to them about such prospective companies. Basically, accounting satisfies the need for information.

2.0 OBJECTIVES

After studying this unit, you should be able to

37. Discuss how accounting is shaped by its environment.
38. Explain the international market in relation to accounting services.
39. State the various possible forms of organization that international aspects have been integrated into financial management.

3.0 MAIN CONTENT

3.1 ACCOUNTING AND THE ENVIRONMENT

Environment is a fundamental factor that determines the development of any phenomenon. Discussing an international accounting system primarily connotes accounting in different types of environment. Just as nations differ in their histories, values and political systems, they also have different patterns of financial accounting development. For example, accounting as studied by students in the United States is not the same accounting that students in other nations study (Gernon/Meek 2001).

The difference is an outgrowth of the variety of business environments around the world and the fact that accounting is shaped by the environment in which it exists. It follows therefore, that when nations' business environments are similar; their financial accounting systems also tend to be similar. Moreover, as national economies become more interdependent and converge into a global economy, so also there is some convergence of accounting around the world.

One basic environment that shapes the development of financial accounting information is the purpose to which it was prepared. Like was stated in the introduction of this unit, that financial accounting is oriented primarily toward those users external to the business enterprise who provided capital used in establishing the business, in many countries, such as the United States, financial accounting information is directed primarily towards the needs of shareholders and those who would make use of the financial accounting information for decision making purposes. However, for some countries, financial accounting is designed primarily to ensure that the proper amount of income tax is collected by the government. While in some other countries, financial accounting is designed to help accomplish macro-economic policies, such as achieving a predetermined rate of growth in the nation's economy.

SELF ASSESSMENT EXERCISE
Accounting is shaped by the environment it exist, discuss.

3.2 GLOBAL MARKET AND FINANCIAL SERVICES

Much has been said and written about the multinational nature of today's world economy. All kinds of automobiles, electronics and all sorts of products are commonplace worldwide, available where they were not originally manufactured. This expresses global economic interdependence. Business enterprises are the main carriers of economic internationalism. Most of today's larger corporations can

be characterized as multinational. According to David E. Lilienthal, multinational corporations are corporations which have their home in one country but operate and live under the laws and customs of other countries as well.

Corporate internationalism takes many forms. For example, many components of a final product assembled in South Africa may in fact be manufactured in the United States. That is, individual parts of consumer goods like cars, personal computers, and television set, routinely originate in countries outside the final assembly location.

Another dimension of corporate internationalism is manifest in cross-border business mergers and acquisitions. For example, highly visible 1989 events include the acquisition of a controlling interest in New York's Rockefeller Centre by a group of Japanese investors.

Yet another dimension of corporate internationalism comes about through truly global markets for corporate securities. Records for off-shore purchases of corporate securities were set in the second quarter of 1989, according to the US Securities Industry Association. During that quarter US investors purchased a net of $4.4 billion of foreign securities. During the same quarter, net purchases of US stocks by foreign investors rose to $4.5 billion – (total buying and selling of US equities by foreign investors during the second quarter of 1989 amounted to $107).

On the other hand, it is important you note that professional accounting services are also delivered on an international scale. Such services include the independent audit of financial statements prepared by management, tax research and consulting, and information systems design. Professional accounting services firms range from single individuals to gigantic multinational partnerships. Since substantial business activities and professional accounting service activities are devoted to international organizations, it is obvious that accounting as a professional field and as an intellectual discipline is internationalized as well.

SELF ASSESSMENT EXERCISE
Do you agree that professional accounting service is internationalized? Substantiate your stand.

3.3 Organization of Management Information System

Some years ago, chief financial officers of larger companies needed to know little about international business and finance. Today, according to a survey by one executive recruiting firm, almost half of all senior financial executive positions to be filled demands thorough familiarity with international dimensions of business. International aspects have been integrated into financial management in general.

Such integration, however, may occur in any one of several possible forms of organization. Some companies organize all of their international business into a single division, which then parallels a number of domestic divisions. Other companies create product lines; each autonomously organized to do domestic as well as international business. Still others employ a functional organizational format. Here such business functions as production, marketing, research and development, finance and

accounting are integrated into worldwide units to perform all corporate activities specifically charged to each function.

Organizational difficulties arise when management information systems are not structured in parallel with the organization as a whole. For example, if a firm is recognized according to product lines of business, the prevailing management information system should not be functionalized within a worldwide accounting unit. Otherwise you have a corporate financial executive function with most of the accounting staff working for product line organizations. Such disparity is likely to cause major inefficiencies and ineffectiveness for the prevailing management information system and possibly destroy its validity altogether.

An equally difficult problem relates to the type of management information system best suited for multinational business operations. Should there be two systems- one for domestic operations and one for international purposes? Does management need the same type of decision- relevant information both at home and abroad? What is the best language to use for worldwide operations? Should managers in different countries get different information for local decision-making purposes? It stands to reason that major communications problems must be resolved when these types of questions are addressed.

SELF ASSESSMENT EXERCISE
Familiarization of international business dimension is essential for effective management. Discuss.

4.0 CONCLUSION

Accounting is often referred to as the language of business. One of the languages that accounting must 'speak' is international. Business enterprises are the main carriers of economic internationalism. Most of today's larger corporations can be characterized as multinational. The international dimensions of business have resulted in the internationalization of accounting. This is because accounting basic goal is to provide information needed by external users of a business entity. Since substantial business activities and professional accounting service activities are committed to international organizations, it is only a consequence that accounting as a professional field and as an intellectual discipline is internationalized as well.

5.0 SUMMARY

In this unit, we discussed the topic financial accounting with international perspective. This was discussed in three sub-units which are accounting and the environment; global market and financial services; and organization of management information systems.

You would recall that environment is a fundamental factor that determines the development of any phenomenon. Discussing an international accounting system primarily connotes accounting in different environment. Most of today's larger corporations can be characterized as multinational. And accounting as a result of business metamorphosis has equally been internationalized.

6.0 TUTOR MARKED ASSIGNMENT

1. International accounting system primarily connotes accounting in different types of environment. Discuss.

2. State the various forms, corporate internationalism takes.

3. State the various possible forms of organization that international aspects have been integrated into financial management.

7.0 REFERENCES/FURTHER READING

Davidson, R. A., Gerlardi, A. M. G., and Li, F (1996), "Analysis of the Conceptual Framework of China's New Accounting System". Accounting Horizons, pp58 – 74.

Gernon, H. and Meek, G. K. (2001), *Accounting, An International Perspective*, New York: McGraw-Hill Higher Education.

Gernon, H. and Wallace, R. S. O. (1995)," International Accounting Research: A Review of Its Ecology, Contending Theories and Methodology". Journal of Accounting Literature 14, pp 54 – 106.

Mueller, G. G., Gernon, H. and Meek, G. (1991), *Accounting, An International Perspective*, Homewood: Irwin Richard D.

MODULE 1: INTERNATIONAL ACCOUNTING

UNIT 2: FACTORS INFLUENCING ACCOUNTING DEVELOPMENT

CONTENT

1.0 INTRODUCTION

Like was stated in unit 1, environment is a fundamental factor that determines the development of any phenomenon. International accounting system primarily connotes accounting in different types of environment. Just as nations differ in their histories, values and political systems, they also have different patterns of financial accounting development. Basically, this environment is expressed by shaping factors that influence the development of accounting. Therefore, it is in the light of this unit to discuss further those factors that influence accounting development.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Discuss external finance as a factor influencing accounting development.
2. Discuss legal system as a factor influencing accounting development.
3. Discuss political and economic ties with other countries as a factor influencing accounting development.
4. Discuss the levels of inflation as a factor influencing accounting development.
5. Discuss size and complexity of business enterprises, sophistication of management and financial community and general levels of education as factors that influence accounting development.

3.0 MAIN CONTENT

3.1 EXTERNAL FINANCE

In situation where a company grows from private ownership to public ownership due to the need for capital increase, the first observation is that the shareholder group become large and diverse. The second observation is that ownership is separated from management. Owners of the business (shareholders) become essentially uninvolved in the day-to-day management of the companies they owned. In such situation, in order to know how well a company is doing, financial accounting

information becomes an important source of information. This was how the industrial revolution in the United States and Britain aided the development of accounting.

Another point in external financing is the credit system. Where banks are primarily the source of capital, financial accounting is oriented toward creditor protection. There are close ties between companies and banks. The information needs of the resource providers are satisfied in a relatively straightforward way through personal contacts and direct visits. Since the business enterprises have to deal with only a few creditors and sometimes even one, direct access in an efficient and practical way to have the company's financial health monitored. Another consideration in external financing is to what extent the government gets involved in company investment. Like in France and Sweden where the National Governments play a strong role in managing the countries resources and business enterprises are expected to accomplish the governments' policies and macro-economic plans. Governments also actively ensure that businesses have adequate capital and will lend or even invest in companies if necessary. Financial accounting is oriented toward decision making by government planners. Firms follow uniform accounting procedures and reporting practices, which facilitate better government decisions.

Finally, the relationship between a company and provider of capital changes when new capital is secured from international financial markets means that the information demands of both domestic and international sources of finance must be satisfied. This would call for going beyond domestic expectations and customs in providing financial reports.

SELF ASSESSMENT EXERCISE
What is the effect of capital increase on shareholders?

3.2 LEGAL SYSTEM

A major factor that influences the development of accounting is the legal system that operates in that country. Many dissect the accounting world into those countries with a 'legalistic' orientation toward accounting and those with a 'non legalistic' orientation. They explained that the legalistic approach to accounting is predominantly represented by the so called code law countries while the non-legalistic approach is the so-called common law countries.

Laws in code law countries stipulate the minimum standard of behaviour expected. Citizens are obligated to comply with the letter of the law. In most code law countries, accounting principles are codified much as the tax code is in the United States. Thus, financial accounting is administered government bodies. Accounting practices and rules tend to be highly prescriptive, detailed and procedural. A primary role of financial accounting in these countries is to determine how much income tax a company owes the government. For example, such countries are Argentina, France and Germany.

The non-legalistic approach found in common law countries establishes the limits beyond which it is illegal to venture. However, within this limits, latitude and judgment are permitted and encouraged. Accounting practices in common law countries are largely determined by accountants in the private sector and they evolve by becoming commonly accepted in practice. Thus, accounting tends to be more

adaptive and innovative. Examples of common law countries that adopt non-legalistic approach are the United States and the United Kingdom.

SELF ASSESSMENT EXERCISE
Distinguish between a legalistic orientation and non-legalistic orientation.

3.3 POLITICAL AND ECONOMIC TIES WITH OTHER COUNTRIES

One factor that has shaped accounting development is the political and economic ties that exist among nations. The United States has influenced accounting in Canada due to geographic proximity and friendly economic ties and because a number of Canadian companies routinely sell shares of common stock or borrow money in the United States. The United States is Mexico's principal trading partner: and also because of proximity, accounting in Mexico is very much like that in the United States.

Another significant force in international accounting has been the United Kingdom. Almost every former British colony has an accounting profession and financial accounting practices patterned after the UK model. These countries include Australia, New Zealand, Malaysia, Pakistan, India, South Africa and Nigeria. The British did not only export their brand of accounting but also exported many accountants. Most early US accountants also came from Britain, seeking the job opportunities associated with the economic expansion that was occurring in the United States around the turn of the 20th century.

The political and economic ties among nations have forced accounting practices to become more similar. Consequently, this has led to the rise of the International Accounting Standards Committee (IASC) which has become the driving force globally to develop international financial accounting standards and sought for their widest possible acceptance and use. Similarly, the International Federation of Accountants Committee (IFAC), among many other activities, develops and issues international auditing standards which were accepted in 1992 for financial reporting in international financial market.

SELF ASSESSMENT EXERCISE
How did United State influence the accounting development in Canada?

3.4 LEVEL OF INFLATION

Another factor that influences the development of accounting development is the level of inflation. Accounting in many countries is based on the historical cost principle. The principle is based on an assumption that the currency unit used to report financial results is reasonably stable. The historical cost principle holds that originally record transactions at prices when they occurred and make no changes to these prices later on. Generally, historical cost principle affects accounting most significantly in the area of assets values that the company keeps for a long time such as land and buildings. The reasonableness of the historical cost principle varies inversely with the level of inflation.

Germany and Japan hold strictly to historical cost principle because they have historically experienced very little inflation. However, some South American countries, ravaged by inflation problem for years, long age abandoned any attachment to strict historical cost. Companies in these countries routinely write up the values of their assets based on changes in general price levels.

SELF ASSESSMENT EXERCISE
Describe how the level of inflation influences the development of accounting.

3.5 SIZE AND COMPLEXITY OF BUSINESS ENTERPRISES, SOPHISTICATION OF MANAGEMENT AND THE FINANCIAL COMMUNITY, AND GENERAL LEVELS OF EDUCATION

These factors define the limits of a country's accounting sophistication. Larger, more complex business enterprises have more difficult accounting problems. Highly trained accountant are needed to handle these more difficult problems; accounting cannot be highly developed in a country where general education levels are low, unless that country imports accounting talent or sends bright citizens elsewhere for the necessary training. At the same time, the users of a company's financial reports must themselves be sophisticated- or else there will be no demand for sophisticated accounting reports.

Most multinational corporations are headquartered in the wealthy, industrialized nations (e.g Japan, Germany, Great Britain and the United States). These countries have sophisticated accounting systems and highly qualified professional accountants. In contrast, education levels in most developing countries are low and businesses are small. As a result, accounting is primitive. From earlier discussion however, it may occur to you that if accounting responds to information needs, then accounting in developing countries may very well be at an appropriate level of sophistication under the circumstances. While many accountants hold this view, some feel that the lack of sophisticated accounting ability in less developed countries actually impedes their potential for economic progress.

SELF ASSESSMENT EXERCISE
How does size and complexities of business enterprises affect accounting development?

4.0 CONCLUSION

From the foregoing, you would appreciate the fact that accounting development differs from country to country. This is due to the fact that accounting development is very much a function of external finance, legal system, political and economic ties with other countries, and levels of inflation, size and complexity of business enterprises, sophistication of management, the financial community and general levels of education of the country in which the accounting system exists. The objectives of the accounting system are often linked from an historical perspective to goals and objectives of the perceived and users of the financial statements.

5.0 SUMMARY

In this unit, you would recall that we discussed those factors that influence accounting development. One of such factors is external finance, which simply shows the information need that would meet the demand of those that provide the finance. The legal system shows the standard behaviour expected by

the government. Political and economic ties with other countries show the influence on accounting development in a country from other countries due to certain considerations such as proximity of both countries. Another factor is the levels of inflation. Accounting in many countries is based on the historical cost principle and the reasonableness of the historical cost principle varies inversely with the level of inflation. Finally, size and complexity of business enterprises, sophistication of management and the financial community and general levels of education as factors that influence accounting development are all factors that define the limits of a country's accounting sophistication.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss external finance as a factor influencing accounting development.

2. Discuss legal system as a factor influencing accounting development.

3. Discuss political and economic ties with other countries as a factor influencing accounting development.

4. Discuss the levels of inflation as a factor influencing accounting development.

5. Discuss the factors that show the limits of a country's accounting sophistication.

7.0 REFERENCES/FURTHER READING

Bailey, D. (1995)," Accounting in Transition in the Transitional Economy". European Accounting Review 4, no. 4 pp 595 – 623.

Gernon, H. and Meek, G. K. (2001), *Accounting, An International Perspective*, New York: McGraw-Hill Higher Education.

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MODULE 1: INTERNATIONAL ACCOUNTING

UNIT 3: DIVERSITY OF FINANCIAL ACCOUNTING PRACTICES

CONTENT

1.0 INTRODUCTION

In unit 2, we discussed those factors that influence accounting development. However, in this unit, we shall proceed further in discussing the diversity in financial accounting practices.

As business become more international, there is a more pressing need for financial information to be prepared by businesses on a comparable basis. Unfortunately, international financial data are frequently not comparable. The rules of financial accounting often differ from one country to another.

It is important you note that major environmental variables that shape accounting development in a country as discussed in unit 2, is one of the reasons why accounting and financial reporting are not the same everywhere. In addition to that, it is in the light of this unit to give further reasons such as accounting groups which a country belong by adherences to a particular financial accounting models and some existing practices differences. The unit further dealt with the consequences of international accounting diversity.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. List and describe the three accounting models.
2. Discuss some existing financial accounting practice differences using goodwill, income smoothing and asset valuation.
3. Explain the opinion of corporate management, investors, stock markets and regulators and accounting professionals and standard setters regarding international accounting diversity.

3.0 Main Content

3.1 ACCOUNTING GROUPS

Nations can be grouped according to accounting similarities. However, it is important you note that no two countries have identical financial accounting practices. Each country is a unique mixture of environmental variables that together have influenced the pattern of accounting development in that country. Therefore, at a broad level of generation, three major accounting models can be identified. And they are as follows:

British-American Model

The term British-American has been used to describe the accounting approach found in the United Kingdom and the United States. The Dutch approach is quite similar; and to be more precise, one should really call this model British-North American-Dutch. The United Kingdom, the United States and the Netherlands are the trend-setting countries for this accounting group.

Their accounting is oriented towards the decision needs of investors and creditors, and they have large, developed common stock and bond markets where companies raise large amounts of capital. Education levels are very high, and users of financial accounting information tend to be quite sophisticated. These countries also possess many large multinational corporations. Besides the three countries mentioned above, are other countries such as Australia, India, Nigeria, South Africa, Tanzania, Malaysia, and Ghana and so on.

Continental Model

Countries in this accounting group include most of continental Europe and Japan. Businesses here have very close ties to their banks, which supply most capital needs. Financial accounting is legalistic in its orientation, and practices tend to be highly conservative. Accounting is not primarily oriented toward the decision making needs of the capital providers. Instead, it is usually designed to satisfy such government- imposed requirements as computing income taxes or demonstrating compliance with the national government's macroeconomic plan. French speaking African countries follow the continental financial accounting model.

South American Model

The third model includes most countries in South American, with the exception of Brazil, which speaks Portuguese; these nations share a common language-Spanish. They also share a common heritage. What distinguishes the South American model from the British-American and Continental models are the persistent use of accounting adjustments for inflation. These countries have a great deal of experience coping with inflation, and their accounting reflects this. Generally, accounting is oriented towards the needs of government planners, and uniform practices are imposed on business entities. Tax-basis accounting is often used as well for financial reporting purposes.

SELF ASSESSMENT EXERCISE
Explain the British-American Model

3.2 SOME EXISTING PRACTICE DIFFERENCES

Let us discuss some existing practice differences using goodwill, income smoothing and asset valuation.

Goodwill

When a company buys another company, a business division, or some other business enterprises, it typically anticipates greater benefits than the fair market values of the net assets acquired. Perhaps such benefit could be an added team of executives which will bring about major synergy, or maybe certain patents or processes lend themselves to higher profit potential. Whatever the anticipated benefit, to the extent that purchase price exceeds total fair market value, something called goodwill is created.

Considerable diversity exists among countries on whether purchased goodwill should be carried on balance sheets, and if so, whether it should be amortized. Three main methods have emerged:

1. Capitalization without amortization- under this method, goodwill is recognized as an asset with an indefinite life. Thus, it remains on the balance sheet.

2. Capitalization with amortization- here, goodwill is recognised as an asset with a finite life. It is written off over time either to income (which reduces annual income) or to equity (which does not reduce annual income). The shorter the life, the greater the write-off.

3. Immediate write-off- instead of capitalizing, goodwill is written off at acquisition. Typically, it is written off to equity, which leaves annual income unaffected.

The goodwill accounting diversity is aggravated by a taxation effect. For instance, goodwill amortization is not tax deductible in the United Kingdom or the Netherland, but it is deductible in Canada, Japan, Germany (post-1986), and the United States (post-1993). The diversity involved affects business practices and therefore global competitiveness. If a company can permanently shield its income statements from goodwill amortization, it will report comparatively higher net earnings and thereby may gain a competitive advantage.

Income Smoothing

Managers of most companies like to present a smooth income pattern from one year to another, preferably a pattern with steady, predictable annual increases. A volatile income pattern normally suggest a company with higher risk of operations, which often leads to lower investor confidence and higher costs of obtaining financing. Smooth income normally means the opposite: less risk, greater investor confidence and lower financing costs.

The opportunities allowed by Generally Accepted Accounting Practices (GAAP) to smooth income vary greatly around the world. The GAAP of some countries for example, the United States, allow little flexibility for income smoothing. By contrast the practice is a notable feature of German and Swiss

accounting. Here, GAAP have built in flexibility that managers routinely take advantage of. The GAAP of still other countries actually encourage income smoothing by companies as a way to stimulate a long-term view of companies' operations and to encourage overall confidence in the nation's economy.

The focus of this section however, is on the quite legitimate use of accounting principles to shift income from one year to the next. Particularly, let us consider the use of provisions and reserves as income smoothing devices. One way is to judiciously choose the amounts of provisions that achieve the desired net income for the year. Or one might even omit a provision if "necessary" in some year. However, reserves can also be "drawn down" in particularly bad years to increase income. In other words, a reserve is decreased and a negative provision recorded in order to increase income.

Some observers argue that the use of provisions and reserves deceives financial statement readers while this is arguably possible, it is important to bear in mind that, as discussed here, the practice is a legitimate application of a nation's GAAP, allowed or even encouraged in certain countries. Whether things are kept secret will also depend on what the country's GAAP requires companies to reveal. In addition, income smoothing opportunities are often tied to a nation's income tax laws. In general, income smoothing is more often practiced in code law countries where financial accounting and taxation are strongly linked.

Asset Valuation

Financial accounting in most countries is based in part on the historical cost principle. This principle is based on the assumption that the currency unit used to report financial results is reasonably stable- that is, there is little or no inflation. Consequently, strict historical cost accounting does not recognise the effects of inflation or other price changes. However, severe inflation is a potential force that can strain the historical cost principle. The reasonableness of the historical cost principle varies inversely with the severity of price changes.

There are two basic approaches to accounting for changing prices. They are general purchasing power (GPP) and current cost accounting (CCA). The GPP uniformly changes the values of assets and liabilities to reflect the general change in the currency unit's purchasing power. While transactions are initially record at their historical costs, they are later notched up or down by changes in the currency' general purchasing power. Consequently, the items on the balance sheet and income statement are reported in units of the same purchasing power.

GPP is most often associated with Latin America. These countries have contended with high inflation rates for a long time and as a result, accounting for changing prices is an issue too serious for their accountants to ignore. Bolivia, Chile and Mexico require companies to comprehensively restate their financials on the basis of changes in general purchasing power. Several others require that fixed assets be revalue at certain intervals for changes in the price level.

The CCA changes the historical costs of assets to their current values and recognizes corresponding expenses at the current cost of obtaining the services represented by those expenses. Many accountants first think of the Netherlands when CCA is mentioned. That is because Dutch accountants

have devoted more attention to it over longer period of time than accountants in other countries. Accounting in the Netherlands is heavenly influenced by business economics (or microeconomics). A fundamental notion in business economics is that the input values of a company' goods and services must be less than their selling prices in order to make profit, hence, ensure survival. Use of current values is thought to best accomplish this, while at the same time preserving the amounts permanently invested in the business firm.

Some countries adapt a piecemeal approach. Many countries allow the selective use of CCA. This means that only some assets are revalue to current market values and that such revaluations are done at management's discretion.

SELF ASSESSMENT EXERCISE
What are the various perspectives of treating purchased goodwill?

3.3 CONSEQUENCES OF INTERNATIONAL ACCOUNTING DIVERSITY

We could see that there are evidences available to conclude resolutely that GAAP differ from country to country. Whether this is good or bad depends on the points of view of a variety of interest groups such as corporate management, investors, stock markets and regulators, and accounting professionals and standard setters. Let us discuss their various opinions about accounting diversity.

Corporate Management

Managers of companies with strictly domestic operations care little about accounting diversity. As long as national GAAP are relatively clear, useful and broadly applied, most medium sized and small companies feel well served by the accounting rules they have to contend with. The multinational companies (MNCs) see it differently. They face global competition every day and sense that accounting diversity affects competitiveness. The MNCs like "level playing fields" for their global operations. Working with many different national GAAP requirements is an expensive proposition. Companies must be careful to communicate effectively with their foreign shareholders.

Investors

Portfolio investors and their agents, financial analysts, probably dislike international accounting diversity the most. Underwriters consistently report that worldwide accounting diversity causes some underwriting (i.e pricing of new securities issues) difficulties. If investors, analysts and underwriters indeed experience difficulties with GAAP diversity, financial markets are not as efficient as they could be and therefore returns to investors are less than they ought to be. This is a powerful indictment on GAAP diversity.

Stock Markets and Regulators

Stock markets and regulators have twin goals of investor protection and market quality. To protect investors, most stock markets (along with professional or governmental regulatory agencies) require listed companies to disclose sufficient information so that investors can assess their past performance

and future prospect. Market quality is achieved by fair and efficient trading and by the availability of investment opportunities for market participants. Stock markets and regulators interpret these goals differently around the world. For example, accounting and disclosure requirements for listing shares vary extensively. Research shows that MNCs consider these requirements to be an important cost when they choose where to list their common stock shares. Indeed, MNCs are less likely to choose stock exchanges that require them to make extensive new disclosures over and above those that they are already making at home.

The United States has the most extensive accounting and disclosure requirements in the world. The US Securities and Exchange Commission (SEC) is the regulatory agency responsible for these requirements. The SEC believes that investors are better protected when there is a "level playing field", that is, when comparable accounting information is provided by US and non-US companies alike. Nevertheless, non-US companies allege that they avoid listing in the United States because they find US requirement too onerous. If that is true, then US citizens are deprived easy access to buying shares in these companies, and the US capital market may become less competitive globally.

Accounting Professionals and Standard Setters

Some have suggested that accounting professionals like diversity because it generates fees for them all the way from assisting in setting up new business units for their clients in different GAAP territories to restating financial reports from one set of GAAP to another. GAAP diversity also makes cross-border auditing more costly and therefore raises auditing fees. Even though not demonstrated by realisable research, it stands to reason that at least some accosting professionals gain from the GAAP diversity factor.

Accounting standard setters, as guardians of public interest, would like to have full authority over all GAAP and financial reporting of companies whose securities are publicly held or whose size is so large that the public interest is affected. But regulations are primarily enforced through national laws and national legal systems. Therefore, a national focus is inevitable for accounting regulation- at least for the time being. Moreover, national regulators want discretion over national GAAP. International or any other GAAP are beyond their reach of influence and hence unacceptable.

4.0 CONCLUSION

Worldwide diversity in financial accounting and reporting exists. Some reasons have been put forward to explain this diversity. In some cases, the diversity among national GAAP is significant; in others it is not. There are some winners and some losers as a result of the diversity condition. When diversity reaches the point of misinformation, it becomes dysfunctional. National environmental factors together with national laws and national accounting standard setting systems will make some degree of GAAP diversity inevitable. However, in domestic terms, national GAAP have reduced practice diversity. A similar degree of diversity reduction may be desirable on the international level. Harmonization of accounting practices is aimed at such reduction.

5.0 SUMMARY

In this unit, we discussed the diversity in financial accounting practices. This was discussed in three sub-units which are accounting groups, some existing practice differences and consequences of international accounting diversity. Accounting groups and some existing practice differences are further reasons for diversity in financial accounting practices while consequences of international accounting diversity explains the opinion of various stakeholders about the presence of accounting diversity.

6.0 TUTOR MARKED ASSIGNMENT

1. List and describe the three accounting models.

2. Discuss some existing practice differences using goodwill.

3. Explain the position of corporate management and investors on the acceptability of international accounting diversity.

7.0 REFERENCES/FURTHER READING

Alexander, D. , and Archer, S. (1998), *European Accounting Guide*, San Diego: Harcourt Brace.

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 1: PROMOTION OF INTERNATIONAL ACCOUNTING HARMONIZATION

CONTENT

1.0 INTRODUCTION

National environmental factors together with national laws and national accounting standard setting systems will make some degree of GAAP diversity inevitable. But when diversity reaches the point of misinformation, it becomes dysfunctional. Therefore, some degree of diversity reduction should be desirable at the international level.

In the previous unit, we discussed diversity in financial accounting practices. In this unit, we shall step further by discussing promotion of international accounting harmonization. Harmonizing accounting standards internationally will improve the comparability of accounting information around the world and thereby eliminate one source of misunderstanding in transnational financial reporting. It is in the light of this unit to discuss the relationship of accounting and auditing standards and the benefits and barriers of accounting harmonization.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain the purposes of accounting and auditing standards and how they are related.
2. List and explain the benefits of accounting harmonization.
3. List and explain the barriers to accounting harmonization

3.0 MAIN CONTENT

3.1 ACCOUNTING AND AUDITING STANDARDS

In this sub-unit, we shall discuss the relationship between accounting and auditing standards. Accounting standards are the rules for preparing financial statements: that is the "generally accepted accounting principles" (GAAP) that specify the type of information that financial statements ought to contain and how that information ought to be prepared. Accounting standards define what is acceptable and unacceptable financial accounting practices.

Auditing standards are the rules governing how an audit is performed. An audit of financial statements is the technical process by which an independent person (the auditor) gathers evidence to form an opinion about how well a set of financial statements conforms to GAAP. In most countries, a particular group of accountants is legally empowered to conduct financial statements audits. In the United States, for example, it is the certified public accountant (CPA). In the United Kingdom, it is the chartered accountants. In the Netherlands, it is the register accountant. In Germany, it is the wirtschafts prufer. In Nigeria, it is mainly the chartered accountants. Financial statements conforming to GAAP are said to be 'reliable' and reliable information is an important ingredient in good decision making.

Accounting standards and auditing standards are interrelated. Accounting standards presumably define what useful financial information is. Auditing standards guide an auditor in determining whether it is also reliable. Useful and reliable financial information puts investors, creditors and others in a position to make better decisions. Accounting has been called the language of business. That analogy is accurate, since accounting is a form of communication. As with all types of communication, though, misunderstanding can arise unless meanings are reasonably clear.

To minimize the possibility of misunderstanding financial communications, approximately 50 countries have created their own national financial accounting standard setting mechanisms. This has harmonized

financial accounting diversity within countries. Unfortunately, international diversity continues to exist. This diversity results in a general lack of comparability in financial reports from one country to the next. As a result, there is a risk of misunderstanding when financial statements are communicated transnational.

The problem of different auditing standard is more subtle. Fundamentally, an audit assures users that they can trust the information communicated by the financial statements. However, if auditors around the world are not comparably trained or if they do not observe comparable standards, then their work varies in quality. Consequently, the inherent reliability of financial statements also varies.

SELF ASSESSMENT EXERCISE
What is an auditing standard?

3.2 BENEFITS OF ACCOUNTING HARMONIZATION

Having explored diversity in financial accounting practices, we can better appreciate the benefits that can be obtained from harmonization. The following can be obtained as benefit from harmonization.

1. Uniform financial reporting- it is the goal of harmonization to give the same financial reporting treatment for like transactions and event by different enterprises in different countries.

2. Coverage for diversities- harmonization accommodates differences in accounting treatment for different transactions and events.

3. Platform for comparison- accounting harmonization provides a level playing field of comparable information on cross-country company comparison to enable investors or creditors make accurate business decision.

4. Standard for regulators- accounting harmonization obligates regulators to ensure that they fulfil their responsibility of providing comparable information to their domestic investors.

5. International transparency- accounting harmonization encourages capital market to be open, fair and transparent in order to attract international investors and creditors.

SELF ASSESSMENT EXERCISE
Outline the benefit of harmonization.

3.3 BARRIERS TO ACCOUNTING HARMONIZATION

There are many barriers in the global environment that make harmonization difficult to achieve. Let us discuss some of such barriers in this sub-unit.

1. Nationalism and pride- each nation’s nationalism and pride can serve as barrier to accounting harmonization. It will be difficult to get a country’s standard setters to accept alternative principles when they clearly believe that the standards they have developed provide the best information from their national perspective. Countries’ standard setters have different

objectives and users. For instance, the primary objective of financial reporting in the United States is to meet the need of shareholders, while in Germany the creditors' perspective is the main concern of the financial reporting process. Finally, a country's legal tradition also influences its perspective. The United Kingdom has a common-law tradition, so it naturally prefers more flexibility and less codification in its standards. Germany has a Roman law tradition, which emphasizes stricter interpretation of the rules.

2. Costs- there are a number of costs in achieving harmonization. The level of costs to be incurred depends upon the manner in which harmonization is achieved. If harmonization is achieved by developing a loose, flexible framework into which a country's accounting standards fit, the costs would be far less than if a specific, rigid set of accounting standards were imposed uniformly on all companies in all countries.

3. Difficulty- harmonization is achieved through reconciliation to an agreed benchmark such as International Accounting Standards (IAS) or U.S GAAP. With the exception of IAS, at the event of resolving accounting issues, it is required to determine the country's accounting profession or standard setters that have the standing to resolve the accounting issues. This is obviously a difficult task to manage given the rate of change in various countries' GAAP.

SELF ASSESSMENT EXERCISE

What are the barriers to accounting harmonization?

4.0 CONCLUSION

The goal of international harmonization of accounting and auditing has been widely accepted. The reason is the globalization of capital markets and the large number of companies listing their shares on "foreign" stock exchanges. Diverse accounting practices used to represent the same reality make little sense as investors everywhere seek comparable financial reporting from companies, no matter where they come from. The debate has moved on from whether harmonization is desirable or practical to how best to achieve it.

5.0 SUMMARY

In this unit, you would recall that we discussed the relationship between accounting and auditing standards, the benefits of accounting harmonization and the barriers of accounting harmonization. Accounting standards are the rules for preparing financial statements. Auditing standards are the rules governing how an audit is performed. The benefits of accounting harmonization include uniform financial reporting, coverage for diversities, platform for comparison, standard for regulators and international transparency. The barriers to accounting harmonization include nationalism and pride, costs and difficulty.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the relationship between accounting standards and auditing standards.

2. List and explain four benefits of accounting harmonization.

3. List and explain three barriers to accounting harmonization.

7.0 REFERENCES/FURTHER READING

McGregor, W. (1999), "An Insider's View of the Current State and Future of International Accounting Standard Setting". Accounting Horizons, pp 159 – 168.

Saudagaran, S. M., and Diga, J. G. (1998), "Accounting Harmonization in ASEAN: Benefits, Models and Policy Issues". Journal of International Accounting Auditing & Taxation 7, pp 21 – 45.

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 2: INTERNATIONAL ACCOUNTING STANDARD COMMITTEE (IASC)

CONTENT

6.0 Tutor Marked Assignment

7.0 References/Further Reading

1.0 INTRODUCTION

The use of financial statements as a medium of communication by companies has been steadily increasing. It is now widely recognised that they are a prime source of information for investors, employee groups, government agencies and many other bodies.

Investors in international markets need to be sure that the information on which they base their assessment is compiled using accounting principles recognised in their own country and comparable with others regardless of the country of origin. Interest groups such as employees, government agencies and regulatory bodies will only find financial statements acceptable if they are based on standards which are relevant, balanced and internationally comparable.

International Accounting Standards are the rules for preparing financial statements. That is, the "generally accepted accounting principles" that specify the type of information that financial statements ought to contain and how that information ought to be prepared for worldwide acceptance.

The International Accounting Standards Committee which founded in 1973 has till date issued 39 IAS. Many of the professional accountancy bodies that are members of IASC have published the texts of international accounting standards in their own countries. Such publications usually include national prefaces or other material that explains the application of international accounting standards in the country concerned. Copies of these publications are available from the appropriate accountancy body. In addition, various professional accountancy bodies have prepared and published translations of IAS.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. State the objectives of IASC.
2. State the obligations member countries of IASC are expected to do to support the objectives of IASC.
3. List and discuss the operating structure of IASC.
4. Describe the operating procedures of IASC for setting up accounting standards.

3.0 MAIN CONTENT

3.1 PURPOSE AND OBJECTIVES OF INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

The International Accounting Standards Committee came into existence on 29th June, 1973 as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United States, United Kingdom and Ireland. A revised agreement and constitution were signed in November 1982. The business of IASC is conducted by a Board comprising representatives of up to thirteen countries and up to four organizations having an interest in financial reporting.

The objectives of IASC as set out in its constitution are:

a. To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance and

b. To work generally for the improvement and harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements.

The relationship between IASC and the International Federation of Accountants (IFAC) is confirmed by the mutual commitments into which they have entered. The membership of IASC (which is the same as IFAC) acknowledges in the revised agreement that IASC has full and complete autonomy in the setting and issue of International Accounting Standards (IAS). The members agree to support the objectives of IASC by undertaking the following obligations to support the work of IASC by publishing in their respective countries every international accounting standard approved for issue by the Board of IASC and by using their best endeavours:

1. To ensure that published financial statements comply with international accounting standards in all material respects and disclose the fact of such compliance.

2. To persuade governments and standards setting bodies that published financial statements should comply with international accounting standards in all material respects.

3. To persuade authorities controlling securities markets and the industrial and business community that published financial statements should comply with international accounting standards in all material respects and disclose the fact of such compliance.

4. To ensure that the auditors satisfy themselves that the financial statements comply with international accounting standards in all material respects.

5. To foster acceptance and observance of international accounting standards internationally.

SELF ASSESSMENT EXERCISE
What are the objectives of IASC as set out in the constitution?

3.2 OPERATING STRUCTURE OF IASC

IASC recognises the need to be fully representative and has accordingly made a number of important changes to its structure.

1. The IASC Board

   The business of IASC is conducted by the Board assisted by a full-time secretariat. The professional accountancy bodies in thirteen countries are now represented on the Board. It is IASC policy that appointments to the Board will preferably include a minimum of three developing countries. The constitution of IASC provides for up to four international organizations which have an interest in financial reporting to be represented on the Board.

2. The Consultative Group

   International organizations representing many of the principal preparers and users of financial statements participate in the consultative group. The consultative group meets regularly with the IASC Board, enabling group members to discuss matters of principle and policy arising from IASC's work, and the practical and conceptual issues which affect the acceptability of international accounting standards.

3. Steering Committee

   Steering committees are formed to consider the issue relating to a particular accounting topic. They comprise four members of which at least one is a board member and whenever possible, one is a representative of a developing country. Member bodies not on the IASC Board are invited to participate in steering committees, the costs of which are borne by IASC.

4. Liaison with national standard setting bodies

   To be fully aware of the difficulties facing individual national standard-setting bodies, IASC believes close liaison is required. The primary points of contact are through the Board representative or the professional accountancy body in the member country. In addition, the national standard setting bodies are visited by IASC delegations to discuss the various problems of implementation and harmonization of standards.

SELF ASSESSMENT EXERCISE
State and explain the structure of IASC.

3.3 OPERATING PROCEDURES OF IASC

The process of exposure and comment is essential to the success of IASC. As well as providing preparers, auditors and users of financial statements with the opportunity to express their view on the accounting standards to be adopted. It is also essential to the maintenance of the quality of international accounting standards.

The procedure of exposure and comment is as follows:

a. The IASC Board selects a topic that is felt to need an international accounting standard and assigns it to a steering committee. All IASC member bodies are invited to submit material for consideration.

b. The steering committee, assisted by the IASC secretariat, considers the issues involved and presents a point outline on the subject to the Board.

c. The steering committee receives the comments of the Board and prepares a preliminary draft of the proposed standard or a statement of principles.

d. Following review by the Board, the draft or statement is circulated to all member bodies for their comments.

e. The steering committee prepares a revised draft, which after approval by at least two-thirds of the Board, is published as an Exposure draft. Comments are invited from all interested parties.

f. At each stage in the consideration drafts, member bodies refer for guidance to the appropriate accounting research committees in their own organizations.

g. At the end of the exposure period (usually six months) comments are submitted to IASC and are considered by the steering committee responsible for the project.

h. The steering committee then submits a revised draft to the Board for approval as an international accounting standard.

i. The issue of a standard requires approval by at least three-quarters of the Board, after which the approved text of the standard is sent to all member bodies for translation and publication.

The above process takes approximately three years. During the process, the IASC Board may decide that the needs of the subject under consideration would be better served by issuing a discussion paper for comments. The intention of such a paper may be to promote discussion of a topic that is not yet ready for an international accounting standard, or to ensure that adequate time is allowed for a full discussion of the various points of view on a complex accounting subject. The monitoring of views and needs on a subject does not stop when an international accounting standard is issued. IASC constantly reviews the effectiveness of its standards both in terms of practical compliance and of the need for updating. From time to time, IASC revises document to take into account the current position.

SELF ASSESSMENT EXERCISE

Outline the procedure of exposure and comment to the success of IASC.

4.0 CONCLUSION

The IASC or the accountancy profession does not have the power to enforce international agreement or to require compliance with international accounting standards. The success of IASC's effort is dependent upon recognition and support for its work from many different interested groups acting within the limits of their own jurisdiction. Recognition of IASC's work comes from groups such as the international bodies

representing financial institutions, financial executives, trade unions, employers, stock exchanges, lawyers, securities commissions and financial analysts involved in the Board and consultative group. Others include the United Nations (UN), the Organization for Economic Cooperation and Development (OECD) and the International Federation of Accountants.

5.0 SUMMARY

In this unit, you would recall that we discussed International Accounting Standards Committee. We discussed the IASC from three perspectives. First, we looked at the purpose and objectives of IASC which discussed the historical background and objectives of IASC considering the relationship with IFAC. Second, the operating structure of IASC which shows; the IASC Board, the consultative group, the steering committee and liaison with national standard-setting bodies. And finally, the operating procedure of IASC which shows how the IAS is developed and approved for use.

6.0 TUTOR MARKED ASSIGNMENT

1. State the objectives of IASC.

2. State the obligations member countries of IASC are expected to do to support the objectives of IASC.

3. List and discuss the operating structure of IASC for setting up standard.

7.0 REFERENCES/FURTHER READING

McGregor, W. (1999), "An Insider's View of the Current State and Future of International Accounting Standard Setting". Accounting Horizons, pp 159 – 168.

Saudagaran, S. M., and Diga, J. G. (1998), "Accounting Harmonization in ASEAN: Benefits, Models and Policy Issues". Journal of International Accounting Auditing & Taxation 7, pp 21 – 45.

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 3: FINANCIAL REPORTING IN THE INTERNATIONAL ENVIRONMENT

CONTENT

1.0 INTRODUCTION

In our previous unit, we discussed the attempt made to harmonize accounting standard by establishing the International Accounting Standard Committee. Let us take it further by discussing financial reporting in the international environment.

Financial accounting practices in a country are determined by a number of environmental variables that interact in a complex way as discussed in unit 2 of this course material.

Companies prepare the financial statements in their annual report, directed towards the needs of their primary users. Financial statement not only looks different but report different information depending on the primary user group. Moreover, even if companies in different nations orient their financial statements toward similar user groups, there are still likely to be differences in accounting practices and in the way that the annual reports appear.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define transnational financial reporting and explain what has caused the phenomenon.

2. Discuss problems confronting users of foreign financial statements.

3. State and explain what multinational corporations do to accommodate foreign readers of their financial reports.

3.0 Main Content

3.1 TRANSNATIONAL FINANCIAL REPORTING

Transnational financial reporting refers to reporting across national boundaries or more specifically, reporting financial results to users groups located in a country other than the one where the company has its headquarters. A Nigeria company is engaged in transnational financial reporting whenever it sends an annual report to a citizen of another country. If you write to a German company and receive its annual report, transnational financial reporting has occurred.

Transnational financial reporting has been encouraged by two phenomena. The first may be termed the global financing strategies of multinational corporations. Global financing includes:

1. Listing a company's capital stock on stock exchanges outside the home country.

2. Selling bonds in various countries, and

3. Arranging for loans with foreign banks.

Multinational corporations no longer look exclusively to the stock markets, bond markets and banks of their respective home countries to raise capital. They go wherever the money is most available and cheapest.

The second phenomenon is transnational investing. Those with funds to invest buy the stocks and bonds of foreign companies in addition to those in their own nation. Thus, the multinational corporation and the shareholders/creditors are responsible for this twin phenomenon.

SELF ASSESSMENT EXERCISE
What is transnational financial reporting?

3.2 INVESTORS PERSPECTIVE OF FOREIGN FINANCIAL REPORT

When a company prepares a financial report for users in its own country, it can reasonably assume that the users understand

1. The general orientation of financial accounting in that country.

2. The particular accounting practices that the company employs.

3. The language in which the annual report is written and

4. The currency unit used to present the financial statements.

However, any or all of these four items may be different when a company sends a financial report to users in another country. Suppose that a friend of yours suggests that you should invest in a company in Germany. In looking at the financial statements, you also notice that all of the amounts are expressed in deutsche marks (DM). The report looks different from Nigeria companies' reports, so you may also suspect that the company uses German accounting practices. Unless you can read German, know German accounting practices, and are familiar with German currency, you will probably have a difficult time understanding that company's annual report. Consequently, you may decide not to invest in that company since it would be "too much trouble" to extract the information you need from the annual report. You may very well pass up a good investment opportunity, although you will never know it. Of course, you may also take other courses of action. One would be to get someone to translate the report into English, while you learn all you can about German accounting practices. At a minimum, this choice would be time-consuming and even cost you money if you had to pay someone for the translation. And having done this, the accounting information would still not be directly comparable to that of a Nigeria company. In most cases, it is impossible for a user to restate financial accounting information so that it conforms to the accounting practices of another country.

Another course of action is to forgo trying to understand the company's annual report and instead rely on the advice of an expert, such as a stockbroker. Many accountants are concerned about the effects that an unfamiliar language, monetary unit, and accounting practices may have on investors and creditors. They fear that resource allocation decisions may be based on misunderstanding and as a result, that these decisions may not be optimal. This is one reason why accountants are trying to harmonize accounting practices around the world.

SELF ASSESSMENT EXERCISE

When a company prepares a financial report for users in its own country, what can reasonably be assumed that the users should understand?

3.3 PRESENTATION OF FINANCIAL REPORTS BY MULTINATIONAL CORPORATIONS

Multinational corporations have a role to play in trying to minimize misunderstanding of financial statements sent to users in foreign countries. We can classify five approaches that multinational corporations take to accommodate foreign readers of their financial reports:

1. No action approach.
2. Prepare convenience translations.
3. Prepare convenience statements.
4. Restate on a limited basis.
5. Prepare secondary financial statements.

No Action Approach

A corporation sends the same financial statements to the foreign user. The financial statements are written in the native language and use the native currency unit and accounting principles. This approach puts the entire burden of understanding the financial report on the user, and it more or less assumes that the report for readers at home is useful to readers in other countries as well.

Why would a corporation choose to seemingly ignore the information needs of its foreign readers? First of all, if the company raises very little capital outside the borders of its home country, the added expense of taking one of the other four approaches may not be worthwhile. Second, some multinationals are able to entice international investment in their securities even though they leave their financial statements in their original form. One way they accomplish this is by selling large blocks of their securities directly to sophisticated overseas investors, such as pension funds (such sales are called private placements) or they may meet directly with investment firms to encourage the firms to recommend investments in their securities. Large investment firms, especially, employ analysts who are skilled at interpreting financial statements in their original form. Either way, these multinational corporations attempt to attract foreign investors without incurring the extra costs associated with the other forms of transnational financial reporting. A third reason why a multinational corporation may choose to do nothing is that the language, currency unit, and accounting principles of its home country are well known and understood around the world.

Prepare Convenience Translations

Convenience translations are financial statements translated into the foreign reader's language. They retain the home country's accounting principles and currency unit. This approach is relatively inexpensive accommodation to the foreign readership. Companies taking this approach typically prepare English, French, Germany and perhaps, Spanish language versions (as appropriate) of their annual reports. The user is saved the bother of dealing with an unfamiliar language but must still understand another country's accounting practices and monetary unit. Companies usually prepare convenience translations in order to enlarge the scope of shareholders/creditor's interest beyond the borders of their home country, and they are a low-cost alternative to the no-action approach. For this reason, convenience translations are also commonly used with private placements or to attract the attention of foreign investment firms.

Prepare Convenience Statements

This approach takes convenience translation one step further. Not only are the financial statements translated into the language of the foreign readers, the monetary amounts are also expressed in the reader's currency. However, the accounting principles of the home country are still used to prepare the financial reports. An exchange rate is simply how much of one currency it takes to buy so much of another currency.

Convenience statements often lose much of their foreign appearance, and unless users realize that another country's accounting principles are used, they will be misled into thinking that the financial statements can be directly compared to those of companies of their home country. Naturally, readers can comprehend their own language and currency better than those of another country, but they must

still be able to understand the accounting practices used in the company's home country in order to derive actual meaning from the annual report.

Restate on a Limited Basis

This approach represents a significant step toward accommodating the information needs of foreign readers compared to the first three. Normally, a company reconciles the net income amount shown on its income statement (prepared using its home-country accounting principle) to a net income amount based on the accounting principles of the reader's country, and often the company restates the balance sheet figures as well. However, sometimes a company restates only selected financial statement items. The annual report is typically written in the reader's language, but the currency is still that of the company's country.

Companies adopting this approach feel a clear need to communicate with their foreign annual report users. If a significant number of shareholders or creditors is located in other countries and if the company's accounting practices diverge significantly from those found in the reader's country, then the need is real. Companies following this approach must keep more than one set of accounting records. Fortunately, computerized accounting systems can significantly reduce the cost and convenience of this approach.

Prepare Secondary Financial Statements

This approach represents a further accommodation to the users of a company's financial statements. Companies continue to prepare their primary financial statements for the home user with the home country's language currency, and accounting principles. For foreign readers, however the company completely restates its financial report to conform to another set of accounting standards.

In practice, the other set of accounting standards used most often is either the generally accepted accounting principles of the United States or the standards of the International Accounting Standards Committee are the most detailed and extensive in the world and they are generally regarded as "world class" in quality. Consequently, many multinationals choose US GAAP when they prepare their secondary financial statements. However, the IASC is increasingly accepted as the voice for acceptable world-wide accounting standards. Secondary financial statements are meant for sophisticated worldwide users. What makes a company go so much trouble to accommodate the foreign reader? As with the previous approaches, it all comes down to whether the perceived benefits exceed the cost. Multinationals preparing secondary financial statements are normally from countries where accounting is legalistic in its orientation. For them, the fair presentation/full disclosure model of accounting with its emphasis on presenting useful information to shareholders and creditors is more likely to attract widespread international investment than is their home country's legal compliance model of accounting.

SELF ASSESSMENT EXERCISE

Mention and explain five approaches that multinational corporation take to accommodate foreign readers of their financial reports.

4.0 CONCLUSION

It should be noted that financial practice and business decision making differ around the world, and readers of foreign financial statements must understand how the business environment in a corporation's home country affects the firm's financial reports. This is especially critical if the user is comparing the accounting numbers of companies from different cultures.

One devise used to analyze financial reports is ratio analysis. Ratios of key items on the financial statements are calculated to determine such things as riskiness, ability to pay off debts and profitability.

5.0 SUMMARY

In this unit, we were able to define transnational financial reporting and what has caused the phenomenon. We discussed investors' perspective of foreign financial report and the presentation of financial report by multinational corporations. We have discussed the problems confronted by financial statement users when they are provided information that is not in their native language, their native currency or prepared according to accustomed accounting principles. We have also discussed what corporations do to help foreign financial statement users overcome these problems.

6.0 TUTOR MARKED ASSIGNMENT

1. Define transnational financial reporting and explain what has caused this phenomenon.

2. What are the problems confronting users of foreign financial statements.

3. State and explain three steps multinational corporations take to accommodate foreign readers of their financial reports.

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 4: GLOBAL ASSESSMENT OF DISCLOSURE PRACTICES

CONTENT

1.0 INTRODUCTION

The term disclosure in its broadest sense encompasses the release of any piece of information about a particular company. It includes everything contained in the company's annual report, press releases, newspapers and magazine stories and so on. However, this unit is more narrowly focused. It is about disclosure contained in annual report information besides that in the main financial statements- the balance sheet, income statement and statement of cash flows.

Measurement issues are concerned with how financial statements should be prepared and how assets and liabilities are to be valued. On the other hand, disclosure issues relate to the information in an annual report that supplements the financial statements.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Distinguish between financial and nonfinancial disclosure.

2. Explain the bases used for ensuring disclosure.

3. Discuss the following:

    d. Segment disclosure

    e. Financial forecast disclosures

    f. Information about shares and shareholders disclosure

3.0 MAIN CONTENT

3.1 FINANCIAL AND NONFINANCIAL DISCLOSURE

Disclosure in financial reports is often classified as either financial or nonfinancial. Financial disclosures consist of those items of information quantifiable in monetary amounts (naira, for Nigeria companies). For example, companies often report one figure for stock on the balance sheet but show in the notes to the account, how much of that is finished goods, how much is raw materials and so on. A company may show one amount for property in the balance sheet and reveal in a note to the account, how much is located in Nigeria or the home country and how much is located outside the home country and so on.

When a company signs a long-term contract obligating it to rent property for a number of years, that obligation does not fit the definition of a liability and therefore will not appear on the balance sheet. However, because cash has been committed for future years, much like the commitments that are considered liabilities, companies generally show lease obligations in the notes to the accounts. Similarly, if a company is a defendant in lawsuit, it wants shareholders to know the amounts of potential damages it may be liable for. The case may not have progressed for enough in the courts for the defendant to know whether it will actually have to pay damages. And so, in the meantime, it reveals in the notes to the accounts the general circumstances surrounding the lawsuit. These are all types of financial disclosure seen in financial statements.

Nonfinancial disclosure is either

1. Narrative descriptions, facts or opinions that do not readily lend themselves to quantification in monetary terms e.g a company's mission statement.

2. Items of information quantified in something other than money e.g data about the number of employees located in each country. Labour cost per country is a financial disclosure but number of employees is nonfinancial disclosure.

Nonfinancial disclosures may be just another way to express things that are already expressed monetarily in the financial statements. Most of the information that accountants provide is financial-financial statements and financial disclosures. However, not everything can be expressed monetarily, and nonfinancial disclosure can be very important.

SELF ASSESSMENT EXERCISE

What do you understand by financial and non-financial disclosure?

3.2 BASES OF DISTINGUISHING DISCLOSURE

Disclosures can also be distinguished based on whether they are required or suggested, or whether they are voluntary. While most countries require certain disclosures to be made by companies operating within their borders, the amount of disclosure required varies by country. Often the GAAP of a particular country will also suggest items to be disclosed in companies' annual reports. Many companies, though, disclose information that is neither required nor suggested; that is, some disclosures are completely voluntary. Disclosure that are required or suggested in one country may be voluntary in another, vice versa.

The fact that companies sometimes disclose more than they have to, suggests that they perceive some advantages in doing so. In particular, it appears that the worldwide competition for investment funds is the most important force propelling increased levels of disclosure by multinational corporations (MNCs). MNCs significantly increase disclosure whenever they seek major amounts of new funds.

Disclosure can also enlarge the scope of interest in a company by expanding the annual report's audience. After all, the annual report is the major medium of getting people interested in what the company is doing. Disclosure enables the firm to maintain the primary orientation of its financial statements and provide information of interest to other parties as well.

Disclosure can overcome differences in generally accepted accounting principles. Until a worldwide harmonization of accounting practices is achieved, disclosure can be effective mechanism for overcoming these problems.

Deciding what and what not to disclose is not always an easy decision for corporate management to make. If they decide not to disclose an item of information, in a very real sense, they have chosen to keep something secret from financial statements users. Many things, of course, are simply irrelevant to users of financial statements. But for many items of information, managements must use judgment to decide on their usefulness to financial statement readers. If too much information is disclosed, a reader can easily get lost. So, management need a way to pare down the amount of information revealed in financial statements.

Disclosure is a substantive issue, since information revealed can potentially affect people's decisions and actions. Unrevealed information does not have that potential. When GAAP requires a disclosure, this is tantamount to saying that the information is potentially significantly enough to affect decision and therefore, ought to be revealed. A suggested disclosure or a voluntary disclosure should be made whenever knowledge of that information has the potential to influence the decisions of financial statement users.

SELF ASSESSMENT EXERCISE

Disclosure is a substantive issue. Explain.

3.3 DISCLOSURE WITH INTERNATIONAL PERSPECTIVE

What, how much and how a company discloses supplemental information varies depending on

1. The requirements of generally accepted accounting principles.
2. The needs of users.
3. The influence of users.
4. The philosophy of management.

This sub-unit would aimed at discussing certain examples of disclosure from an international perspective which are as follows

1. Segment disclosures

   Consolidated financial statements combine the separate financial statements of a parent company and its subsidiaries so that a single set of financial statements is issued for the entire economic entity. The argument is that for a multinational corporation operating in a number of different product lines, consolidated financial statements may in fact hide some important information. If a company's continued profitability depends heavily on a certain region of the world or on a particular product, knowledge of that may be useful to shareholders, creditors, employees and other financial statement users. Thus, in addition to consolidated financial statements, perhaps companies should be more detail about where and how total profits are derived.

2. Financial Forecast Disclosures

   Given that a primary concern of investors is assessing a company's future profitability and cash flows, it is reasonable to ask whether companies provide their own internal forecasts of such financial information. Financial forecasts would seem to be relevant information for investors. In practice, few MNCs provide them. One reason is that forecasts can be unreliable because they incorporate subjective estimates of uncertain future events. In addition, there can be legal repercussions for managements if the forecasts are not met. In litigious countries such as the United States, the potential for lawsuits is a major deterrent to providing financial forecasts.

3. Information about Shares and Shareholders

   A number of continental European companies disclose rather extensive information about their shares and shareholders. The value of such information is aimed at current and prospective shareholders. Past trend data can be useful in predicting future patterns and it is also useful when making comparisons with the trends of other companies. Shares are more marketable when they are traded on several exchanges and when the volume of trading is high. Widely scattered ownership tends to provide ready sales opportunities when present shareholders wish to dispose of some or all of their share holdings. Ownership concentration also indicates the locus of corporate control. On the other hand, dispersed ownership normally means that the

company is controlled by shareholders and their agents, the company's management team. On the other hand, a concentrated ownership suggests that power is exerted by a more narrowly defined group. Management may be constrained if a large block of shares is owned by relatively few individuals or groups, and other shareholders may have relatively less influence in such situations. The identities of the largest shareholders might also be of interest to current and potential shareholders for the same reason. There are no standards that require companies to provide information about shares and shareholders, although, the practice seems to be growing.

SELF ASSESSMENT EXERCISE

Explain financial forecast disclosures.

4.0 CONCLUSION

Back in the 1960s and 1970s a disclosure explosion took place in most industrially developed countries, mandated by new national laws. Companies began revealing information about them that they had never revealed before. A major motivation for such laws seemed to be a low level of investor confidence. Beyond that, companies began to realize that secrecy is self-defeating. Failure to make reasonable disclosures in response to user needs can severely limit the pool of funds available to a corporation. Potential provider of capital, when kept in the dark will simply put their money elsewhere. Studies by accountants have shown that firms significantly increase disclosure levels when they seek new sources of investment funds, that differences in disclosure levels among nations are rapidly narrowing and that increased disclosure can lead to lower costs of capital for business enterprises.

5.0 SUMMARY

In this unit, you would recall that the unit is focused on global assessment of disclosure practices. Basically, the topic was discussed in three sub-units which are financial and nonfinancial disclosure, bases of distinguishing disclosure and disclosure with international perspective.

From the discussion, we explained that disclosure issues relate to the information in an annual report that supplements the financial statements. We also discussed disclosure in financial reports are often classified as either financial or nonfinancial. Further distinguishing of disclosure was discussed based on whether they are voluntary. Furthermore, disclosure was discussed considering an international perspective of disclosure using three examples such as segment disclosures, financial forecast disclosures and information forecast disclosures and information about shares and shareholders.

6.0 TUTOR MARKED ASSIGNMENT

1. Distinguish between financial and nonfinancial disclosure.

2. Explain the bases used for ensuring disclosure.

3. Discuss the following examples of disclosure

a. Segment disclosure.

b. Financial forecast disclosures.

c. Information about shares and shareholders disclosure.

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 1: THE MULTINATIONAL CORPORATIONS

CONTENT

1.0 INTRODUCTION

You must have come across the words multinational corporations being used in previous units in this study material. This is because you cannot discuss international accounting without discussing multinational corporations due to the fact that multinational corporations are major player in the phenomenon of international accounting. Therefore, it is in the light of this unit to discuss issues relating to multinational corporations.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain what a multinational corporation is and distinguish between a traditional multinational corporation and transnational corporation.
2. Explain the motives for direct foreign investment.
3. Discuss the international perspective on consolidated financial statements.

3.0 MAIN CONTENT

3.1 WHAT IS A MULTINATIONAL CORPORATION?

A multinational corporation (MNCs) or multinational enterprise (MNE) is a corporation enterprise that manages production or delivers services in more than one country. It can also be referred to as an international corporation.

The International Labour Organization (ILO) has defined an MNC as a corporation that has its management headquarters in one country, known as the home country and operates in several countries known as host countries.

Some multinational corporations are very big, with budgets that exceed some nation's gross domestic products (GDPs). Multinational corporations can have a powerful influence in local economies, and even the world economy and play an important role in international relations and globalization.

It is important to distinguish a transnational corporation (TNC) from a traditional MNC. A transnational corporation differs from a traditional MNC in that it does not identify itself with one national home while traditional MNCs are national companies with foreign subsidiaries. TNCs spread out their operations in many countries sustaining high levels of local responsiveness. An example of TNC is Nestle who employ senior executive from many countries and try to make decisions from a global perspective rather than from one centralized headquarters. However, the terms TNC and MNC are often used interchangeably.

SELF ASSESSMENT EXERCISE

What is the difference between multinational corporations and transnational corporation?

3.2 MOTIVES FOR DIRECT FOREIGN INVESTMENT

New MNCs do not pop up randomly in foreign nations. It is the result of conscious planning by corporate managers. Investment flows from regions of low anticipated profits to those of high returns.

1. Growth motive- a company may have reached a plateau satisfying domestic demand, which is not growing. Therefore, proceed to looking for new markets.

2. Protection in the importing countries- foreign direct investment is one way to expand bypassing protective instruments in the importing country. For example, European community imposed common external tariff against outsiders. US companies circumvented these barriers by setting up subsidiaries.

3. Market competition- the most certain method of preventing actual or potential competition is to acquire foreign businesses.

4. Cost reduction- cheap foreign labour. Labour costs tend to differ among nations. MNCs can hold down costs by locating part of all their productive facilities abroad.

SELF ASSESSMENT EXERCISE
What are the motives for direct foreign investment?

3.3 INTERNATIONAL PERSPECTIVE ON CONSOLIDATED FINANCIAL STATEMENTS

Like you would recall, consolidated financial statements combine the separate financial statements of two or more companies to yield a single set of financial statements as if the individual companies were really one. Multinationals are often required by the countries in which they do business to set up a separate corporation in each country. The point is that a legal entity is not necessarily the same as an economic entity. From an economic point of view, the activities of these various legal entities are centrally administered from corporate headquarters. Thus, the intent of consolidated financial statements is to provide financial accounting information about the group of companies from an overall perspective.

Consolidated financial statements first appeared around the turn of the 20^{th} century in the United States. This was a time of great economic expansion during which a number of corporations grew into economic giants. The era witnessed a wave of corporate mergers. It is said that J.P. Morgan was so proud of his US steel company (the first billion-dollar company in the world) that he insisted on preparing and disseminating consolidated financial statements since the company's inception in 1901. Since holding companies first became important in the United States, it is not surprising that US accountants were the first to experiment with consolidated financial statements. These statements are now a part of US generally accepted accounting principles.

Holding companies became important in Great Britain and Netherlands in the 1920s, so consolidated financial statements appeared there somewhat later than in the United States. Today, they are required in both countries. The practice moves much more slowly in the other European countries.

SELF ASSESSMENT EXERCISE

A legal entity is not the same thing as economic entity, explain.

4.0 CONCLUSION

Some argue that ownership is a key criterion. A firm becomes multinational only when the headquarters or parent company is effectively owned by nationals of two or more countries. For example, Shell and Unilever, controlled by British and Dutch interest are good example. However, by ownership test, very few multinationals are multinational. The ownership of most MNCs is uni-national. Therefore, ownership does not really matter.

5.0 SUMMARY

In this unit, we discussed the multinational corporations. We discussed what a multinational corporation is and what the motives that drive direct foreign investment are. We also discussed the international perspective on consolidated financial statements.

6.0 TUTOR MARKED ASSIGNMENT

1. What is a multinational corporation?

2. Explain the motives for direct foreign investment.

3. Discuss the international perspective on consolidated financial statements

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 2: INTERNATIONAL FINANCIAL STATEMENT ANALYSIS

CONTENT

6.0 Tutor Marked Assignment

7.0 Reference/Further Reading

1.0 INTRODUCTION

Assuming you had just been recently hired as a financial analyst for a major Nigeria multinational corporation. And you are required to carry out analysis from a set of financial statements from a Japanese corporation which your company intended buying over because of its sustained growth and profitability. As the company comes so highly recommended, you assume it will be a routine exercise to generate the supporting members to back up the purchase decision.

Assuming you discovered that the Japanese company is a financial disaster. Its debt to equity ratio is nearly twice as large as that of Nigeria firms. Contributing to your worries is short-term debt nearly double that of Nigeria firms. In addition, the net income numbers are very low compared to what you expected for this growing firm. And you are wondering what could be wrong selecting such a company for acquisition. That is the essence of this unit, that a framework should be developed that uses information to analyze a foreign based corporation's financial position in the light of the environment in which it operates.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain how cultural values influences accounting system.
2. Discuss the following accounting values
    a. Professionalism versus statutory control
    b. Uniformity versus flexibility
    c. Conservatism versus optimism
    d. Secrecy versus transparency

3.0 MAIN CONTENT

3.1 FINANCIAL ACCOUNTING REFLECTS THE ENVIRONMENT IT SERVES

The use of home country ratio analysis expectation for analyzing foreign financial statements is only effective if the foreign financial accounting system and the operating environment closely parallel that of the home country. Unfortunately, that is rarely the case. Each country's national financial accounting system evolved to serve the needs of its domestic environment and in particular, the needs of the users of accounting information in that country. Therefore, each country's national financial accounting and

reporting requirements are different. The best way to properly analyze financial statements from another country is to understand the domestic accounting system and business practices in that country.

Becoming familiar with each country's accounting and business practices is a monumental task. However, we have the necessary tools. We need to develop an approach, that is, a framework that can be use with any country.

SELF ASSESSMENT EXERCISE
Explain what you understand by financial accounting reflects the environment it serves.

3.2 A FRAMEWORK FOR FINANCIAL STATEMENT ANALYSIS

This sub-unit explains the framework for analyzing financial statement, as seen in the light of the culture, accounting values and accounting systems existing in both countries of comparison, that is, the home country and host countries.

CULTURE VALUES

The accounting system is also influenced by culture and the values that a society shares. Knowing something about a people's values can help us understand their accounting system. Values are defined as a tendency to prefer a certain state of affairs over another. For instance, people in the United States value the concept of individualism, whereas in Japan it is not the individual who is important but how the individual relates to the group. Japanese culture maintains a strong degree of interdependence among individuals. Group norms are far more important than a single individual's opinion or professional judgment. The Japanese society accepts that there is a natural hierarchical order in which each person has a role that is not questioned. In the United State, it is not accepted that power is distributed unequally. In fact, people having equality are demanded.

Another cultural difference between US and Japan is how a society feels about uncertainty and ambiguity. A culture that prefers less uncertainty depends on institutions to maintain conformity, and deviating from the norm or the rule is discouraged, as in Japan. Rules make people comfortable because the rule prescribes what to do in any circumstance, thus, removing the uncertainty and need for judgment. The opposite is a society that values practice more than principles and allows for the exception to the rule, as in the United States and the United Kingdom.

ACCOUNTING VALUES

The following accounting values are not meant to be exhaustive, but are offered as representative of values that influence the development of national accounting systems and measurement and disclosure practices:

1. Professionalism versus statutory control

2. Uniformity versus flexibility

3. Conservatism versus optimism

4. Secrecy versus transparency

PROFESSIONALISM VERSUS STATUTORY CONTROL

Accounting values include a preference for independent professional judgment as opposed to statutory control. A preference for exercising professional judgment is consistent with a preference for individualism and subjectivity, which we find in the accounting systems of countries listed in the fair presentation/full disclosure model. The United Kingdom values the concept of presenting a 'true and fair view' of a company's financial report, and the auditor is given the right to use professional judgment to accomplish this goal. This is also the case of Nigeria. Statutory control or compliance with prescriptive legal requirements is an accounting value of both the legal compliance and inflation-adjusted models. In Japan, France and Germany, accountants follow legal rules and exercise much less judgment than in the United Kingdom.

UNIFORMITY VERSUS FLEXIBILITY

A second set of accounting values that influence financial reporting systems is uniformity versus flexibility. A society that values uniformity shows a preference for the enforcement of a uniform accounting practices, whereas a society that values flexibility takes into account the circumstances of individual companies. There is a link between this accounting value and the cultural value of dealing with uncertainty that we discussed in the prior section. Uniformity is found in the accounting practices of the code law legal compliance and inflation-adjusted models. Flexibility is exhibited by the countries in the common law fair presentation/full disclosure model. Once again, we see a difference between Japan and the United States. Japan's accounting system is influenced by uniformity while flexibility prevails in the United States.

CONSERVATISM VERSUS OPTIMISM

The accounting value of conservatism relates to the measurement of accounting information and manifest s itself in a preference for a cautious approach to measurement as a way to cope with the uncertainty of future events. Optimism tolerates more uncertainty in measurement practices. To illustrate, many expenditures made by a company are expected to benefit future periods. Of course, the benefit is uncertain. Should these expenditures be expensed immediately, or should they be shown as an asset and charged to expenses in future periods? Conservatism calls for the former, while optimism would allow the latter in certain situations. Countries in the fair presentation/full disclosure model take a more optimistic approach to measurement than do those countries of the legal compliance and inflation-adjusted models. The difference in approach has been attributed to different providers of capital and the demands of different users as well as the influence of tax laws. For example, Japanese financial accounting is strongly influenced by the tax law, which leads to more conservative measurement practices in order to minimize taxes.

SECRECY VERSUS TRANSPARENCY

The last set of accounting values we discuss here is secrecy versus transparency in regard to disclosure practices. The countries of the legal compliance and inflation-adjusted models show a preference for confidentiality and tend to restrict disclosure of information to management and those who provide the business financing. Secrecy and conservatism are related in that both result in a more cautious approach to reporting, as is seen in Japan. The fair presentation/full disclosure model countries disclose more information and take a more publicly accountable approach to financial reporting, which are their response to the providers of capital being private investors.

Explain the accounting value uniformity versus flexibility.

4.0 CONCLUSION

Knowing something about a country's accounting values helps us to interpret and understand the financial reports of companies operating in that environment. The goal is to be able to realistically analyse the financial reports of any multinational corporation, given the national accounting and business practices that evolved from the operating environment.

5.0 SUMMARY

In this unit, you would recall that the unit is focused on international financial statement analysis. The topic was discussed in two sub-units which are financial accounting reflects the environment it serves and a framework for financial statement analysis.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain how cultural values influence accounting system.

2. Discuss the following

   a. Professionalism versus statutory control

   b. Uniformity versus flexibility

   c. Conservatism versus optimism

   d. Secrecy versus transparency

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 3: INFORMATION SYSTEMS FOR MULTINATIONAL PLANNING AND CONTROL

CONTENT

1.0 INTRODUCTION

We live in the information age. The integration of the telephone, the computer and television is producing the 'information highway'. Information feeds management decision making and control. In international business operations, the information system provides the information that the multinational corporation (MNC) needs to plan, control, evaluate and coordinate all of its business activities.

Managers at all levels in the MNC need internally developed and reported information to monitor and improve their decision making. MNCs information system must incorporate and report changes in the economic and political environments, legal constraints, cultural and sociological differences in each country of operation. This information is generally provided by the subsidiary managers.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Gain familiarity with the nature of business information systems and the functions they perform.
2. Identify communication problems that challenge the effectiveness of the MNC planning and control system.

3.0 MAIN CONTENT

3.1 MNC AFFECTS THE INFORMATION SYSTEM

An MNC has various levels of managers with varying degrees of authority and responsibility. The distribution of these management levels constitutes the MNC organizational structure and determines what information each level needs to plan and control its operations. The information needs define how the data are collected and processed within the information system. Therefore, the structure of data collecting, processing and reporting within an information system ought to parallel and complement the organizational structure of the MNC.

The classic multinational company has operated as a decentralized unit with the ability to respond to national and local differences and opportunities. The traditional global company has managed operations by tightly controlling its worldwide subsidiaries through centralization. Today's companies must be local and global, that is, transnational. The transnational company must operate efficiently and economically through global-scale operations. It must be able to respond to both national and local differences, retaining local flexibility while achieving global integration. The innovative company that can transfer knowledge quickly and efficiently by linking operations to each other will survive. Never before has the design of the information system been so critical to the success of the transnational company. Information processing and technology transfer systems between parent and subsidiary and among the subsidiaries must be flexible and shared. Companies that can develop this transnational organizational capability will have the key to long-term success.

SELF ASSESSMENT EXERCISE
How does Multinational Corporation affect the information system?

3.2 COMMUNICATION PROBLEMS IN MNCs

1. Differences in Measurement and Disclosure Practices

Accounting measurement, disclosure, and reporting practices vary a great deal across geographic boundaries. In many countries, accounting is not well developed and reporting practices are not as defined as those in the United States. However, for effective control, an MNC needs an internal reporting system with standardized, consistent and uniform accounting principles and practices. Ideally, all subsidiaries should use comparable accounting practices. Assets and liabilities should be valued and reported according to a common plan. Expense recognition should be consistent from year to year (e.g each subsidiary should use the same depreciation method from year to year). All domestic and foreign managers should understand how headquarters defines the word 'profit'. All domestic and foreign subsidiaries of US based MNCs should use US generally accepted accounting principles for reporting back to corporate headquarters. Consistency and uniformity are particularly important when the information is used to compare one subsidiary's performance to another.

2. Ease of Communication

Geographic proximity is also a consideration in terms of facilitating the flows of information back and forth between the subsidiaries and headquarters. For example, a US based MNC would probably find it easier to communicate to a subsidiary in Mexico than one in Chile, simply because the Mexican

subsidiary is physically closer. Traditionally, MNCs have transmitted information by mailing paper documents or making phone calls. However, these are giving way to electronic forms of communication (such as e-mail). Electronic communication reduces the amount of time it takes for a parent company to communicate with a distant subsidiary (and vice versa) and in many cases makes it nearly instantaneously. Even so, communication across borders can still be difficult. In many MNCs, computer systems are not compatible worldwide. The sheer rate of technological change poses problems for keeping employees up-to-date in using new technology. Cultural barriers can also cause difficulties. Nevertheless, innovations in electronic communication will simplify and improve how MNCs send information around the world.

3. Financial and Operating Information for Internal Reporting

Many firms equate volumes of reports with good financial control. However, subsidiaries' local management may complain that the volume of required reporting hampers its ability to cope with daily operating problems. In fact, local management is responsible for reporting financial data to the parent and operating the subsidiary successfully. Therefore, the problem is to identify the relevant information that top management needs to maintain the planning and management control systems. This is difficult to achieve. In fact, several studies have shown that MNC headquarters may require a single subsidiary to submit over 200 different financial reports annually. Even with this many reports, there is no assurance that the MNC is well managed.

4. Goal Congruence

Most major companies in the United States use the profit centre or investment centre concept for domestic control systems. This approach works relatively well domestically because profit centre managers make the major decisions affecting their centre's performance. Good decision making ensures good performance evaluation, and good performance evaluation ensures good decision making. The goals are congruent because authority and responsibility are delegated to the same people. Managers are evaluated based on the performance that results from their decisions. Manager performance and profit centre performance are linked.

International operations do not lend themselves to management control systems based on a profit centre concept. Foreign subsidiary profits are often somewhat manipulated to facilitate paying the somewhat manipulated to facilitate paying the smallest possible amount of income taxes on a worldwide basis. Or by manipulating the prices at which goods are transferred into a country, an MNC can minimize the import duties paid. Each scenario affects a subsidiary's reported profit. Therefore, using the strict profit centre is inappropriate.

For the profit centre idea to work effectively, subsidiary managers must have the authority to make all decisions affecting their profits. Yet many MNCs maintain centralized control over subsidiaries, and many decisions are made at headquarters. Foreign managers may have responsibility for operations, but they do not have the authority to make major decisions affecting their profitability. Such a situation does not have the authority to make major decisions affecting their profitability. Such a situation does

not enhance goal congruence. Regardless of the situation, some degree of responsibility and authority should be provided to subsidiary mangers so that they remain responsive to their local environment.

SELF ASSESSMENT EXERCISE

Explain three communication problems in Multinational Corporations.

4.0 CONCLUSION

Planning defines a company's objectives and provides a strategy to achieve them. Such plans require a management control system as well as a performance evaluation system. The management control system should complement the plan so that the goals of the international managers are congruent with the overall goals of the MNC.

5.0 SUMMARY

In this unit, we discussed information systems for multinational planning and control. The topic was discussed in the light of two sub-units which are MNC affects the information system and communication problems in MNCs.

6.0 Tutor Marked Assignment

1. Explain the nature of business information systems as it relates to MNC.

2. Identify and explain the communication problems that challenge the effectiveness of the MNC planning and control system.

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 4: MULTINATIONAL BUDGETING SYSTEMS

CONTENT

1.0 INTRODUCTION

The budgeting process for a multinational company is basically not different from that for domestic operations, except that it must recognize diverse environments as well as the addition of the impact of currencies. The currency factor is perhaps the most visible difference between domestic and multinational budgeting. It requires the forecasting of exchange rates for, first establishing capital budgets and profit plans and second, controlling them later on.

In the light of that we shall be discussing forecasting exchange rates, basic approaches to capital budgeting and planning, and building the capital budget.

2.0 OBJECTIVES

After studying this unit, you should be able to

1. Explain the fundamental and technical approaches.
2. Explain what are the basic approaches to capital budgeting and profit planning.
3. Discuss the steps involved in building the capital budget.

3.0 MAIN CONTENT

3.1 FORECASTING EXCHANGE RATES

Briefly stated, forecasting technique follow either the traditional, fundamental approach or the more recent technical approach.

1. Fundamental Approach- The fundamental approach has evolved from classical economics. In applying this technique, management (usually the treasurer) assesses certain economic and socio political variables of a nation to predict the economy's performance and how such performance will affect the supply of, and demand for and demand for that nation's currency.

   Economic variables include domestic monetary and fiscal policy, inflation rates, unemployment, development of natural resources, international trade competitiveness, and capital flows, socio-political variables include the general attitude of government and population towards the private business sector, the system of government, its involvement in the commercial sector, labour relations, and the degree of political stability. The forecaster must also be aware of the sensitivity of each variable and its relative importance with respect to the time horizon projected. Relevant variables should be forecast for the times of interest to management in the budgeting process, for example one, three or five years.

2. Technical Approach- Technical analysis has developed from the study of international money market behaviour in an attempt to predict cyclical trends in the demand and supply of individual currencies. This forecasting technique concentrates more on predicting the timing of exchange rate movements than on the underlying fundamentals per se. By forecasting when a shift in currency values is expected the user of technical analysis expects to be in a position to hedge accordingly. Technical analysts often postulate that the market adjusts too swiftly to changes in fundamental variables to make a forecast based on fundamentals meaningful. They argue that it is best to observe the signals which mark a change in market mentality and to climb on board before the market leaves them behind. Fundamentalists have often argued that this game plan

is little better than the “school of fish” theory, which states that a fish is best protected if it swims with the main stream and in the centre of the school out of a predator’s reach.

From a practical point of view, management must decide whether it wants to forecast exchange rates on the basis of one of the aforementioned theories or whether it concludes that exchange rates cannot be forecast and that, the current exchange rates (at the time of initiating a particular budget cycle) should be used for the forward period.

SELF ASSESSMENT EXERCISE

Explain the fundamental and technical approaches.

3.2 BASIC APPROACHES TO CAPITAL BUDGETING AND PROFIT PLANNING

When examining the methods and procedures used for capital budgeting and profit planning, we find two approaches: top-down and bottom-up.

If the corporate level determines the perimeter of the capital budget, the total amount of dollars to be spent and then apportions to division, regions and affiliates, this constitutes a top-down approach. If, conversely, the corporate level asks the affiliates to determine their capital requirements and proposed net income and the regions and divisions merely aggregate the affiliates’ proposal, we refer to this process as a bottom-up approach.

In practice, these two approaches are frequently combined. At the corporate level, the overall perimeters will be determined.

3.3 BUILDING THE CAPITAL BUDGET

a. Objectives- Prior to the establishment of a capital budget, it is important that the company determine its long-range objectives and prepare a strategic plan that specifies timing horizons and overall capital requirements. In a multinational company, objectives and capital needs are then suggested for each country and each major affiliate or function within the countries.

b. Annual and Total Requirements- Frequently, a negotiating period is needed during which the corporate level negotiates with the division, the division with the region, and, finally, the region with the affiliates what capital projects will eventually yield the desired objectives. To enable the affiliates to do the necessary preparatory work, two dimensions of all proposed capital projects are considered. The total cost of the project and the timing of cash expenditures to complete the projects. For purposes of capital budgeting, the total cost, which may stretch out over several years is included; for purposes of cash budgeting, the annual funds required are essential to determine the annual overall financing aspects.

c. Interface between Objectives and Capital Budget- It is desirable, but not absolutely necessary, to prepare objectives for a three or five year period in sufficient detail, that is, stating requirements for each major program or projects, so that the first forward year’s data can- and frequently do- from the

capital budget for that year. The remaining years of the objectives will then represent preliminary indications, which will be fleshed out in subsequent cycles.

d. Determination of Exchange Rates- The reason for making year 1 of the objectives the capital budget for the year is the complexity caused by the need to set the exchange rates for each country's use in the objectives and capital budgeting process. It is recommended that the exchange rates be fixed at the beginning of that process; otherwise, a lot of time will be consumed in arguments between a region and affiliate as to which rate is to be used for what purpose.

SELF ASSESSMENT EXERCISE

State and explain the steps in building capital budget.

4.0 CONCLUSION

Capital budgeting and profit planning in a multinational environment are not fundamentally different from those for domestic operations. The two factors: nationalistic and currency aspects matters do not apply to purely domestic operations. The nationalistic factors mean the legal and behaviour elements that are present in dealing with operations in other countries.

5.0 SUMMARY

In this unit, we discussed multinational budgeting systems considering forecasting exchange rates, basic approaches to capital budgeting and profit planning and building the capital budget.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the fundamental and technical approaches.

2. What are the basic approaches to capital budgeting and profit planning.

3. Discuss the steps in building the capital budget.

7.0 REFERENCES/FURTHER READING

Choi, F. D. S and Lewis, G. F. (2003)," Multinational Budgeting and Control Systems." In International Finance and Accounting Handbook, New York: John Wiley & Sons.

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MODULE 4: EVALUATION AND TRANSLATION

UNIT 1: PERFORMANCE EVALUATION IN MULTINATIONAL CORPORATIONS

CONTENT

7.0 References/Further Reading

1.0 INTRODUCTION

Performance evaluation is a critical issue in international accounting. The development of the multinational corporation requires an accounting system that records and reports the results of worldwide operations. Headquarters relies on information to evaluate the performance of subsidiaries and managers from all over the world.

This unit begins with a definition of performance evaluation. We then take a look at various financial measures used by multinationals to evaluate their operations.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define performance evaluation.
2. Explain the following
    a. Profitability measures
    b. Sales growth and cost reduction
    c. Budgets as a success indicator

3.0 MAIN CONTENT

3.1 PERFORMANCE EVALUATION DEFINED

Performance evaluation is the periodic review of operations to ensure that the objectives of the enterprise are being accomplished. In other words, it is a report on the success or failure of an operation. A corporation's performance evaluation is part of its financial control system. One reason for performance evaluation is to reward managers for achieving the organization's goals. Corrective actions can also be taken when achievement falls short of the goals. Performance evaluation guides resource allocation decisions within the multinational organization.

SELF ASSESSMENT EXERCISE
Define performance evaluation.

3.2 FINANCIAL MEASURES USED BY MNCs TO EVALUATE DOMESTIC AND FOREIGN SUBSIDIARIES

MNCs use the various measures to evaluate the results of their operations at home and abroad. Let us discuss some of the measures.

1. Profitability Measures

A fundamental measure of operating success is profitability. This can be expressed as gross profit, net income, or return on investment (ROI). Gross profit (or operating margin) is the difference between revenues and the cost of products sold or services provided. Net income is the "bottom line" profit figure of an operation. Expressed as a rate of return, ROI relates profitability to invested capital. It is said that since shareholders are profit oriented, manager should be as well. Profitability measures imply a level of decentralization that does not always exist in multinational operations.

2. Sales Growth and Cost Reduction

   The ability to reach customers is vital to company's long-run success. Customer acceptance of a company's products or services translates directly into the sales (or revenue) figure. Sales growth may also indicate increased market share.

   Cost reduction intensified in the 1990s in response to increased competition brought on by the globalization of product and services markets. Most MNCs re-engineered their businesses to improve efficiencies and many spun off peripheral activities in order to focus on their so-called "core competencies". Outsourcing such functions as accounting and information technology were other cost reduction moves. Sales growth and cost reductions should also improve profitability.

3. Budgets as a Success Indicator

   Sometime, budgeting has been accepted as a management tool for controlling operations and forecasting future operations of domestic companies. One purpose of the budget is to clearly set out the objectives of the entity. A budget generally provides a forecast and a means of comparing the actual results, of operations to the budget. This comparison produces variances that can be analyzed to evaluate performance and improve the efficiency of future operations.

   When a budget is used for a foreign subsidiary, the budget should be developed be that subsidiary. The experience of the local manager is extremely important, in that, it produces a deep knowledge of the specific business situation. Thus, the subsidiary manager should fully participate in establishing the subsidiary's goals and in developing its budget. A budget developed on this level will help control the operations and make achievement of goals possible. This budget can be used by the local manager on a daily basis.

   Budgeting gives local managers the opportunity to set their own performance standards. In international operations, top management is not as familiar with what the standards should be. Headquarters must rely to a greater extent on good local or regional budgets, which help facilitate the strategic planning process.

   The subsidiaries' budgets are approved at the parent-company level and often require the endorsement of the president and/or the board of directors. Presumably, headquarters uses the budget to consider the circumstances peculiar to each subsidiary. All of this should ensure a

two-way flow of communication between the subsidiary and headquarters, which in turn, will improve the overall budgeting process.

SELF ASSESSMENT EXERCISE

What are the various measures used by MNCs to evaluate the results of their operations at home and abroad?

4.0 CONCLUSION

Multinational corporations need flexible performance evaluation models capable of incorporating factors peculiar to an MNC for the separate evaluation of subsidiary and managers. Because performance evaluation systems used by MNCs have international economic impact, these systems should be under constant examination, and improvements should be made continuously.

5.0 SUMMARY

In this unit, we discussed performance evaluation in multinational corporations. We were able to define performance evaluation and discussed financial measures used by MNCs to evaluate domestic and foreign subsidiaries.

6.0 TUTOR MARKED ASSIGNMENT

1. Define performance evaluation

2. Explain the following financial measures

   a. Profitability measures

   b. Sales growth and cost reduction

   c. Budgets as a success indicator

7.0 REFERENCES/FURTHER READING

Borkowsi, S. C. (1999), "International Management Performance Evaluation: A Five Country Comparison." Journal of International Business Studies 30, no. 3, pp 533 – 555.

Indjejkian, R. I. (1999), "Performance Evaluation and Compensation Research: An Agency Perspective." Accounting Horizons 13, no. 2, pp 147 – 157.

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MODULE 4: EVALUATION AND TRANSLATION

UNIT 2: ISSUES TO CONSIDER WHEN DEVELOPING MNC EVALUATION SYSTEMS

CONTENT

1.0 INTRODUCTION

In the previous unit, we discussed performance evaluation in multinational corporations. We are taking a step further in this unit to discuss several issues that must be considered when evaluating domestic and foreign operating environments, subsidiaries and managers.

2.0 OBJECTIVES

After studying this unit, you should be to:

1. Discuss separating manager performance from subsidiaries performance.
2. Discuss treating foreign subsidiaries as profit centres
3. Discuss currency choice

3.0 MAIN CONTENT

3.1 SEPARATING MANAGER'S PERFORMANCE FROM SUBSIDIARY'S PERFORMANCE

Many managerial accountants advocate making a distinction between the performance of the subsidiary manager and that of the subsidiary itself. In practices, MNCs report that they do not make a distinction between the evaluation of the manager and the subsidiary. Surveys continue to show that MNCs use the same measures to evaluate the same performance of the manager as that of the foreign subsidiary.

Responsibility reporting as an accounting system traces costs, revenue, assets and liabilities to the individual manager who is responsible for them. It follows that a manager who has the ability to control

the results of operations should be evaluated on the basis of the results over which she or he has control. This system has been widely implemented in US domestic operations and has proven to be generally effective as an evaluation tool. However, the very nature of international operations does not lend itself to effectively implementing a responsibility reporting system in MNCs.

MNC headquarters manages from a worldwide perspective and allocates costs and sets transfer prices to optimize companywide profits and to facilitate worldwide cash flows. Therefore, it is naive to evaluate the operating performance of foreign subsidiary managers without first considering all the possible uncontrollable cost that could be allocated to their operations. For these reasons, evaluating a manager's performance should be separate from judging the subsidiary as an investment. The manager's evaluation should involve a degree of subjectivity that considers the uniqueness of the subsidiary, environmental peculiarities, actions of the host government, and specific goals of the manager being evaluated. If managers are delegated responsibility for results that are beyond their control, it may lead to behaviour that is not in line with headquarters' goals.

SELF ASSESSMENT EXERCISE
Should the performance of managers be separated from the performance of the subsidiaries?

3.2 TREATING FOREIGN SUBSIDIARIES AS PROFIT CENTRES

Profit centres located international do not operate in a uniform environment. They operate in environment with different inflation rates and different economic, political, cultural and technological conditions. Top management is not likely to understand all the peculiarities of each environment; therefore, it will have trouble evaluating the manager's performance. For these reasons, the profit centre concept is less useful when applied to foreign subsidiaries than when applied to domestic subsidiaries. Therefore, it is less successful as a performance indicator. Local managers and subsidiaries of MNCs are often evaluated like profit centres. Yet central coordination of the MNC makes it difficult to evaluate the local managers' performance. These managers do not make many of the important decisions affecting their operations. It is also difficult to evaluate how effectively a subsidiary is using its resources. The responsibility reporting concept implies that the manager and the local entity should be evaluated separately. Separating the two; enables each to be judged according to its contribution to global optimization.

SELF ASSESSMENT EXERCISE
Profit centres located international do not operate in a uniform environment. Explain.

3.3 CURRENCY CHOICE

The accounting records and financial statements of a foreign subsidiary are generally maintained in the subsidiary's local currency. Therefore, an issue arises as to which currency should be used to evaluate the performance of the subsidiary and its manager. Two logical candidates are the subsidiary's local currency or the parent's home currency.

It was recommended to use local currency information. This is because, it would results in far more meaningful and valid comparisons of past, present and future operations of a subsidiary. Using the local

currency is consistent with isolating and weighing the environmental peculiarities of each operating environment. Such information relates to local conditions and it avoids the distortions that result from fluctuating exchange rates. A local currency perspective also applies to evaluating the foreign manager. Managers should be evaluated as meeting primary goals in the local currency (e.g annual profits and sales forecasts, meeting projected production levels, managing the effects of inflation and managing employees).

SELF ASSESSMENT EXERCISE

Why was it recommended to use local currency information?

4.0 CONCLUSION

If the parent's home currency is used for performance evaluation, then foreign currency translation methods must be employed. Studies have shown that most US MNCs use the same method to translate for internal reporting purposes (managerial accounting) that they use for external reporting purposes.

5.0 SUMMARY

In this unit, we discussed those issues to consider when developing MNC evaluation systems. This was discussed under various sub-units such as separating manager's performance from subsidiary's performance, treating foreign subsidiaries as profit centres and currency choice.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss separating manager's performance from subsidiary's performance.

2. Discuss treating foreign subsidiaries as a profit centre.

3. Discuss currency choice

7.0 REFERENCES/FURTHER READING

Borkowsi, S. C. (1999), "International Management Performance Evaluation: A Five Country Comparison." Journal of International Business Studies 30, no. 3, pp 533 – 555.

Indjejkian, R. I. (1999), "Performance Evaluation and Compensation Research: An Agency Perspective." Accounting Horizons 13, no. 2, pp 147 – 157.

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MODULE 4: EVALUATION AND TRANSLATION

UNIT 3: FOREIGN CURRENCY TRANSLATION

CONTENT

1.0 INTRODUCTION

The foreign subsidiaries of multinational corporations normally keep their accounting records and prepare their financial statements in the currency of the country in which they are located. They do this because it would be too inconvenient to transact business in anything other than the local currency and too impractical to record these transactions in accounting records using another country's currency. As a result, the individual financial statements of a multinational's foreign subsidiaries are expressed in many different currencies. Yet in order for worldwide consolidated financial statement to be prepared, the subsidiaries' financial statements must all be expressed in a single currency. Therefore, whenever multinational corporations prepare their consolidated financial statements, the financial statements from individual foreign subsidiaries must be translated from the currency of the foreign country into the currency of the country where the multinational is headquartered. Foreign currency translation is accomplished using exchange rates.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. List and explain the reasons for exchange rates changes.
2. State the steps taken in the translation of financial statements as contained in Financial Accounting Standard 52.
3. Familiarize yourself with the impact of foreign exchange rates changes.

3.0 MAIN CONTENT

3.1 EXCHANGE RATES

The major currencies of the world are traded in many places and in many ways. An exchange rate is the price of one currency relative to another. That is, how much of one currency it takes to buy so much of another currency. Exchange rates are not stable over time; they fluctuate just like the price of nearly everything else does. Exchange rates change for the following reasons:

1. Trade balance of payments surpluses or deficits. When a country exports more than it imports, it is said to run a trade balance of payments surplus. Surpluses cause the nation's currency to appreciate in value. The opposite condition-trade deficits, - causes a currency to command less of other nations' currencies.
2. Relative rates of inflation- currencies of countries with higher rates of inflation depreciate relative to the currencies of countries with lower levels of inflation. Generally speaking, inflation means that one is able to buy less and less of everything (including another country's currency) for a fixed amount of one's own currency.
3. Relative interest rates- whenever one nation has higher interest rates relative to other nations, its currency appreciates in value.
4. Political factors and government intervention. For international transactions, the currencies of countries considered politically stable tend to be favoured over the currencies of unstable countries. Governments also buy and sell currencies when they want to change exchange rates.

SELF ASSESSMENT EXERCISE
State the reasons for the changing of exchange rates.

3.2 Translation

The entire task of foreign currency translation can be understood as determining the correct exchange rate to be used in converting each financial statement like item from the foreign currency to the headquarters country's currency. The translation adjustment is an inherent result of this process, in which balance sheet and income statement items are translated at different rates. Financial Accounting Standards (FAS 52) establishes these steps:

1. Determine the functional currency. The functional currency is defined as the currency of the primary economic environment in which the entity operates. Normally, that is the currency in which the majority of the subsidiary's business activities are transacted. The functional currency is not necessarily the home currency or the currency in which the subsidiary keeps its books.

2. Determine whether the functional currency of the subsidiary is also its home currency.

3. If the functional currency is the home currency, the current method is used. The current method translates all assets and liabilities at the current spot rate at the date of translation. Equity items, other than retained earnings are translated at the spot rates in effect on each related transaction date (specific identification). Retained earnings are translated at the weighted-average rate for the relevant year, with the exception of any components that are identifiable with specific dates, in which case the spot rates for those dates are used. Income statement items are translated at the average rate for the period, except where specific identification is practicable.

4. If the functional currency of the subsidiary is not its home currency, the temporal (historical) method is used. Under this method, nonmonetary balance sheet accounts and related income statement accounts are re-measured using historical exchange rates.

5. Under FAS 52, the temporal method is also used when the subsidiary operates in a highly inflationary environment. Companies reporting under International Financial Reporting Standards (IFRS) treat this differently by re-measuring the financial statements at the current balance sheet rate in order to present current purchasing power. GAAP, on the other hand, does not generally permit inflation- adjusted financial statements. Instead, it requires the use of a more stable currency as the functional currency.

SELF ASSESSMENT EXERCISE
Outline the steps in translation of currency.

3.3 DETERMINING EXCHANGE RATE(S)

A question may arise as to which exchange rate should be used to translate the financial statements of a foreign subsidiary given that exchange rate changes. One possibility is the exchange rate at the balance sheet date. Accountants often refer to this as the current or year-end exchange rate. However, translating all financial statement items at the rate existing at the balance sheet date is incompatible with historical cost.

Suppose a US parent company invest $30,000 in a foreign subsidiary and the subsidiary converts the money to its local currency when the exchange rate is 1LC (local currency) = $1.25. The foreign subsidiary takes its LC24,000 (i.e $30,000/1.25) and buys land. On a historical cost basis, the land has a value of LC24,000 or $30,000. If by year end the exchange rate changes to 1LC=$1.50 and is used to translate the LC24,000 piece of land, it will appear on the consolidated US dollar financial statements at $36,000 (i.e LC24,000 X $1.50). The piece of land appears to have magically increased in value.

The $1.25 equal to 1LC which was the exchange rate when the transaction was first recorded is what is referred to, by the accountants as the historical exchange rate. This way, the land would always appear on the consolidated balance sheet at $30,000.

Unfortunately, another problem arises when historical exchange rates are used. Since the various assets are acquired at different times, different exchange rates have to be used to translate them. When this happens, the translated balance sheet no longer balances. What to do with the difference between debits and credits is a highly controversial subject among accounts. The amount of the imbalance arises mechanically as a result of the translation process and does not fit the definition of asset, liability or owners' equity. Yet, it has to go somewhere to preserve the accounting equation.

The following example illustrates the point. Assume that on January 1, US multinational forms a foreign subsidiary and converts $100,000 into the subsidiary's local currency (let say naira) at a time when the exchange rate is N1=$1.25. The initial investment, therefore, is N80,000. The subsidiary opening balance sheet would be

Subsidiary

Balance sheet as at 1st January, 2011

Cash N80,000 X (N1=$1.25) = $100,000

Financed by:

Owners' equity N80,000 X (N1=$1.25) = $100,000

Now assume that on February 1, when the exchange rate is N1= $1.30, foreign subsidiary buys N40,000 worth of inventory. On February 28, when the exchange rate is N1=$1.40, subsidiary buys a fixed asset for N40,000. The March 1 balance sheet will look like this.

Subsidiary

Balance sheet as at 1st March, 2011

Inventory N40,000 X (N1=$1.30) = $52,000

Fixed asset N40,000 X (N1=$1.40) = $56,000

N80,000 $108,000

Financed by:

Owners' equity N80,000 X (N1=$1.25) = $100,000

N80,000 $100,000

While the balance sheet before translation (in local currency) balances, it does not balance after translation into US dollars. In the translated balance sheet, debits exceed credit by $8,000. What to do with the nonexistent credit is a good question, and accountants disagree on the answer.

SELF ASSESSMENT EXERCISE

Translating all financial statement items at the rate existing at the balance sheet date is incompatible with _____.

4.0 CONCLUSION

Preserving the historical cost basis of accounting by translating foreign financial statements at different historical exchange rates introduces a dangling debit or credit whose nature is difficult to define. That problem can be solved by translating financial statements using a single exchange rate, but the procedure is inconsistent with the historical cost basis of accounting. Either choice involves some undesirable side effects.

5.0 SUMMARY

In this unit, we discussed foreign currency translation. Basically, we defined exchange rate and state the reasons why exchange rates changes. We also looked at the steps taken in carrying out translation as contained in financial accounting standards 52. And finally, we tried discussing which exchange rate should be used to translate the financial statements of a foreign subsidiary.

6.0 TUTOR MARKED ASSIGNMENT

1. List and explain the reasons for exchange rates changes.

2. State the steps taken in the translation of financial statements as contained in FAS 52.

7.0 REFERENCES/FURTHER READING

Benjamin, J. J., Grossman, S. And Wiggins, C. (1996), "The Impact of Foreign Currency Translation on Reporting during the Phase-in of SFAS No. 52". Journal of Accounting, Auditing, and Finance 1, no. 3, pp 174 – 184.

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MODULE 4: EVALUATION AND TRANSLATION

UNIT 4: TRANSLATION METHODS

CONTENT

1.0 INTRODUCTION

This unit is an extension of the previous unit on foreign currency translation. Having discussed the relevant issues as contained in unit 13, it becomes imperative here that we should step further in discussing the translation method and modified current rate method.

2.0 OBJECTIVES

After studying this unit, you should be able to

1. Discuss what it means to translate a financial statement item at the historical exchange rate.
2. Discuss what it means to translate items in the financial statement at the current exchange rate.

3.0 MAIN CONTENT

3.1 TEMPORAL METHOD

Before statement 52 of FAS on foreign currency translation issued by the Financial Accounting Standards Board (FASB) IN 1981, US multinational corporations translated the financial statements of their foreign subsidiaries under the terms of statement 8 issued by the FASB in 1975. Statement 8 required the use of what is called temporal method of foreign currency translation. A mixture of different historical exchange rates and the current exchange rate are used to translate the items on the subsidiary's balance sheet and income statement. The resulting "dangling debit or credit" is treated as a loss or gain on the consolidated income statement. During the years that statement 8 was in effect, exchange rates were highly volatile, and because the translation imbalance was required to increase or decrease reported income or loss, corporations experienced more volatility in their reported earnings than management desired. A volatile earnings pattern normally indicates riskiness, yet management alleged that translation gains and losses were on paper only- that they had little or no direct effect on actual cash flows. A large number of accountants cried 'foul' and it is fair to say that statement 8 was probably the most unpopular statement ever issued by the FASB. For this reason statement 8 was replaced by statement 52.

Illustration of Temporal Method

Assume that the following trial balance, expressed in local currency (Naira), is received from a foreign subsidiary. The year-end exchange rate is N1=$1.40 and the average exchange rate for the year is N1=$1.20. Under the temporal method, the trial balance is translated as follows:

1. Inventory and cost of goods sold, at the exchange rate when the inventory was purchased. Assume this is N1=$1.25.
2. Fixed assets and depreciation expense, at the exchange rate when the fixed assets were purchased. Assume this is N1=$0.90.
3. Other balance sheet items, the year-end exchange rate (i.e N1=$1.40).

4. Revenues and expenses that are incurred evenly throughout the year (sales and other expenses) at the average exchange rate (N1=$1.20).
5. Beginning owners' equity in dollars equals last year's ending owners' equity (translated) in dollars. Assume this is $81,000.
6. A "translation" gain or loss is created to balance the dollar dominated trial balance.

   Thus, the temporal method translation would be

	Naira		Exchange rate	Dollars	
	Debit	Credit		Debit	Credit
Cash	15,000		(N1=$1.40)	21,000	
Inventory	70,000		(N1=$1.25)	87,500	
Fixed assets	35,000		(N1=$0.90)	31,500	
Payables		30,000	(N1=$1.40)		42,000
Owners' equity (beginning)		70,000			81,000
Sales		200,000	(N1=$1.20)		240,000
Cost of goods sold	120,000		(N1=$1.25)	150,000	
Depreciation exp.	5,000		(N1=$0.90)	4,500	
Other expenses	55,000		(N1=$1.20)	66,000	
Translation loss				2,500	
	300,000	**300,000**		**363,000**	**363,000**

SELF ASSESSMENT EXERCISE

Solve the question in the illustration without looking at the solution and compare your answer to the solution in the illustration.

3.2 MODIFIED CURRENT RATE METHOD

Under the provisions of statement 52, a foreign subsidiary is classified as either

1. Self-sustaining and autonomous or
2. Integral to the activities of the parent company.

A self-sustaining, autonomous subsidiary is one that operates relatively independently from the parent company. Revenues and expenses respond mostly to local conditions, few of the subsidiary's cash flows impact the parent company cash flows, and there are few intra company transactions with the parent. The local (foreign) currency is said to be its 'functional' currency. The balance sheet for a self-sustaining subsidiary is translated at the year-end exchange rate and the income statement at the average for the year exchange rate. There is no effect on reported consolidated earnings from translating the financial statements of autonomous foreign subsidiaries. This is called modified current rate method which preserves the balance sheet and income statement financial ratios in the US dollars as in the local currency.

Illustration of Modified Current Rate Method

	Naira		Exchange rate	Dollars	
	Debit	Credit		Debit	Credit
Cash	15,000		(N1=$1.40)	21,000	
Inventory	70,000		(N1=$1.40)	98,000	
Fixed assets	35,000		(N1=$1.40)	49,000	
Payables		30,000	(N1=$1.40)		42,000
Owners' equity		70,000	to balance		102,000
Sales		200,000	(N1=$1.20)		240,000
Cost of goods sold	120,000		(N1=$1.20)	144,000	
Depreciation exp.	5,000		(N1=N1.20)	6,000	
Other expenses	55,000		(N1=$1.20)	66,000	
	300,000	**300,000**		**384,000**	**384,000**

SELF ASSESSMENT EXERCISE

What is a self-sustaining or autonomous subsidiary?

4.0 CONCLUSION

Consolidated financial statements are intended to present an overall look at a company's operations and financial position. Unfortunately, for multinational corporations existing accounting tools are not always up on the task. Measuring accounting earnings is an imperfect process anyway, but when fluctuating foreign exchange rates are introduced into that process, it gets even more jumbled.

5.0 SUMMARY

In this unit, we discussed translation methods which are temporal method and modified current rate method. The temporal method was based on statement 8 issued by the Financial Accounting Standards Board and the modified current rate method is based on statement 52 of FASB.

6.0 TUTOR MARKED ASSIGNMENT

1. What does it mean to translate a financial statement item at the historical exchange rate?

2. What does it mean to translate an item at the current exchange rate?

7.0 REFERENCES/FURTHER READING

Benjamin, J. J., Grossman, S. And Wiggins, C. (1996), "The Impact of Foreign Currency Translation on Reporting during the Phase-in of SFAS No. 52". Journal of Accounting, Auditing, and Finance 1, no. 3, pp 174 – 184.

Choi, F. D. S., Frost, C. A. And Meek, G. K. (1999), "Foreign Currency Translation." In International Accounting , Upper Saddle River: Prentice Hall.

Harris, T. S. (1997), "Foreign Currency Transactions and Translation." In International and Finance Handbook, New York: John Wiley & Sons.

COURSE GUIDE

BHM745: SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

Course Code	BHM745
Course Title	Security Analysis and Portfolio Management
Course Developer/Writer	Dr. J. N. Obi National Open University of Nigeria
Course Editor	……
Programme Leader	Dr. O.J. Onwe National Open University of Nigeria
Course Coordinator	Dr. J.N. Obi National Open University of Nigeria

CONTENTS **PAGE**

INTRODUCTION

BHM 745: Security Analysis and Portfolio Management, is a one semester course work having two credit units. It is available to students on Postgraduate Diploma Programme in the School of Management Sciences at the National Open University of Nigeria.

The course of made up of 16 units covering essential topics in Security Analysis and Portfolio Management. It also treated in detail valuation of common stocks, bonds and preferred stock and discussed the sources of common stock value

This course guide tells you what the course is all about, the relevant textbooks you should consult, and how to work through your course materials to get the best out of it. It also contains some guidelines on your tutor-marked assignments.

COURSE CONTENTS

The aim of this course is to introduce you to the subject of Security analysis and the management of portfolios of investment. The course contains core security analysis topics such as types of stock and risk and returns inherent in each type, how to measure risks and returns in your investment, random walk of stock prices, efficient markets, and how to manage investment portfolios.

Security analysis and choice of investment instrument are almost daily affairs in human life. Sometimes we carry out security analysis and investment activity without even being aware that what we are performing the exercise. Before we put money into any business undertaking or attempt to buy shares from any company (blue chip or otherwise), we have to, first of all, analyze the stock and understand how safe and profitable it will be for us.

COURSE AIMS

The course aims to groom the student in the process of security analysis which prepares him for life journey through investment and portfolio management. Sooner or later, the student, after his studies, will be involved in making one investment or another to make gains to sustain himself and his family. Also, knowledge of security analysis and portfolio management, and the understanding of the tricks and intricacies of risks and returns on investment instruments will be useful to the student in other areas of human endeavour.

COURSE OBJECTIVES

In order to achieve the full aims of the course, the study is divided into coherent units and each unit states, at the beginning, the objective it is out to achieve. You are therefore advised to read through the specific objectives before reading through the unit. However, the following represent some of the broad objectives of the course. That is to say, after studying the course as a whole, you should be able to:

* Overview of Security Analysis and Portfolio Management.
* Describe the participants in the investment process and the various types of investors
* Explaining random walk of stock prices and efficient markets
* Describe the basic types of security markets and the characteristics
* Processes of investment in bond
* Describe steps in the investment process and the establishment of investment goals
* Explaining deficiencies of financial statements
* Evaluation of common stocks
* Review the concept of return, its components and its importance
* Analysis of investment return
* Risk and returns on investment
* Investment in fixed income securities
* Preferred stocks and convertible securities

WORKING THROUGH THIS COURSE

It is imperative that you read through the units carefully consulting the suggested texts and other relevant materials to broaden your understanding. Some of the units may contain self-assessment exercises and tutor-marked assignments to help you. Only when you have gone through all the study materials provided by the National Open University of Nigeria (NOUN) can you satisfy yourself that indeed you have completed the course. Note that at certain points in the course you are expected to submit assignments for assessment, especially the Tutor-Marked Assignment (TMAs). At the end of the course, there will be a final examination to test your general understanding of the course.

COURSE MATERIALS

Major components and study units in the study materials are:

Course Title: BHM 745 SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT

Study Units

CONTENTS

TEXTBOOKS AND REFERENCES

You should use the prepared text for the course made available to you by NOUN. However, in your own interest, do not limit yourself to this study text. Make effort to read the recommended texts to broaden your horizon on the course.

ASSIGNMENT FILE

The assignment file will be made available to you (where applicable). There, you will find details of all the work you must submit to your tutor for marking. The marks you obtain from these assignments will count towards the final mark you will obtain to hit the required pass-mark for the course.

ASSESSMENT

Your performance on this course will be determined through two major approaches. The first is through your total score in the Tutor-Marked Assignments, and the second is through the final examination that will be conducted at the end of the course. Thus, your assessment in the course is made up of two components:

Tutor-market Assignment	30%
Final Examination	70%

The self-assessment tests which may be provided under some units do not form part of your final assessment. They are meant to help you understand the course better. However, it is important that you complete work on them religiously so that they will help in building you strongly and serving you as mock-examination.

TUTOR-MARKED ASSIGNMENT

At the end of each unit, there is a Tutor-Market Assignment (TMA), which you are encouraged to do and submit accordingly. The study centre manager/ tutorial facilitator will guide you on the number of TMAs to be submitted for grading.

Each unit of this course has a TMA attached to it. You can only do this assignment after covering the materials and exercise in each unit. Normally, the TMAs are kept in a separate file. Currently, they are being administered on-line. When you answer the questions on-line, the system will automatically grade you. Always pay careful attention to the feedback and comments made by your tutor and use them to improve your subsequent assignments.

Do each assignment using materials from your study texts and other sources. Try to demonstrate evidence of proper understanding, and reading widely will help you to do this easily. The assignments are in most cases easy questions. If you have read the study texts provided by NOUN, you will be able to answer them. Cite examples from your own experience (where relevant) while answering the questions. You will impress your tutor and score higher marks if you are able to do this appropriately.

FINAL EXAMINATION AND GRADING

At the end of the course, you are expected to sit for a final examination. The final examination grade is 70% while the remaining 30% is taken from your scores in the TMAs. Naturally, the final examination questions will be taken from the materials you have already read and digested in the various study units. So, you need to do a proper revision and preparation to pass your final examination very well.

HOW TO GET THE BEST OUT OF THIS COURSE

The distance learning system of education is quite different from the traditional or conventional university system. Here, the prepared study texts replace the lecturers, thus providing you with a unique advantage. For instance, you can read and work through the specially designed study materials at your own pace and at a time and place you find suitable to you.

You should understand from the beginning that the contents of the course are to be worked on carefully and thoroughly understood. Step by step approach is recommended. You can read over a unit quickly y to see the general run of the contents and then return to it the second time more carefully. You should be prepared to spend a little more time on the units that prove more difficult. Always have a paper and pencil by you to make notes later on and this is why the use of pencil (not pen or biro) is recommended.

FACILTATORS/TUTORS AND TUTORIALS

Full information about learning support services or tutorial contact hours will be communicated to you in due course. You will also be notified of the dates, time and location of these tutorials, together with the name of your tutors. Your tutor will mark and comment on your assignments. Pay attention to the comments and corrections given by your tutor and implement the directives as you make progress.

USEFUL ADVICE

You should endeavour to attend tutorial classes since this is the only opportunity at your disposal to come face to face with your tutor/lecturer and to0 ask questions on any grey area you may have in your study texts. Before attending tutorial classes, you are advised to thoroughly go through the study texts and then prepare a list of questions you need to ask the tutor. This will afford you opportunity to actively participate in the class discussions.

SUMMARY

Security analysis and portfolio management is at the heart of every investor. Some investors do it locally or traditionally and others do it in a sophisticated way through experienced analysts. As we have earlier noted, the ultimate purpose of security analysis is to guide us to make wise investment that will yield us profits. You put the money you have today in an asset with the hope of earning profit or interest on it tomorrow. If you put money in the wrong stock, you will make loss. Careful security analysis will always reveal profitable stocks in which the would-be investor can invest.

NATIONAL OPEN UNIVERSITY OF NIGERIA

BHM745 **SECURITY ANALYSIS & PORTLOFIO MANAGEMENT**

Course Code BHM 745

Course Title	Investment Management Analysis I
Course Developer/Writer	Dr. J. N. Obi National Open University of Nigeria
Course Editor	……..
Programme Leader	Dr. O.J. Onwe National Open University of Nigeria
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CONTENTS

MODULE 1

UNIT 1 THE INVESTMENT SETTING

CONTENTS

1.0 INTRODUCTION

Investment has many facets. It may involve putting money into bonds, Treasury bills, or notes, or common stock, or paintings, or real estate, or mortgages, or oil ventures, or cattle, or the theatre. It may involve speculating in bull markets or selling short in bear markets. It may involve choosing growth stocks, or blue chips or defensive stocks or income stocks.

2.0 OBJECTIVES

At the end of this unit, the student should be able to:

* Give the true definition of security analysis
* Understand how inflation affects common stock value
* Know different types of common stock

3.0 MAIN CONTENT

3.1 What Investment Means

Investment could mean buying 100 shares of Coca Cola at N10 per share, and watching it appreciate over a few years and be able to sell them and make capital gain. It could mean buying Xerox shares at N20 per share and seeing it grow to N35 per share. When stock prices appreciate, the investors make capital gain and when prices fall he investor suffers losses of capital loss.

3.1.1 How Investment Alternatives Compare

Every investment is a balancing of objectives and purposes. A very safe investment may not provide protection against inflation. An inflation resistant investment may not provide liquidity. And there is still an on-going debate over the risk-return trade off

It has been widely assumed that the higher the risk undertaken in an investment, the more ample the return and, conversely, the lower the risk, the more modest the result. But recent research has shown that this is often not the case. Different investment media fit different investment objectives but the fit is seldom perfect. The average investor seeks a safe, inflation resistant investment, which provides a good return, with capital gains opportunities, but which can be liquidated quickly if necessary.

3.1.2 Common Stock and Inflation

To most individuals, investment means buying common stock. There are several reasons why this is so. First, the bull market in the 1980 provided substantial capital gains for many of those in the market. In fact, over a longer period, a study conducted by the Centre for Research in Security Prices of the University of Chicago found that anyone who had invested in common stock broadly from 1980 on and had held through 1987 would have realized an average annual rate of return compounded annually.

3.1.3 Common Stock Hedge

How effective has the common stock hedge been over the long run? A study by the Anchor corporation Chicago, U.S.A. indicated that living costs rose in 62 percent of the one-year period since 1980 and in 66 percent of the ten-year period. When longer periods were tabulated, it was found that living costs increased in 73 percent of the 15-year period, 80 percent of the 20 –year period, and in 95 percent of the 30-year period. Whether they had invested for one year or longer, investors have had inflation in

store for them more than half the time since 1982. Over 20-year span they have experienced inflation three quarters of the time; over 30-year span nearly all the time.

3.2 Types of Common Stock

There is a diversity in common stock which extends not only to industry and to company but to type of stock as well. In the loose and flexible language of the street, it is customary to speak of blue chip stocks, of growth stocks, of cyclical stocks, of income stocks, of defensive stocks, and of speculative stocks. Lines of demarcation between types are not precise and clear, but investors have a general notion of what is meant by each of these imprecise categories.

3.2.1 Blue Chip Stocks

Blue chip stocks are high-grade investment quality issues of major companies which have long and unbroken records of earnings and dividend payments. Stocks such as American Telephone and Telegraph, and Liver Brothers in Nigeria are generally considered "blue chips." The term is used to describe the common stock of large, well-established, stable, and mature companies of great financial strength. The term was originally derived from Poker Card Game where blue chips (in contrast with white and red chips) had the greatest money value.

The ability to pay steady dividends over bad years as well as good for a long period is, of course, an indication of financial stability. Some of the "blue chips" of yester-years have fallen from greatness. What constitutes a blue chip does not change over time but the stocks that qualify as blue chips do change from time to time.

3.2.2 Growth Stocks

Many of the blue chips may also be considered growth stocks. A growth stock is the stock of a company whose sales and earnings are expanding faster than the general economy and faster than the average for the industry. The company is usually aggressive, research-minded, paying dividends but plowing back enough earnings to facilitate expansion.

Growth stocks are usually quite volatile. They go up faster and farther than other stocks, but at the first hint that the high rate of earnings is either leveling off or not being sustained, prices can come tumbling down. For example, Texas instrument, a high-flying growth company of the late 1970s saw its earning fall from N300 million in 1970 to about N80 million in 1975.

3.2.3 Different Criteria for Measuring Growth Stock

Some prominent American fastest growing companies use somewhat different criteria to measure growth stock. Under this method, a company is listed as growth stock company if its annual profits per shared have grown without interruption over the most recent three years at a minimum compound rate of 10 percent a year and if there is evidence of continued growth at the time of listing. A company is removed from the list (a) when profits in any 12-month period decline more than 10 percent from its most recent fiscal year period or when a reliable forecast reveals that such a decline is in prospect or (b) if annual growth in earnings over the most recent two years averages less than 5 percent and growth in the latest reporting is less than 10 percent over the like period of the prior year.

3.3 Income Stocks

Some people, particularly the elderly and retired, buy stock for current income. While in recent years stocks have yielded less, on the average, on current dividends, than bonds or the return on savings accounts. There are also some stocks which may be classified as income stocks because they pay a higher than average return. Income stocks are those that yield generous current returns. They are often sought by trust funds, pension funds, university and college endowment funds, and charitable educational and health foundations.

Selecting income stocks can be a very tricky business. The stock can be paying high return because price has fallen due to the fact that there is considerable uncertainty as to whether the dividend can be maintained in the light of declining earnings or the stock may be that of a lackluster company in an unpopular industry, with little future.

3.3.1. Cyclical Stocks

Cyclical shares, in Wall Street terminology, refer to stocks of companies whose earnings fluctuate with the business cycle and are accentuated by it. When business conditions improve, the company's profitability is restored and enhanced. The common stock price rises. When conditions deteriorate, business for the cyclical company falls off sharply, and profits diminish greatly.

Industries which may be regarded as cyclical include steel, cement, paper, machinery and machine tools, airlines, railroads and railroad equipment, and automobiles.

3.3.2 Defensive Stocks

At the opposite pole from cyclical stocks are the so-called defensive stocks. Defensive stocks are shares of a company which is likely to do better than average, from an earnings and dividends point of view, in a period of deteriorating business cycle . If a recession is anticipated, a growing interest tends to develop in certain recession-resistant companies. While such stocks lack the glamour of the fallen

market leaders, they are characterized by a degree of stability desirable when the economy faces a period of uncertainty and decline.

Utility stocks are generally regarded as defensive since their slow (5 to 7 percent) but steady growth rate tends to hold up in recession years as well as in boom years. They are, however, very sensitive to interest rate changes. They fall in price if interest rates rise sharply, and, on the other hand, they increase in price if interest rates decline.

In addition to the electric and gas utilities, the shares of gold mining companies have tended to be effective defensive issues. The price of gold either rises or remains stable during recessions, while the cost of mining may decrease due to lower costs. Also, the market demand for gold seems to hold up or even increase. Other defensive issues are found among companies whose products suffer relatively little in recession periods. These include shares in companies producing tobacco, snuff, soft-drinks, candy bars and other staples. Also, companies that provide the essentials of life, particularly food and drugs tend to hold up well. Packaged foods and grocery chain companies are good examples.

3.3.3 Speculative Stock

Speculation can be defined as a transaction or business that leaves its profit to chance and luck. That is a conjectural transaction with no certainty of profit. In this sense, it means that all common stock investments are speculative business. When you buy shares you have no promise, no certainty that the funds you will receive ultimately when you sell the stock will be more, less or the same as the dollars or Naira you originally paid.

Yet in the accepted parlance of the street, speculative shares or speculative stocks have a more limited or restrictive meaning. High-flying glamour stocks are speculative. Likewise, hot new issues and penny mining stocks are speculative. Other types can be identified as they come and go from time to time. Some are easy to identify and others are quite difficult to analyze and classify.

4.0 CONCLUSIONS

We have discussed in this unit that investment may involve putting money into bonds, Treasury bills, or notes, or common stock or real estate. The basic objective in any form of investment is to earn more profit or to increase your wealth. We also noted that all investments are a

balancing of objectives and purposes. A very safe investment may not provide protection against inflation. An inflation-resistant investment may not provide liquidity in times of need. Common stock can be categorized as blue chip stocks, growth stocks, cyclical stocks, income stocks, defensive stocks and speculative stocks.

5.0 SUMMARY

This unit has looked at what investment stands for – putting money into shares, stocks and real estate with a view to earning future profits. The student has been taught that most investments involve risks since one cannot be sure today what the earnings will be tomorrow. Common stock can be broken into many types and each time has its own peculiar characteristics.

6.0 TUTOR-MARKED ASSIGNMENT

* All investments are a balancing of objectives and purposes. Explain this statement.
* What are the outstanding qualities of a blue chip firm?

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
Published by McGraw-Hill Company Inc., 1221 Avenue, New York, U.S.A.

Cohen, J. (1977) Investment Analysis & Portfolio Management (Third Edition)
Richard D. Irwin Inc. New York, U.S.A.

Gitman, L.J and Joehnk, M.D. (1998). Fundamentals of Investment (Seventh Edition)
Printed by RR Donnelley & Sons Company , U.S.A.

Rufus, I.A. (2004) Investment Decisions, Concepts, Analysis and Management
Glorious Hope Printers, Glorious Hope House, 53 Jagunmolu Street, Bariga, Lagos.

UNIT 2 RANDOM WALKS AND EFFICIENT MARKETS

CONTENTS

1.0 INTRODUCTION

This unit will look at what is known as Random Walks and Efficient Markets. The basic concept is the fact that it is not clear what causes changes in stock price. Movement of Price may not follow conventional rules and price movement becomes random and difficult to understand.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with:

- The Random Walks of stock price
- The meaning and characteristics of Efficient Market

3.0 MAIN CONTENT

3.1 Random Walks and Efficient Markets

Before beginning to look at common stock and its analysis, the aspiring security analyst must, first of all, navigate the perils of two widely held academic concepts: "Efficient Market" and "Random Walk."

Both concepts will engage the security analyst and the portfolio manager in an academic exercise which sometimes seems futile and endless

3.1.1 The Meaning of Random Walks and Efficient Markets

According to one authority, an efficient market is one in which prices always fully reflect all available relevant information. Adjustment to new information is virtually automatic and instantaneous, while a random walk implies that there is no discernible pattern of travel or movement of stock price. The size and direction of the next movement of stock price cannot be predicted from the size and direction of the previous movements. Random walk is a term used in mathematics and statistics to describe a process in which successive changes and movements are statistically independent.

Combined, in the words of another authority, "first, the theory (random walk and efficient markets) says that new information about a company, its industry, or anything that affects the prospects of the company is disseminated very quickly, once it becomes public. Second, the price of a stock at any particular time represents the judgment of all investors, based on all the information that is public. And third, new information about as company is disseminated randomly over time.

3.1.2 Forms of Random Walk

A guru in security analysis pointed out that there are two forms of random walk – narrow and broad random walks. He further said "thus an accurate statement of the narrow form of the random-walk hypothesis goes as follows: The history of stock price movement contains no useful information that will enable an investor to consistently out-perform a buy and hold strategy in managing a portfolio. If this is correct, then the technical analysis (predicting future stock prices based on analysis of past stock prices and other internal market factors such as volume, breadth, highs and lows) are simply futile academic exercise.

Fundamental analysis of stock is also not of any significant importance. The guru in security analysis demolished the useful of fundamental analysis of stock in his broad form statement which says:
The broad form states that fundamental analysis of stock is not helpful either. It says that all that is known concerning the expected growth of the company's earnings and dividends, all of the possible favourable developments affecting the company that might be studied by the fundamental analyst, are already reflected in the price of the company's stock.

3.1.3 Stocks that Do Better

The position of some investment experts has even been more extreme than the strong form of the random walk hypothesis. They argue that attempts to pick stocks that do better than others are not successful. Actively managed portfolios do not do better than buy-and-hold portfolios gross of

expenses, and do worse than buy-and-hold portfolios when transactions and administrative costs are taken into consideration.

This is particularly true when you adjust the performance of actively managed portfolios for the extra risk that they incur, because they tend to concentrate their investments in a relatively small list of stocks. Thus, they said that it is better to buy a well diversified portfolio of stocks at a chosen risk level and hold it. An investor should change his list of stocks only to compensate for changes in the risk of stocks that he holds and to keep his portfolio well diversified.

3.2 The Dilemma of the Aspiring Security Analyst

What does all these theoretical jargon mean for the aspiring security analyst? To many, it may suggest that he is pursuing a career that has no real purpose of function. Why? Because in an efficient market, buyers and sellers factor into their buying and selling decisions all known influences and knowledge, both public and private that has impacted, or is currently impacting or will in future impact on the price of a security. Since the current price reflects all the facts about the security and since prices generally reflect swiftly any new developments, all the digging by the security analyst can add little or nothing to the body of knowledge, which has itself determined the current price of a security. In its strongest form, the random-walk, efficient market hypothesis maintains that past stock prices or earnings cannot be used to forecast future prices or earnings since both series behave randomly and already reflect all known facts and information about the market, an industry, a company, stock prices, or the price of a single stock.

Yet all is not lost. It is the thousands of trained security analysts who are the eyes and ears of the efficient market. It is the industrious, probing, prying analyst who ensures that relevant information, and even rumour and hypothesis, is quickly reflected in the current price, and who, by the collective weight and chain reaction to prospective trends, helps determine the future price.

3.2.1. Development of Index Funds

One response of the investment community to the efficient market concept has been the development of “index” funds. A small but growing number of money managers administering pension accounts have placed part of their investment assets in so-called index funds. The idea is that, since the average

money manager cannot do as well as the averages, the way to be sure of at least keeping up with the averages is via the index fund approach. This has the added advantage of doing away with so-called analytical judgment and attendant investment fees. The portfolio manager is, in essence, replaced by a computer. In the process, brokerage fees are held down since these funds have low portfolio turnover rates.

3.2.2 Styles in Stocks

Fads and enthusiasms can be either very costly or very profitable to investors. Styles in common stocks, an expert analyst pointed out change almost as rapidly as women's fashion. Reviewing past enthusiasms, one can go back as far as World War I, during the course of which a company like Bethlehem Steel was in high fashion. It jumped from $10 a share in 1914 to $200 in one year.

In more recent years, aluminum stocks were very much in style in the early 1950s. Alcoa went from 46% in 1949 to the equivalent of 352% in 1955. Raynolds Metal rose from 19% to the equivalent of 300% over the same period. As a group, the aluminum stocks rose some 430% in the early 1950s and then fell out of bed in 1957, declining by more than 50%. The advent of the computers helped push IBM from 40% to over 600% and Control Data from 2% to over 100%

3.2.3 Conversion into Common Stock

The bonds were subsequently converted into common stock at $10.75 per share. The preferred shares were converted into common stock at $1 per share. There followed, after conversion, a 2.5% stock dividend, a 2 for 1 stock split, and another 2.5% stock dividend. When LIT common stock hit q high of $143 per share by 1961, each $29,200 unit had grown to 29,416 shares of common stock worth $4.2 million.

Other investors were not so fortunate. Towards the end of 1961 Business Week reported that Glamour Industry took its lumps. Shake-out among electronics companies is starting as industry matures after a decade of fast, youthful growth. To survive, the report said, a company will need sharp management.

3.3 Fundamental Analysis

The heart of the investment process is choosing what to buy and when to buy it, deciding what to sell and when to sell it. Coal and Steel (seemingly both basic industries), why buy one and not buy the other? The choice to the casual investor may not have appeared very crucial or complicated but over the recent decade coal shares were among the best performers. If you had bought Eastern Gas and Fuel, you would have a 142% gain.

The Pittson Company shares rose 687%. On the other hand, national Steel fell 39%, while Republic Steel declined 37%. By and large, investments in utilities, aerospace, automobiles, food and food chains, life insurance, cement, telephone, aluminum, and apparel would likely have had poor results, while, on the other hand, coal, gold mining, beverages (soft drinks), retail variety stores, office equipment, distillers, and drugs would have done well.

3.3.1 Fundamental Analysis of Common Stock

By security analysis we mean, of course, fundamental analysis. This is the basic process of ther evaluation of common stock by studying earnings, dividends, price-earnings multiples, econ omic outlook for the industry, financial prospects for the company, sales penetration, market share, and quality of management. Selecting the industry or industries which are likely to do best over the next three to five years and then choosing the company or companies within the selected industries which are likely to out-perform their competitors – this is the essence of fundamental analysis.

In general terms, there are four aspects of any complete and concise analysis: (a) the sales analysis and forecast, (b) the earnings analysis and forecast, (c) the multiplier analysis and forecast, and (d) the analysis of management, a qualitative consideration.

Basic to any estimate of earning power is a sales analysis and forecast. Growth of demand for a company's products is essential for common stock appreciation. While expanding production and sales do not guarantee rising profits, rising demand or the introduction of new products, at least gives a company an opportunity to earn a rising profit.

What the analysis is seeking is a working forecast of sales in order to determine the profit implications of the sales forecast. But just as a sales forecast is essential to an effective profits forecast, an economic forecast is a preliminary pre-requisite to the sales forecast. The starting point of an effective industry and company forecast may be a GNP forecast, with a breakdown of components. For example, a forecast of sales for the automobile industry may be tied to the gowth of real GNP by using historic figures on the number of cars sold per billion dollar increase in real GNP.

3.3.2 Obtaining the Estimate of Prospective Earnings Growth Rates

Having obtained an estimate or range of estimates of prospective sales growth rates, the next step is to proceed to obtain an estimate, or range of estimates, of prospective earnings growth rates. To achieve this, an analysis of earnings is necessary. One approach is to start with the GNP forecast and drive from it a prospective corporate profits trend for all industry. Then factor out a profits trend for the particular industry under review, making such adjustments as special industry characteristics suggest a greater or lesser rate of growth than that or the total corporate profits series. From this develop a company estimate, again making adjustment for special company characteristics.

One can also prefer to start with the sales forecast developed earlier and relate this to the company's profit margin, operating income, equity turnover, rate of return on equity, earnings before interest and taxes. Net income after interest and taxes, returns on total capital, and net earnings per share. By dissecting the anatomical character of a corporation's profitability and measuring the impact of prospective changes on each element, it is possible to derive an estimate of a range of future earnings from one to three years ahead.

Once an earnings forecast, or a range of forecasts, is derived, it remains to develop and apply a multiplier, the price earnings ratio. Many factors help to determine a price-earnings ratio. Among these are the growth rate of earnings, actual and anticipated, the dividend payment, the marketability and volatility of the stock, the stability or volatility of earnings, and the quality of earnings and of management. Of these, perhaps, the growth rate of earnings is the most significant. In general, there seems to be a consensus that the higher the growth rate of earnings, the higher the price earnings ratio.

From this brief summary of fundamental analysis, it should be clear that the modern approach to common stock, evaluation centres on a two-part question. That is the potential growth of earnings and dividends of a company whose stock is being analyzed and what is a reasonable price to pay for that potential?

3.3.3 Investment Timing

Decision as to when to buy and sell stocks is as important as the choice of what stocks to buy. Investment timing is possibly even more difficult a task than investment choice. But the competent analyst must constantly make a judgment as to the trend and level of the market as a whole to provide the appropriate environmental setting for portfolio additions or deletions.

4.0 CONCLUSION

Under this unit we studied the efficient market and the random walk as they affect the stock price movement. We stated that in an efficient market, prices reflect all available relevant information. The random walk, on the other hand, implies that there is no discernible pattern of travel of stock prices. We also discussed that the heart of the investment process is choosing what to buy and when to buy it.

5.0 SUMMARY

The key topic of this unit is the efficient market and the random walk of stock prices. The price of stocks change from time to time but there is no definite pattern followed by this change in price. In investment practice, the choice of what stocks to buy is essential and it requires careful analysis. Investors should also be aware that investment timing is as important as the choice of stocks to buy.

6.0 TUTOR-MARKED ASSIGNMENT

* Briefly explain what you understand by Random Walks and Efficient Markets
* Investment timing and the choice of stock in which to invest are not important. Discuss.

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
Published by McGraw-Hill Company Inc., 1221 Avenue, New York, U.S.A.

Cohen, J. (1977) Investment Analysis & Portfolio Management (Third Edition)
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UNIT 3 BOND INVESTMENT

CONTENTS

1.0 INTRODUCTION

The two most popular financial instruments in which investors can invest are the common stocks and bonds. While the common stock makes the investor part owner of the company, the bond holder is largely a provider of funds on which interest is to be paid. This unit will discuss the various types of bond an investor can invest on.

2.0 After studying this unit, the student will be familiar with the following:

* Different types of bond
* Bond pricing and interest rates
* Bond Analysis and Ratings

3.0 MAIN CONTENT

3.1 Investment in Bonds

When a bull market begins to near its peak, when blue chips begin to sag, when speculative high fliers and low-priced cats and dogs begin to get the play, when stock yields fall to 3 percent or less and the yield spread between stocks and high-grade bonds widens to 4 percent in favour of bonds, when business is booming and interest rates are tight, the shrewd institutional

investment manager who has choice and flexibility will quietly withhold funds from new common stock commitments and place the funds in high-grade bonds.

When prosperity tops out into recession, when business and common stock prices begin to slide, high-grade bonds come into favour. As interest rates decline, high-grade bond prices rise. High-grade bond prices tend to vary inversely with interest rates and with common stock prices. As recession turns into recovery, reverse trends set in. Interest rates and common stock prices which have fallen start to rise and high-grade bond prices tend to weaken. Generally speaking, high-grade bonds are those bonds rated AAA or AA by the Rating Services.

3.1.1 Primary Investment Interest in Bonds

The primary investment interest in bonds comes from institutions such as banks and insurance companies which must pay obligations in fixed number of dollar or Naira. If you have a $50,000 Life Insurance Policy, for example, at some point in the future, whether 5 years or 30 years later, the company will have to pay the $50,000. If it invests in securities (bonds) which will return it a fixed number of dollars, it is in a position to meet its obligation. It does not matter in this case whether the dollars it gets back buy half as little as when they were invested. It has a fixed dollar obligation, not a purchasing power obligation.

The individual investor may shy away from high-grade bonds because of the purchasing power risk, but most institutional investors have less need to worry about this problem. Individual investors, especially wealthier ones, find special interest in several types of bonds particularly tax-exempts and convertibles. As a hedge against recession and deflation, however, switching from common stock to high-grade bonds as a boom tops out may be an excellent, profitable move for any investor.

3.1.2 Bond Price and Interest Rates

The principal price risk in high-grade bonds is related to the trend of interest rates. If a commercial bank holds high-grade bonds, and interest rates, which had been low, start to rise, and the bank must sell its bonds, because funds are needed for some other purposes, such as expanding business loans, then a capital loss results. Why? If the bonds carry a coupon rate of

interest of, say 6 percent, and similar quality bonds now are being issued with coupons of 7.5 percent or higher, no one will be willing to purchase the 6 percent bond at par value.

The unwillingness of buyers to pay the previously prevailing prices, coupled with the actual selling pressure of investors who are seeking to raise funds for other investments, forces the price of the old 6 percent issue down, and it will fall to the point where its price in the market yields the new purchaser approximately the same rate of return as the average new, higher level of rates in the market. Thus, as the boom moves ahead, the demand for funds expands, and interest rates rise, high-grade bond prices will fall as stock prices rise.

At the peak of the expansion, when the central banking authorities are pursuing a tight money policy, which has driven interest rates up, bond prices down, the institutional investment manager may start switching from common stocks to high-grade bonds. As expansion turns to recession, tight money will be relaxed, interest rates will be allowed to fall, and they will go down because the demand for funds has slacken, and high-grade bond prices will rise. In fact, the deeper the recession, the higher will go the prices of high-grade bonds as institutional investment demand switches to them and thus bids up their prices. However, if inflation accelerates during a recession, interest rates will rise since lenders will demand a premium to cover the inflation.

3.2 Types of Bonds

Bonds may be either secured or unsecured and may range from first-mortgage bonds on the one hand to subordinated debentures on the other. The security behind a bond, while important, is not crucial. The earning power, financial condition, and quality of management are vital. Because of this, one company's unsecured bonds may be rated higher than another company's secured obligations. For example, the debentures of AT&T Company are rated higher than the first-mortgage bonds of Indianapolis Power and Light Company in the United States.

Mortgage bonds are secured by a conditional lien on part or all of a company's property. Id the company defaults (fails to pay interest or repay principal), the bond holder, through the trustee appointed to represent them and look after their rights, may foreclose the mortgage and take over the pledged property.

Some corporate mortgages have what is called “after acquired” property clause, which provides that all property thereafter acquired will become subject to the mortgage and automatically be pledged to secure the bond issue. While this is not widely found, it is very favourable to the investor, and where it exists, if the company wishes to float another bond issue secured by mortgage on its property, this second mortgage will be a junior lien, subordinate to the first mortgage or senior lien on the property.

3.2.1 Junior Issues

Usually, when companies float junior issues, secured by junior liens, they do not clearly label them as such. They call them “general” or “consolidated.” A prospective investor determines the security status of bonds by reading the bond indenture. The indenture is the formal, and usually lengthy, legal contract between the borrowing company and the creditor bond holders. The indenture spells out all the detailed terms and conditions of the loan. It also indicates whether more bonds may be issued with the same security or under the same mortgage. If so, the mortgage is said to be “open-ended.” Additional issues of bonds under an “open-end” mortgage will naturally dilute the security available for earlier issues. If the mortgage is “close-ended,” no additional bonds may be issued under the same mortgage, and the issue therefore has better protection and value.

3.2.2 Pledge of Specific Securities

A bond secured by a pledge of specific securities is known as a “collateral trust bond.” These are issued mainly by holding companies, close-ended investment companies, and finance companies. They have not been popular in recent years. The “equipment trust bond” or “equipment trust certificate.” is usually used to finance the purchase of rail-road stocks. Under this arrangement, title to equipment (freight cars. Locomotives, passenger cars and so on) being bought by a railroad rests in a trustee who holds it for the benefit of certificate holders. The railroad makes a down payment say 20%, and the trustee issues equipment trust certificate to cover the balance of the purchase price of the equipment. The trustee then leases the equipment to the railroad under an agreement whereby the railroad obtains title to the equipment only when all obligations have been met.

3.2.3 Debentures

Debentures are unsecured bonds protected only by the general credit-worthiness of the borrowing corporation. They may contain a “covenant of equal coverage” which means that if

any mortgage bond is issued in the future, which ordinarily would take precedence over the debentures, the issuer agrees to secure the debentures equally. This type of security is protected only by the general promise to pay. In the event of default, the debenture holder is merely a general creditor. The value of a debenture must be judged wholly in terms of the earning power and overall financial status and outlook of the issuing company, which, sometimes, is the best way for evaluating any bond.

Convertible Bonds: Convertible bonds are bonds which may be exchanged, at the option of then holder, for a specified number or amount of other securities, usually common stock. Usually the bond is convertible into a fixed number of shares of common stock.

Income Bond: An income bond is a debt instrument whose distinguishing characteristic is that interest need be paid only if earned. Originally, many income bonds arose out of railroad reorganizations and reflected the effort to reduce the burden of fixed charges to manageable proportions.

Tax-Exempt Bonds: Tax-exempt bonds are of special interest to wealthy investors and to certain institutional investors. The income from State and Municipal bonds is not subject to the United States Federal income tax. This may mean that a non-taxable yield of 3.5% on a state or municipal bond may be equivalent to twice or three times as much as on a taxable security, depending on the investor's income tax bracket.

3.3 Bond Analysis and Ratings

For the individual investor and smaller institutional investor, an initial step in bond analysis is to go to one of the financial services firm such as Standard and Poors or Moody Company and see what rating they have assigned to the bond you want to invest in. While these rating companies are not infallible, their expert staff are accustomed to judging the relative merits of fixed income securities, and the rating will give you a clear idea of the approximate quality of the bond. It is a useful orientation for looking further into the merits, or lack of merits of the proposed purchase. It may be that when the rating assigned is seen, there may be no further interest in the bond.

In one sense, bond evaluation is not very different from stock evaluation. The real basis for evaluation lies in the financial status and earning power of the corporation borrowing or governmental unit. The far-sightedness and efficiency of management, the outlook for the industry, the position of the particular firm in the industry, the company's earning power and

then soundness of its internal finances as reflected in its balance sheet and income account, all must be carefully considered.
The security behind a bond is, in itself, no guarantee of soundness, since the value of the pledged property is usually dependent on earning power. If the company fails, its fixed assets may prove to be worth very little.

3.3.1 Risk and Return on Bonds

Investors are subject to major types of investment risks. These include the following:

1. Business risk (i.e., a decline in earning power), which reduces a company's ability to pay interests or dividends.
2. Market risk (i.e., a change in "market psychology"), which causes a security's price to decline irrespective of any truly fundamental change in earning power.
3. Purchasing power risk (i.e., a rise in prices), which reduces the buying power of income and principal.
4. Interest rate risk (i.e., a rise in interest rates), which depresses the prices of fixed income type securities.
5. Political risk (for example, price control, wage control, tax increases, changes in tariff and subsidy policies).

4.0 CONCLUSION

Under this unit, we discussed investment in bonds. There are many types of bond which include secured and unsecured bonds, debentures, convertible bonds income bonds and tax-exempt bonds. We noted that the principal price risk in high-grade bonds is related to the trend of interest rates.

5.0 SUMMARY

We discussed under this unit that investment in bonds differ from investment in common stocks. Bonds produce a fixed interest yield while common stock gives the investor dividend which is dependent on the earnings power of the company. Bonds can be secured or unsecured. Unsecured bonds are usually referred to as debentures.

6.0 TUTOR-MARKED ASSIGNMENT

- The primary Investment interest in bonds comes from institutions such as banks and insurance companies. Discuss.
- Name and explain two types of bond you know.

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
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CONTENTS

1.0 INTRODUCTION

Of all the sources of investment information, a company's financial statements are among the most vital. They are indispensable ingredients of any effort to determine the value of a corporate stock or bond. They are the principal reference we turn to for information on the level and trend of a company's earning power and debt repayment ability. However, some investment experts are of the opinion that financial statements leave much to be desired.

2.0 After studying this unit, the student will be familiar with the following:

- The methods of interpreting financial statements
- The format of income statement
- Determination and measurement of revenue

3.0 MAIN CONTENT

3.1 Courteousness over Financial Statements

Many years ago, security analysts had to guard against the possibility that corporate financial statements might be fraudulent. But today regulations of the Securities and Exchange Commission and the Nigerian Stock Exchange have reduced this fear. Nevertheless, a security analyst cannot accept, at face value, the figures designated by a company as net income or net worth.

The net income and net worth figures shown in a company's annual report may be given a "clean opinion" by the independent auditors. This means that they certify that:

(a) No circumstances precluded the application of reasonable auditing procedures

(b) The accounts are fair and adequate representation of the company's financial position and of the results of its operations, conforming to "generally accepted accounting principles."

(c) No substantive uncertainties exist which cannot be reasonably provided for in the accounts.

Notwithstanding the clean opinion, "generally accepted accounting principles" are neither unambiguous nor uniformly interpreted and applied to be truly reliable and useful from an investment point of view.

3.1.1 Income Statement Format

For purposes of security analysis, it is convenient to adopt as an income statement format something similar to the following:

3.1.1 Interpretation problem

Problem of interpretation are involved in almost every item of this sample income statement. Among the most common problems are the following, which we shall examine in detail:

(1) even so apparently simple an item as "sales" causes difficulty. For example, when a Company sells merchandise on an installment payment plan, questions arise as to when the sale should be recorded as revenue in the income statement. Will it be at the time of sale or when payments are received? Similar questions arise when a company fills an order on a gradual basis because a long production process is involved, or when a company leases merchandise rather than sells it outright.

(2) Cost of goods sold is affected by a company's method of evaluating (costing) Inventories. Different companies use different methods. Furthermore, a breakdown

of the materials versus labour cost components of cost of goods sold is of vital interest to the investor, but information providing such breakdowns is seriously deficient. Of particular concern are inter-company differences in accounting for obligations under employee pension plans.

(3) Depreciation and depletion charges are subject to a great deal of managerial discretion and are further affected by legislative changes.

(4) Problems are caused by the need to distinguish between the basic profitability of a firm's primary activities – manufacturing, wholesaling, retailing, and the like – and profits or losses resulting from "non-operating" transactions or "extraordinary" occurrences.

(5) Many companies report to the Internal Revenue Service one way and to stockholders another way.

3.2 Sales

An authority on accounting theory stated that revenue (and related expenses) should be recognized only when it is "captured," "measurable," and "earned." Revenue is said to be "captured" when the company is reasonably certain that it will be paid for what it has sold, or when it is clear that the portion which might be lost is small and can be estimated in terms of amount.

But this innocent-sounding phrase can create problems, as has been illustrated dramatically in the case of land development companies. These companies sell parcels of land to buyers who pay in periodic installments over a period of many years. Now, after how many payments can it be assumed that the buyer has a sufficient stake to be likely to continue his payments? Accounting guidelines have been issued on minimally acceptable standards, but some companies choose a more conservative accounting policy than suggested by then guidelines while others follow only the minimally acceptable standards.

3.2.1 Measurability of Revenue

Revenue is said to be "measurable" if the medium of payment can be valued without serious difficulty. Clearly, cash payment presents no difficulties at all. Nor do accounts receivable if the terms of trade are clearly stated to be 60 or 90 days. But what if the terms are, as in the case of the land companies 10 or 15 years? The "value" of such long-lived receivable should be" discounted" at a rate which reflects appropriately the credit worthiness of the buyer. But what should this discount rate be? Some companies are likely to be more liberal than others in choosing a rate.

Finally, revenue is said to be "earned" when no significant activities remain to be performed for the customer. But it is not uncommon for revenue to be "captured" and "measurable" but not fully "earned." For example, machinery companies usually undertake substantial potential future costs in connection with service contracts and warranties. This may create an important element of non-comparability among companies which use different methods of providing for such possibilities.

3.2.2 Different Perspectives on Revenue Allocation

Another way of viewing the problems inherent in revenue recognition is to consider a company's schedule of activities, such as marketing, production, deliver and collection. There are various points in this cycle at which accountants will differ on how revenue should be recorded. Among the obvious possibilities are to record revenue (a) at the time the company produces the product or service which it has agreed to sell; (b) at the time the company delivers ; and (c) at the time it receives payment. Among the various questions which arise in this context, and which have caused numerous problems in comparing the income of firms in similar industries but using different methods of revenue recognition, are the following:

1. Many products have a very long production period – ships, planes, buildings, process-control systems, and so on. Some companies follow a conservative policy of refraining from recording revenues on the income statement until an order has been completed and delivered. Many other companies, however, record revenues on a "percentage completion" basis. That is as each critical phase of the production process is completed, a percentage of the final value of the product is recorded as a sale. But how do we determine this critical phase objectively? Furthermore, what will happen if, after booking 80 percent of the value of, say, an order of aircraft, some serious design defect is discovered which causes the entire project to fail or to require renegotiation?

2. Some products such as computers may be either sold outright or leased. Leasing involves some extremely complex problems of revenue recognition because of the many

varieties of lease terms. In some cases, the leased product is viewed as remaining the property of the lessor (the party who receives the rental payments). This results in a straightforward procedure whereby each payment is income to the lessor and expense to the lessee. But in other cases, the lease is viewed as a method of financing an acquisition of the property by the lessee – that is, as a sale by the lessor. This creates problems for the lessor company similar to those described above for the land development companies. When is the sale assumed to be consummated? Do we need to discount the future payments and, if so, at what rate?

3.2.3 Outright Sale versus Leasing

Additional difficulties are presented because the mix between outright sale and leasing, and among the different types of leases, varies both among companies and, for any given company, from one year to the next. This creates very erratic movements in trends of income over time.

While one may find it frustrating that we have enumerated many questions and problem areas without offering solutions, it is a fact of life that there are no clear solutions. But the analyst who recognizes the existence of the problems should be better able to make at least qualitative adjustments to net income when evaluating, say, two companies, one o which follows very conservative practices in recording revenues and one of which typically opts for the most liberal treatment available under Generally Accepted Accounting Principles (GAAP).

3.3 Cost of Goods Sold.

Accountants calculate cost of goods sold in an indirect manner. At the beginning of an accounting period, the value of the firm's inventories on hand is ascertained. The sum of this value plus the value of goods subsequently acquired for sale equals the cost of all goods available for sale during the period. By subtracting from this sum the value of inventories on hand at the end of the period, a determination is made of the cost of what was actually sold. For wholesale and retail firms, this is simply the value of merchandise which they bought from others. For manufacturing firms, cost of goods sold includes not only merchandise (that is, cost of raw material) but also wage and other costs directly associated with the manufacturing process (e.g., depreciation of owned plants and rents on leased plants).

3.3.1 Inventory Accounting

If prices were stable and consistently unchanging, the method of determining cost of goods sold would involve no problems. It would merely boil down to counting the number of units in inventory at the start of the period, adding the number purchased or produced during the period, and subtracting the number on hand at the end of the period. But the fact is that, prices do change. And this means that the number of units is only one variable in determining cost. Let us illustrate this with an example. Suppose that a Goods Retail Company begins the year with no inventory, and during the year buys three lots of 1,000 units for an item at successive prices of N15, N16, and N17 per unit respectively. Its purchases, then, will be:

1,000 units at N15	=	N15,000
1,000 units at N16	=	N16,000
1,000 units at N17	=	N17,000
Total purchases	=	N48,000
		=======

Assume now that during this same year, the firm sold 2,500 of the 3,000 units purchased. This being the case, it will end the year with 500 units of inventory. A key question is how value these 500 units. The traditional rule will favour valuing the inventory at the "current market price."

On the one hand, the firm can assume that units were sold in the same order as they were purchased. This is the so-called first-in-first-out (FIFO) method of inventory accounting. Using FIFO accounting, final inventory will have a unit cost equal to the most recent price (i.e. N17) and will be worth N8,500. On the other hand, it can be argued that when prices are rising or falling, FIFO does not properly match current costs with current selling prices. Those holding this view prefer last-in-first-out (LIFO) accounting, whereby the most recent purchase costs are charged against sales before earlier costs. Under this method, the unit cost of the final inventory in our example would be the earliest price (i.e., N15) and the total inventory would be N7,500.

Thus, both accepted accounting procedures produce different inventory "costs" N8,500 and N7,500. When final inventory is subtracted from the N48,000 of purchases, cost of goods sold becomes either nN39,500 or N40,500. But the value of sales during the period was what it was,

regardless of the method of inventory accounting adopted. Therefore, the gross profit on these

sales will be highest under FIFO accounting (i.e., sales minus N39,500), and lowest under LIFO accounting (i.e., sales minus N40,500). This occurs during a period of rising prices. During a period of falling prices, FIFO would produce the lowest profits and LIFO the highest profits.

3.3.2 FIFO and LIFO Inventory Accounting

Note that FIFO accounting reported profits to move in the direction of price changes as compared with LIFO accounting. Stated another way, FIFO accounting incorporates inventory profits and losses while LIFO accounting does not.

Since FIFO incorporates inventory gains and losses, it usually causes profits to be more volatile during the course of the business cycle than LIFO. During prosperous methods, when profits are normally rising, prices also frequently rise, and FIFO accounting causes inventory profits to be recorded on top of regular operating profits. LIFO does not. The opposite often occurs during recessions, when normal operating profit declines are augmented by inventory losses under FIFO but not under LIFO

4.0 CONCLUSION

Under this unit, we discussed financial statements and their uses. We also stated that financial statements do not contain all the information required to guide the investors in their investment decisions. Security analysts also differ in their interpretation of financial statements. There is usually problems in the valuation of inventory under FIFO and LIFO accounting methods.

5.0 SUMMARY

We have seen that financial statements though useful documents that provide information for the prospective investors and analysts, they are not completely reliable since some information contained are not completely accurate. FIFO and LIFO are different methods of valuing stocks and they provide different profits levels when used. This is a serious problem to accountants and investment analysts who must give accurate advice to the prospective investor.

6.0 TUTOR-MARKED ASSIGNMENT

* What are the uses of financial statements to a prospective investor.
* What kind of information does an income statement carry

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
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aluation

MODULE 2

Unit 1 Evaluation of Common Stocks
Unit 2 Analysis of Sales Growth
Unit 3 Relative Growth in Recent Years
Unit 4 Market Analysis

UNIT 1 EVALUATION OF COMMON STOCKS

CONTENTS

1.0 INTRODUCTION

The objective of common stock evaluation is to obtain standards against which prevailing prices of stocks may be judged. It is assumed that investors, as a whole, are essentially rational over

the long run, and that rational individuals attempt to measure the economic, or "going concern" values of the corporations whose stocks they buy and sell. Since there are millions of investors, there will exist vastly different ideas about the value of any given stock at any given time, and purchases and sales of the stock will be made in accordance with this multitude of ideas. Therefore, over an extended period of time, prices will fluctuate in a wide range but they will tend to fluctuate around some consensus of value.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with:

* How to evaluate common stock
* The general sources of common stock value
* Dividend payment and Dividend Growth Prospects

3.0 MAIN CONTENT

3.1 The Sources of Common Stock Value

Readers who ponder over the problem of common stock valuation will realize that a common stock has value for only three possible reasons. First, the ownership of common stock confers a claim to a corporation's net income. This claim bears fruit when the corporation's board of directors declares dividends. Second, if the corporation enjoys growing success, earnings and dividends will rise, and the price of its stock may rise also. The third, and least significant, source of common stock value is that if a corporation is liquidated, the common stock owner has a pro rata claim to any asset value that may remain after all creditors and the preferred stockholders have been paid. This residual claim, therefore, may give the common stock some value. But it is not a very important source of value because an efficiently operating corporation is not usually liquidated. And if it is liquidated because it is not operating efficiently, the asset value is not likely to be high enough to leave much of residual gain for the stockholders.

3.1.1 Dividend and Common Stock Value

When earnings and dividends are put together and considered in the context of common stock value, it gives rise to an interesting question on both a practical and a philosophical plane. We often hear the argument that dividends are distinctly subordinate to earnings as a

determinant of stock values. The evidence offered in support of this argument is the activity of thousands, perhaps millions, of investors whose dominant objective in buying common stock is to sell it to someone else to at a higher price to make capital gain rather than to keep it in order to collect dividends on it.

It is, of course, true that many individual stockholders do not intend to hold their stocks for dividends, ho9ping instead to sell then stocks to others at capital gains. But to conclude from this observation that "dividends do not count" would be quite misleading. In the first place, it is a frequent occurrence for the price of common stock to change substantially when a dividend increase or dividend reduction is announced. One likely explanation for this is that since reported earnings do not necessarily "true" earnings, investors look to dividends for an indication of what management really thinks earnings are (or are going to be in the future).

3.1.2 What the Investor Thinks of Dividend Payment

On a more theoretical plane, the significance of dividends has some time been illustrated by hypothesizing the existence of a corporation which has written into its bylaws a perpetual prohibition of dividend payments or a return of capital to stockholders via sale of assets or by any other means. With these byelaws, no rational investor will be willing to purchase the corporation's stock, no matter how high its earnings or how low the asking price. Of course, people sometimes become irrational or follow the "the greater fool theory" where each buyer assumes that he or she will be able to sell at a higher price to a "greater fool." Bus such bubbles must inevitably burst. Our hypothetical corporation's stock might trade for a while, but people must eventually recognize that they are buying and selling a mere piece of paper, without any value in the absence of an ability to pay dividends. Thus, while much of a stock's value to an investor undoubtedly lies in the prospect of price appreciation prices cannot be divorced from dividend prospects any more than they can be divorced from prospective earning power.

3.2 The Concept of Present Value of Future Dividends

Those who recognize the significance of dividends as a determinant of stock values can understand the reasoning behind a widely accepted tenet of investment theory. The tenet is that a common stock is "worth" the present value of all future dividends.

The concept of present value is really quite simple and can be illustrated with easy understanding. Assume that Mr. A wants to borrow money from Mr. B, repayable at a future date. Mr. B is willing to make the loan, but feels that, considering the risk involved, he is entitled to a 10 percent annual rate of return. This being the case, how much money will Mr. B advance Mr. B on IOU for $10 payable one year hence? The answer is $9.09, because the $10 paid next year provides 91 cents interest, which is 10 percent of a $9.09 loan. Thus $9.09 is the present value of $10 payable one year hence at a "discount" rate of 10 percent.

Likewise, if Mr. A offers $10 IOU payable two years hence, how much will Mr. B be willing to lend? Answer: $8.26. Ten percent of $8.26 is 83 cents (first year's interest); $8.26 plus $0.83 = $9.09. Ten percent of $9.09 is 91 cents (second year's interest; $9.09 plus $0.91 = $10. The present value of $10 payable two years hence is $8.26 at a discount rate of 10 percent.

3.2.1 Present Value of Perpetual Dividend Growth

Let return to the matter of future dividends on common stock, suppose we estimate that dividends on Standard & Poors Stock Price Index will grow at a rate of 7 percent far into the future. Suppose we estimate that "the market" (not any individual investor but all investors as a group) will always demand a 10 percent rate of return in order to undertake the risks of common stock investment. Recognizing that these assumptions are made purely for illustrative purposes, what is the value of the S & P Index today?

There is a simple formula for approximating the present value of perpetual dividend growth, at a constant discount rate. The formula is:

$$\text{Present Value} = \frac{\text{Current dividend rate}}{\text{Discount rate minus growth rate}}$$

Under our illustrative assumption, this becomes:

$$\frac{\text{Current dividend rate}}{0.10 \text{ minus } 0.07}$$

3.2.2 Today's Investors and Dividend Growth

Does it mean then that today's investors actually have to estimate dividend growth and discount rates to perpetuity in order to utilize the theoretical concept of present value of future dividends? This is not really so because the proportion of the total value represented by distant years' dividends diminishes rapidly unless the discount rate is quite close to the growth rate. Under most reasonable discount and growth rate assumptions (for example, where the discount rate is at least several percentage points higher than the growth rate), two thirds or more of the total "value" is accounted for by the first 30 years of dividends. Note that if one assumes a growth rate equal to, or greater than, the discount rate, a nonsense "value" results.

Of course, 30 days is by no means a short period for estimating either growth rates or discount rates. Indeed, most security analysts consider themselves fortunate if their growth rate estimates for the companies they follow hold good for five years. On the other hand, while long-term estimates are highly uncertain for individual stocks, the potential errors are diminished when considering all stocks in aggregate.

3.3 Growth Prospects for Stocks in Aggregate

As economists, the authors have a proclivity to relate most economic variables to gross national product, which they feel can be subjected to future estimation more accurately than most other variables. The question of aggregate dividend growth, therefore, is broken into three parts. First, what rate of GNP growth can be expected in the years ahead; second, will earnings per share of common stock keep pace with GNP; and third, will dividend growth keep pace with earnings growth? It should be emphasized at the outset that our main purpose is to provide a frame-work for thinking about these problems rather than to argue that our specific perspectives and specific answers are correct.

3.3.1 Growth of Gross National Product (GNP)

The growth of gross national product can be conveniently divided into four variables for analytical purposes: The growth of the employed labour force; the trend of average hours worked per week; the trend of output per hour worked (productivity); and the rate of change in the price level. By combining forecasts of the first three of these variables, a forecast of growth of so-called GNP is derived, that is, growth of physical output of goods and services excluding the effects of price changes.

The three determinants of real GNP have had a stable enough history during the past century to enable us to make some long-term estimates with a far degree of confidence. Without outlining their views in detail, it can be said that the estimates of most economists fall within the following ranges; approximately 1.5% to 2% annum growth in the employed labour force; 0.5% per annum decline in hours worked per week; and 2% to 3% per annum growth of output per hour worked. These elements combine to produce a 3% to 5% range of real GNP growth possibilities, with about 3% to 4% being the most common forecast.

3.3.2 Earnings Per share Relative to GNP

Turning to the question whether earnings per share will keep pace with GNP, a look at the past is in order. That is to say, we should study the history of earnings of the company for the past six years. The trend will generally give us an idea as to whether then earning per share is keeping pace with the GNP.

Dividends Relative to Earnings: Except during periods of recession, when dividend payout ratios may rise sharply because management may wish to maintain payments to stockholders even in the face of declining earnings. Most well-established companies adopt this strategy to ensure that stock prices in the market are not affected by a decrease in the dividend pay out to shareholders.

4.0 CONCLUSION

Under this unit, we made it clear that the objective of evaluating common stock is to obtain standards against which prevailing prices of stocks may be judged. We mentioned that there are three sources of common stock value. These are: Through ownership of stock which confers part-ownership of the company to the investor, dividend payment by the company, and third, possible residual gains from the company's assets in the event of liquidation.

5.0 SUMMARY

Common stock is valued to obtain standard or yardstick for measuring prevailing prices of stocks in the market. It is assumed generally that investors are rational human beings and that rational individuals attempt to measure the economic value of the company whose stocks they buy and sell. Since there are many investors, there will always be different ideas about the value of any given stock at a given time. Dividend payment level to shareholders has tremendous impact on the price of a company's shares.

6.0 TUTOR-MARKED ASSIGNMENT

* What is the reason for evaluating common stocks
* Enumerate and explain the three sources of common stock value
* What do you understand by “present value of future dividends”?

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
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UNIT 2 ANAYSIS OF SALES GROWTH

CONTENTS

1.0 INTRODUCTION

Virtually any logical approach to the evaluation of a corporation's common stock requires, as primary information an estimate of the corporation's probable growth in earning power (either in absolute terms or relative to the growth of all corporations in aggregate). So important is the estimate of earning power that we shall devote time in the survey of techniques that can assist the analyst in making such estimates.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with the following:

* Analysis of growth in the sales of an organization
* Understand the stages in industrial life cycle

3.0 MAIN CONTENTS

3.1 Why Start with Sales?

Since the 1930s, when common stocks first attained a degree of respectability as a sound investment vehicle, security analysts have stressed growth of demand for a company's products as the key determinant of investment success. Why the emphasis on growing demand" and on "growing sales"? Probably the main reason is that overhead has been a factor of steadily increasing importance in many industries. Taking American economy s an example, except during depressions, the economy has always had a shortage of skilled labour. Pressure has therefore constantly been in the direction of increasing utilization of labour-saving plant and equipment. But capital equipment carries a heavy fixed overhead in the form of interest on debt incurred in buying the equipment, depreciation, maintenance, insurance, taxes, and supervisory salaries. This raised the break-even point of companies, that is, the number of units which must be produced and sold in order to cover costs alone without making any profit. In order for a company to operate profitably under conditions of increasing mechanization and skilled-labour shortage, it is essential that its market expands so that its plants can operate at a high percentage of capacity.

Not that expanding production and sales automatically guarantee rising profits, which in the final analysis is what investors are after. But rising demand does, at least, give a company an opportunity to earn a rising profit. In many cases, rising demand can even absorb losses from managerial errors that must be expected to occur from time to time. Indeed, without the cushion of rising demand, management may be unwilling to take risks, and without risk-taking, little can be expected in the way of rising profits.

3.1.1 History as a Guide

Experience indicates clearly that the best way to begin to estimate future development is to examine what has happened in the past. Analysts first become familiar with the historical data, with the actual record of sales growth. They then try to learn why the past record was what it was. For example, if sales growth had been exceptionally rapid relative to the sales of competitors, analysts might want to find out the extent to which exclusive patent rights accounted for the competitive advantage.

As they begin to understand the conditions that created the past trends, analysts question whether these conditions are likely to persist6 in the future. Continuing the above illustration, analysts would investigate whether any basic patents were nearing expiration or whether any other companies had developed some improvements that would render the existing product technologically obsolete. If the conditions that created the past trends seem likely to persist in the future, analysts can simply project the past trends forward. But if, as is more likely, analysts believe that certain past conditions will probably be altered in form, or disappear entirely, they will try to estimate the impact of the changes and make allowance for them in their projections of the past record. In either event, however, the key to the future lies in the understanding of the past.

3.1.2 Variety of Economic Conditions

If possible analysts should try to gather data for a period which encompasses a variety of economic conditions. In this way they have an opportunity to observe the impact of changing conditions on the company's sales (and on its prices, labour costs, raw material supplies, and other profit determinants). They also can examine management's response to change more adequately than if they have only a few years of data available.

3.2 The Industrial Life Cycle

An analysis of the sales growth record and growth prospects of an industry or a company frequently can be conducted within the frame-work of the so-called industrial life cycle. Many students of economic history have argued that industries, like people, go through a few fairly well-defined stages of development. In the early part of their lives they grow at a very rapid rate. After a time the growth rate slows down; they continue to expand, but at a more moderate pace. Finally, they stop growing and either live a relatively stable existence for a long time or die.

3.2.1 Pioneering Stage

Exponents of the industrial life cycle concept, see the pioneering stage of an industry's development as being characterized by rapid expansion of the market with concomitant opportunities for large profits. These opportunities, however, give rise to fierce competition and high risk of bankruptcy. The automobile industry provides a dramatic example of this phenomenon. Between 1900 and 1908, more than 500 automobile companies were organized.

Of these, about300 quickly went out of business, either voluntarily involuntarily. By 1917, 76 companies were active in the industry, but 10 produced three quarters of the total output. Today, of course, only a few companies dominate the American automobile industry. More recent examples of rampant competition in new fields include air conditioners, television manufacturing, and electronic components such as semi-conductors.
Some investment authorities recommend that the best way to participate in the pioneering phase of the industrial life cycle is to buy the stocks of several competing companies. By spreading risks in this way, investors take the position that even if only one of the several companies survives, the profits on that one will more than make up for the losses on the others.

3.2.2 Investment Maturity and Stabilization Stages

Most of the discussion in the balance of this chapter, and in those which follow, will focus on the phase of growth that follow the pioneering stage. The second stage of growth is labeled "investment maturity." It refers to the fact that after some years, through consolidations and internal expansion, a relatively few companies usually take over a fairly large percentage of a young industry's total volume of business. They broaden the market by improving the quality and reducing the price of the product or service. They establish a strong financial position and a record of dividend payments, even if the dividends are quite modest. Growth of the industry's market continues to be quite rapid. It is not as rapid as in the pioneering stage, but neither are the risks as great. Then air-conditioning, television manufacturing, and semi-conductor industries all can be said to have passed from the pioneering to the investment maturity stage.

Gradually, however, even this second stage of growth begins to slow down. Technological advances become fewer and occur after longer time lags. Unit costs become more difficult to reduce, and the ability to broaden markets through reduced prices is thereby restricted. The market itself tends to become saturated, a process which is aggravated by the inroads of newer products and services.

3.2.3 New Perspective on the Industrial Life Cycle

The theory of the industrial life cycle departs from a strict conventional analogy at this point. Although the industry may, in fact, die, it is not argued that an aging industry necessarily must ultimately die. Indeed, in absolute terms, its sales may continue to grow may be below

average. The industry's sales may expand less rapidly than the economy during periods of general prosperity, and they may decline more rapidly during recessions. This stage in the evolution of an industry is labeled "stabilization."

To many proponents of industrial life cycle concept, the investment implications of the stabilization stage are quite bleak. In their view, investors should dispose of their stockholdings in the industry before stabilization takes hold. If they wait until it is common knowledge that the industry is leveling off, it may be too late. Stock prices may decline, and opportunities for a good rate of return may disappear. According to this approach, investment success will be achieved by:

(a) Detecting growth industries that are about to emerge from the pioneering phase.
(b) Investing in the stocks of the dominant companies in those industries.
(c) Selling the stocks just before the industries enter the stabilization phase.

3.3 Critique of the Industrial Life Cycle

In many respects, the life cycle approach offers a convenient method of classifying the growth pattern of different companies. But while the industry life cycle concept is useful, several criticisms can be leveled at the concept and at its investment implications. First, it is not necessarily true that a new industry is pioneered by large numbers of small companies which kill each other off in a bitter competitive struggle. For example, the synthetic fiber industry was largely pioneered by a single giant company called Du Pont. The company did not face any vigorous competition until many years after the original introduction of nylon.

Furthermore, the latter years of an industry's life are not necessarily characterized by permanent stagnation. Many industries go through a long period of oscillation between prosperity and recession. This type of oscillation is more common in the cement and copper industries.

3.3.1 The Factor of Security Prices and Values

Finally, the most important criticism of the life cycle approach to investment analysis is that to equate automatically each growth stage with a different degree of investment attractiveness is to overlook the factor of security prices and values. A major premise of this text is that it is possible to pay too much for growth and that at the right price even a no-growth situation can be attractive. Surely, the disastrous price declines which befell the stocks of many growth

companies in the last decade, in spite of continued above-average sales gains, attests to the importance of being careful not to pay too much for growth.

Illustrations. For all of its deficiencies, the life cycle framework does provide an interesting basis for at least an initial review of an industry's sales history. The Aluminum and Semi-conduct industries have been chosen for illustration.

The history of the American Aluminum industry is a long one. Aluminum production was begun long ago in 1888 by the Pittsburg Reduction Company, a predecessor of the Aluminum Company of America. The industry's growth rate at its formative years was in excess of 20% per annum, and 15% growth rate was maintained from 1910 to 1920. As its markets became increasingly saturated, the growth rate slowed down in the 1920s, but evidence of the continued vitality of the industry was the 6% growth rate achieved during the years of the Great Depression. World War II gave rise to major new aluminum-consuming industries such as mass-produced aircraft, and the industry's growth rate accelerated. Since 1960, a slowing has taken place once again, but a rate well in excess of aggregate real economic growth has been maintained. Thus, one can categorize the aluminum industry as having been in its pioneering phase until about 1920, and in extended investment maturity phase since them.

3.3.2 The Semi-conductor Industry

In contrast to the long history of the aluminum industry, the semi-conductor industry was born in the early 1950s, although research in this field can be traced to the 19th century. Another significant difference is that semi-conductors are not a homogeneous product like aluminum. One major segment of the market, "discreet" devices such as transistors, exhibited ten years of explosive growth and then entered an investment maturity phase which, as will be shown in succeeding pages, exhibited many of the characteristics of the stabilization phase. The other major segment of the market, integrated circuits, arose early in the 1960s and since then has exhibited the same explosive growth as in the early years of transistors. Whether a rapid maturation process will similarly occur will be considered below.

4.0 CONCLUSION

Under this unit we noted that the logical approach to the evaluation of a corporation's common stock requires an estimate of the corporation's probable growth in earning power either in absolute terms or relative to the growth of all corporations in aggregate. In the industrial life cycle analysis, we saw that each phase is characterized by different investment response in the investment market

5.0 SUMMARY

Common stocks attained a degree of respectability as sound investment vehicle in the 1920s. Since then, security analysts have stressed the growth of demand for a company's products as a keystone of investment success. The industrial life cycle affects the response of investment to a large extent. However, critics of industrial life cycle have argued that it is not right to equate each growth stage in the industrial life cycle with a different degree of investment attractiveness. They maintained that to do so would be tantamount to ignoring the factor of security prices and values.

6.0 TUTOR-MARKED ASSIGNMENT

* Why is the growth of demand for a company's product important for investment Success?
* Explain the three phases of the Industrial Life Cycle.

7.0 REFERENCE/FURTHER READING

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UNIT 3 RELATIVE GROWTH OF SALES IN RECENT YEARS

CONTENTS

1.0 INTRODUCTION

Having examined the historical record of the aluminum and semiconductor industries from a broad life cycle perspective, this unit turns to a more intensive study of the recent history of these industries.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with:

* Method of comparing the performance of different Industries
* Competitive factors to look out for when comparing two industries
* Computing Industry Dollar Sales and Unit Sales

3.0 MAIN CONTENT

3.1 Recent History of Aluminum and Semiconductor Industries

An adequate study of the recent history of the aluminum and semiconductor industries should include a comparison a comparison of the Naira sales of the industry with the Naira sales of competing industries if such can be identified (for example, aluminum competes with copper but semiconductors have no direct competitor), and with one or more broad economic measures such as gross national product, personal consumption expenditures, and durable goods manufacturing.

Similar comparisons to those above can also be carried out in physical unit rather than Naira terms. Sole reliance on Naira sales data is inadvisable. Naira sales are equal to the number of units sold multiplied by the sales price per unit. But as is well known, the prices of different commodities, such as aluminum, copper and steel, do not change uniformly. Differences in price movement exist both in timing and in magnitude. Thus it is quite possible to conceive of the following situation. Industry A expands its unit sales faster than competing Industry B. In order to accomplish this, Industry A has gradually reduced its prices relative to those of Industry B. As a result, the Naira sales of A have expanded less rapidly than those of B.

3.1.1 Competitive Factors

Analysts who concern themselves solely with Naira sales comparisons in this example would miss an opportunity to gain real insight into the competitive forces at work. If they project future sales relationships on the basis of the past without recognizing that the past record reflects sharply contrasting price-volume patterns, their projections will turn out to be very inaccurate. This is because it is most unlikely that the past price-volume patterns will remain unchanged. Accordingly, it is strongly recommended that inter-industry and industry-economy sales comparisons be carried out in terms of volume in addition to Naira.

3.1.2 Industry Naira Sales

Admittedly, a summation of leading companies' revenues usually is not equivalent to aggregate U.S. industry sales, because (a) there are other firms in each industry, and (b) the sales of most large companies are not exclusively concentrated in the products of a single industry and often include foreign operations. However, up-to-date aggregate industry data, in Naira amounts,

usually are available only for broader categories than we are interested in. For example, all non-ferrous metals (and summations of leading companies' revenues generally serve as a convenient and useful substitute. Until recently, the semiconductor industry was an exception to this generalization. Aggregate Naira sales data were published for each major product line. After a few years, a major producer stopped submitting its data, and it became necessary to rely on "expert opinion" for such information. It should be noted that almost every important industry in the United States has at least one trade association publication, and these often serve as valuable data sources for industry analysis.

3.1.3 Industry Unit Sales

For both aluminum and semiconductors industries, unit volume data have been published by the respective trade associations. Interestingly, volume data are often available for industry aggregate while they may be unavailable for individual companies. The situation is quite the opposite from that of Naira sales. Sources of industry volume statistics often are found in the Statistical Abstract of the United States, together with summary data for selected years. The Conference Board and trade journals are other excellent sources of statistics. In addition, one of the several dozen industry subgroups of the Federal Reserve Board Index of Industrial Production may be used. Many of these sub-indexes are published monthly in the Federal Reserve Bulletin, and additional details are contained in the monthly releases by the Board, which are kept on file at most business libraries.

3.2 Aggregate Economic Data

Industry dollar sales of aluminum and semiconductors are usually compared with gross national product. Industry unit sales, on the other hand, are usually compared with "constant dollar" or "real" gross national product. The constant dollar data for GNP and its major components are published regularly along with the current dollar data in "Survey of Current Business."

3.2.1 Ratio Analysis of the Data

Industry sales are divided by GNP and the resulting quotients, or ratios, are plotted on a graph. The underlying data need not be expressed in similar units (example, dollars versus dollars) to make ratio analysis possible. Pounds of one product can be compared with bushels, or quarts of another. The absolute amounts of the ratios are not significant but the changes in the ratios are. In examining each ratio line, answers should be sought to four questions:

1. Is the line rising or falling (that is, is the numerator of the ratio growing more or less rapidly than the denominator) over the whole length of the period
2. Has the relative growth (or relative decline) of the numerator been fairly uniform or has it occurred in fits and starts? The less the variability around trend, the more confidence one can have in using the past trend as the starting point of an analysis. Indeed, if the variability is slight it may be possible to use some type of mechanical trend projection technique. Remember that stability is an important determinant of stock's price-earnings ratio.

3. Is there any sign that the overall trend of the ratio line has been leveling off in recent years.

3.2.2 Influence of Movements in the General Business Cycle

When the questions asked above are appli9ed to a chart, some interesting observations will emerge. In the analysis we used it was shown that unit sales of aluminum and of both major types of semiconductors rose much more rapidly than total economic output. The relative growth of aluminum, however, did not proceed steadily from year to year, and the relative growth of the transistor segment of the semiconductor industry was very volatile during several years of the period. In each recession year, aluminum was more vulnerable than the overall economy.

3.3 Prices

There are two price factors which should be distinguished because they may have different implications for the future. One is the natural secular price decline of growth products; the other is the erratic price movement of industries whose productive capacity periodically spurts far ahead of immediate sales potential.

Think of an industry which has grown rapidly in sales volume for a period of 10 or 20 years, and then think of what has happened to its selling prices relative to the general price level. Almost invariably, the selling price of a growing product has shown a secular downtrend, either in absolute terms or at least relative to other prices. Aluminum and semiconductors both are examples.

Where the basic demand for a product is strong, management tries to tap and expand the market by reducing cost and improving quality. Productivity gains are used, in part, to lower selling prices. On the other hand, in non-growth industries, like steel an d railroad passenger transport, selling prices tend to be raised whenever possible, instead of lowered to broaden markets. When prices do get cut in non-growth industries, it usually takes the form of price warfare rather than secular price reduction. Price warfare refers to intra-industry price cutting in an attempt to capture a larger share of a relatively fixed market. But secular price reduction is designed to enlarge the total effective demand for a product or service.

3.3.1 Price Characteristics of a Stagnant Market

Frequently, however, situations are encountered where an industry exhibits the price characteristics of a stagnant market and yet demand for the industry's product is growing at above-average rate. Typically, the cause of this peculiar behaviour is excess capacity. Although demand for the product is rising, productive capacity may be rising much more rapidly. As a result, the companies in the industry engage in extremely vigorous price competition in order to build up their sales relative to capacity. Then, when a better sales/capacity balance is achieved, they attempt to restore their previous prices.

3.3.2 New Era for the Metal

The unprecedented strength of aluminum prices during a severe economic recession caused many analysts to proclaim that a new era had arrived for the metal, and, indeed, for many other raw materials whose price showed similar strength. Their argument was that the cosdts of building new capacity had risen to such high levels that without high selling prices no new capacity would be built. But while this argument perhaps had long-run merit, the fact was that by late 1985, with production showing markedly lagged response to the recession, price-cutting reappeared in the industry. Although the renewal price weakness may, in retrospect, be viewed as a temporary aberration, the long history of aluminum prices just recited suggests two conclusions regarding the years ahead. First, aluminum prices are more likely than not to decline secularly relative to other prices, in line with industry's expansion of markets. Second, this secular trend is likely to be punctuated by periodic episodes of over-expansion and cyclical price reductions.

4.0 CONCLUSION

This unit dealt with the relative growth of sales in recent years. We noted that any intensive study of the recent history of the industries should include comparison of the dollar sales of the industry with the dollar sales of identifiable competing industries. We further noted that analysts must not concern themselves solely with dollar sales comparisons otherwise they would miss an opportunity to gain real insight into the competitive forces at work.

5.0 SUMMARY

We have examined the historical record of the aluminum and semiconductor industries from a broad life cycle perspective. We emphasized that comparison should be based on the dollar sales of competing industries where we can identify such competitors. Dollar sales are equal to the number of units sold multiplied by the sales price per unit. But as it is well known, the prices of different commodities, such as aluminum, copper and steel, do not change uniformly.

6.0 TUTOR-MARKED ASSIGNMENT

* Why is it necessary to compare the dollar sales of one industry with the dollar sales of competing industries.
* Explain the natural secular price and erratic price movement of industries.

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
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UNIT 4 ANALYSIS OF EARNINGS GROWTH

CONTENTS

1.0 INTRODUCTION

Since stock values ultimately are dependent upon prospective earnings and dividends, the analysis of sales growth is merely the starting point of a broader investigation. To understand adequately the forces shaping business growth, it is helpful to break down the past earnings growth record into several key component parts. It is the objective of this chapter to illustrate the analysis of earnings by component parts. Unless otherwise mentioned in our discussion in this unit, references to net income should be taken to mean “income available to common stockholders” that is after deducting preferred dividends.

2.0 The Sources of earnings growth

Net income per share of common stock is equal to the rate of return on stockholders' equity multiplied by the per share value of stockholders' equity. This can be shown algebraically, as follows:

$$\text{Net Income Per Share} = \frac{\text{Net income}}{\text{Shareholders' equity}} \times \frac{\text{Stockholders' Equity}}{\text{Number of common shares}}$$

Note that stockholders' equity appears in the denominator of one fraction and in the numerator of the other, thus cancelling out each other and leaving Net income/Number of common shares, or net income per share. Stockholders' equity, also referred to as book value, equals the same as total assets minus liabilities and preferred stock.

It follows from this relationship that growth of net income per share can stem from either an increase in stockholders' equity per share, or from an increase in return on stockholders' equity, or from some combination of the two. (Actually a sufficient increase in one can offset a reduction in the other).

3.0 MAIN CONTENT

3.1.1 Sources of Equity Growth

Growth of stockholders' equity per share has two principal sources. First and foremost, is the plowed back of earnings into the business (that is, paying out only a small portion of net income in cash dividends to common stockholders and retaining and reinvesting the balance). The contribution of earnings retention to growth of net income per share can be illustrated by a numerical example. Assume that a company is earning 10% on stockholders' equity, that is, N1 of net income per common share for every N10 of stockholders' equity per share. And assume, further, that the company has a dividend payout ratio of 40% per share, that is, it pays dividends of N0.40 per share for every N1 of available earnings. Its "retention rate" then is 60%. This means that N1.60 is plowed back into the business out of every N1 earned.

Now, if the company continues to earn 10% on the old capital and, in addition, is able to put the new plowed-back funds to work at a 10% return, its earnings per share will grow by 6%. This six per cent may be shown as follows:

Previous stockholders' equity					
per share (old capital)	10%	X N10.00	=	N1.00	Earned per share
Retained earnings					
per share (new capital)	10%	X N 0.60	=	N0.06	Earned per share
New level of earnings			=	N1.06	Earned per share
Growth rate of earnings per share	1.06/1.00		=	6%	

It should be noted that the percentage growth rate is equal to the rate of return on stockholders' equity (10%) multiplied by the retention rate (60%). That is, 60% X 10% = 6%. This algebraic function is of great significance in security analysis.

In the preceding illustration, it was assumed that the growth of stockholders' equity per share came from earnings retention. But stockholders' equity per share also can grow in another way, that is, by the company selling additional shares of common stock at a price per share which is higher than the existing book value per share. For example, if book value is N100 million and 10 million shares are outstanding, book value per share is N10. If one million additional shares are sold at 2 times book value, or N20 per share, total book value rises to N120 million and total shares outstanding to 11 million. Book value per share thus is raised to N120/11, or N10.91 per share. This provides a basis for growth in earnings per share if the rate of return on stockholders' equity can be maintained.

3.1.2 Sale of Common Stock at a Premium over Book Value

Sale of common stock at a "premium over book value" traditionally has been an important source of growth for public utility companies. In addition, mergers often result in a rise in book value per share of the surviving corporation. This comes about when the acquiring corporation exchanges its shares for those of the acquired corporation and the book value of the acquired shares is greater than the book value of the shares given in exchange. However, earnings retention is the major source of growth of stockholder' equity per share.

To summarize, growth of net income per common share can be looked upon as stemming from two sources: Growth of stockholders' equity per share and improvement in the rate of return on stockholders' equity. Since the former source of growth is primarily a reflection of earnings retention, it may be stated as a generalization that the growth rate of earnings per share is a function of the product of the rate of return on stockholders' equity multiplied by the retention rate. This can be expressed algebraically as:

$$\frac{\text{Net income}}{\text{Stockholders' equity}} \times \frac{\text{Net income - Dividends}}{\text{Net income}}$$

It should be noted that in applying this expression, general practice is to use the average of beginning-of-the–year and end-of-the-year stockholders' equity, to allow for the gradual plowback of earnings during the year and for any new common stock financing that may have been done during the year.

3.2 Analysis of Return on Equity

Additional insight into the factors underlying a company's record of earnings growth can be gained by examining the components of its rate of return on common stock equity. By examining the trends in each component, the analyst can isolate the principal causes of a decline or rise in return on equity, which gives him a sounder basis for determining whether past rates of return will persist or change during the years ahead.

Return on common stock equity can be viewed as the product of the "profit margin" on every Naira of sales multiplied by the "equity turnover," or number of Naira of sales per Naira of stockholders' equity. This can be expressed algebraically as follows:

$$\frac{\text{Net income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Stockholders' equity}} = \frac{\text{Net income}}{\text{Stockholders' equity}}$$

(Profit margin) (Equity turnover) (Rate of return on equity)

3.2.1 Net Profit Margin and Equity Turnover

Examination of interaction between net profit margin and equity turnover provides useful insight into the sources of rate of return on equity. But it is too broad brush for a deep understanding and a confident estimate of the future. For example, the net profit margin reflects not only the basic operating efficiency of a firm, but also its non-operating income and expense and its income tax rate. These factors should be examined separately in an intensive analysis. Similarly, equity turnover reflects not only the degree of utilization of the company's assets but also the method of financing those assets (debt versus equity). Since a company's asset utilization and its financial policies are two quite different factors, they should be examined separately.

Following this line of reasoning, it is instructive to approach the interaction of margin and turnover from a somewhat different angle than we have just done. First, we shall focus on the interaction of the operating margin (pretax) and the turnover of operating assets. The product of these two ratios is the return on operating assets (pretax):

$$\frac{\text{Operating income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Operating assets}} = \frac{\text{Operating income}}{\text{Operating assets}}$$

(Operating margin) X (Turnover of operating assets) = (Return on operating assets)

3.2.2 Components of Operating Margin

Let us here examine the components of operating margin. That is to establish the extent to which changes in the margin are attributable to changes in specific cost components (labour, materials, selling and administrative expenses, and depreciation). We shall also examine the main components of turnover of operating assets (turnover of receivables, inventories, and plant).

Following this study of operating margin and turnover of operating assets, we shall consider the influence of non-operating income and expense, of leverage (the relationship of debt to equity), and of tax rate.

3.3 Growth of Equity Per Share

The basic growth potential of earnings per share can be estimated by multiplying the anticipated rate of return on stockholders' equity by the proportion of earnings expected to be retained in the business. Studies of corporate dividend and retention policies suggest that many interacting factors are at work in any given situation. Among these factors, the following may be listed, although not necessarily in order of importance:

(1) An effort to project systematically future financial requirements, rates of return, and costs of alternative sources of funds.
(2) Subjective attitude of the executives towards debt.
(3) A weighing of the desires and tax status of the principal stockholders against the desires and tax status of the typical stockholders.

(4) The policies of competing companies.
(5) A reluctance to set dividends at a rate that may later have to be cut back.

3.3.1 Stability of Dividend Payout Ratio

In general, the result of all there cross currents is a relative stability of dividend payout ratios. While payout ratios vary considerably from company to company, any one corporation's average dividend payout ratio tends to remain cyclically. Therefore, reference must be made to average payout ratios. It may be helpful also to examine the ratio of dividends to cash flow (net available for common plus depreciation, amortization, and depletion), since this figure tends to be more stable from year to year than the more traditional payout ratio.

Of course, security analysts cannot simply assume that the average historical payout and retention rates will be maintained in the future. They must try to determine whether any changes in policies are under way or forthcoming. Evidence of such changes might be present in the payout data themselves. For example, the analyst may observe a gradual increase or reduction in the payout percentage), or in statements made by management in stockholder reports or at annual meetings, or in the analyst's projections of future capital expenditures and capital requirements. Indeed, just as corporations are now required by the SEC to include a statement of sources and application of funds along with their income statements and balance sheets, so too is nit becoming increasingly common for security analysts to make projections of future sources and application of funds along with their projections of future sales and earnings.

3.3.2 Effects of Selling New Stock

While earnings retention is the principal source of growth of equity per share, it it was also noted at the outset of this unit that growth can be achieved by selling new shares at a price higher than the existing equity per share (that is at a premium over book value).

4.0 CONCLUSION

We noted under this unit that stock values are dependent upon prospective earnings and dividends payout of the company. To understand adequately the forces influencing profit growth, it is helpful to break down the past earnings growth record into several key components parts. Generally speaking, the growth of stockholders' equity per share has two principal sources. These sources are; the plowback of earnings into the business and the sale of common stock at a premium over the book value.

5.0 SUMMARY

Under this unit we saw that analysis of sales growth is merely the starting point of a wider investigation of the forces responsible for changes in stock value. Stockholders' equity is subject to growth from time to time. The principal factors responsible for the growth are traceable to earnings plowback and the sale of shares at a premium.

6.0 TUTOR-MARKED ASSIGNMENT

* Mention and discuss the two major sources of growth of stockholders equity.
* Discuss the effect non-payment of dividends could have on a company's stock price.

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
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MODULE 3

Unit 1 Investment Return
Unit 2 Risk : The other Side of the Investment Coin
Unit 3 Investing in Common Stocks
Unit 4 Buying and Selling of Common Stocks

UNIT 1 INVESTMENT RETURN

CONTENTS

1.0 INTRODUCTION

When you go shopping for clothing materials, you will naturally go to the store and inspect and possibly try out the materials. But when you invest in a company, there is nothing to sample or try out physically. It is difficult to find out exactly the risks associated with the stock you have just bought from a company. In this unit we are going to study returns on the investment you make and the risks associated with investments.

2.0 OBJECTIVES

After studying this unit, you should be able to:

* Understand the concept of Return and Risks on Investments
* How to calculate Capital Gains and Capital Losses on your Investments

3.0 MAIN CONTENT

3.1 The Concept of Return

When we mention the word "Return", we mean the level of profit from an investment, that is, the reward for investing. Investors are motivated to invest in a given instrument by its expected return. Suppose you have N1,000 in a savings account paying 5 per cent annual interest, and a business associate asks you to lend him that amount of money. If you lend him that money for one year, at the end of which she pays you back, your return will depend on the amount of interest you charged him. If you gave him the money as an interest-free loan, your return will be zero. If you charged him 5 per cent interest, your return will be N50, that is, (0.05 x N1,000)

Note that some investment instruments guarantee a return without failure, others do not. For example, if you deposit N1,000 in the savings account of a large and strong commercial bank, your return can be viewed as certain since such strong bank is unlikely to go bankrupt over a short period. But if you lend the same amount of money to your business associate, your return might be less certain. Because your business associate might run into financial difficulty and be unable to pay you the interest charge and sometimes even the principal sum.

3.1.1 Components of Return

The return on an investment may come from more than one source. The most common source is periodic payments such as dividends or interest. The other source of return is appreciation in the value of your investment instrument, that, is the gain from selling an investment instrument for more than its original purchase price. We will call these two sources of return "current Income" and "capital Gain" respectively.

3.1.2 Current Income

Current income may take the form of dividends from stocks, interest received on bonds, rent received from real estate, and so on. To be considered to be an income, it must be received in the form of cash or be readily convertible into cash. For our purpose, current income is usually cash or near-cash that is periodically received as a result of owning an investment.

3.1.3 Capital Gains (or Losses)

The second type of return is concerned with the change in the market value of an investment. Investors pay a certain amount for an investment, from which they expect to receive, not only current income but also the return of the invested funds sometime in the future. The amount by which the proceeds from the sale of an investment exceed its original purchase price is called a "capital gain." In the contrary, if an investment is sold for less than its original purchase price, we have what is called "capital loss."

3.2 Why Return is Important

Return is a key variable in the investment decision: It allows us to prepare the actual or expected gains provided by various investments with the levels of return we need to be fairly compensated for the risks involved. For example, you would be satisfied with an investment that earns 12 per cent if your original expectation is that it should earn at least 10 per cent. Conversely, you will not be satisfied with an investment that 15 per cent return if your original anticipation is that it should earn at least 20 per cent return. Return can be measured in a historical sense or it can be used to formulate future expectations.

3.2.1 Historical Performance

Although most people recognize that future performance is not guaranteed by past performance, they would agree that past data often provide meaningful basis for formulating future expectations. A common practice in the investment world is to look closely at the historical performance of a given instrument when formulating expectations about its future. Because interest rates and other measures of financial return are most often cited on an annual basis, evaluation of past investment returns is typically done on the same basis.

3.2.2 Expected Return

In the final analysis, it is the future that matters when we make investment decisions. Expected return is a vital measure of performance. It is what you think the investment will earn in the future (in terms of current income and capital gains) that determines what you should be willing to pay for it.

To project future returns, we need insights into the investment prospects. If the trend in returns as recorded historically over a given range of years (say from 2005 to 2008) continued to rise, an expected future return in the range of 12 per cent to 15 per cent for 2012 to 2016 would be reasonable. On the other hand, if future prospects seem poor, or if the investment is subject to cycles, an expected return of 8 per cent to 10 per cent may be a more reasonable estimate.

3.2.3 Level of Return

The level of return achieved or expected from an investment will depend on a variety of factors. The key factors are internal characteristics and external forces.

Internal Characteristics: Certain characteristics of an investment affect its level of return. Examples include the type of investment instrument, the quality of management, the way the investment if financed and the customer base of the issuer. For example, the common stock of a large and well-managed company would be expected to provide a level of return higher from that of a small and poorly managed firm. Assessing internal factors and their impact on return is one important step in analyzing potential investments.

External Forces: External forces such as Federal Reserve actions, shortages war, price controls, and political events may also affect the level of return. None of these is under the control of the issuer of the investment instrument. Because investment instruments are affected differently by these factors, it is not unusual to find two instruments with similar internal characteristics offering significantly different returns. As a result of the same external force, the expected return from one instrument may increase, whereas that of another decreases. Likewise, the economies of various countries respond to external forces in different ways.

Another external force is the general level of price changes, either upwards caused by "inflation" or downwards caused by "Deflation." Inflation tends to have a positive impact on certain types of investment instruments, such as real estate, and a negative impact on others, such as stocks and fixed income securities. Rising interest rates, which normally accompany increasing rates of inflation, can significantly affect returns

3.3 The Time Value of Money

Imagine that Mr. Andrew who is 25 years of age begins making annual cash deposits of N1,000 Into a savings account that pays 5 per cent annual interest. After 40 years, that is at the age of 65 years, Mr. Andrew would have made deposit totaling N40,000, that is, (40 years x N1,000 per year). Assuming Mr. Andrew made no withdrawals, what do you think Mr. Andrew's account balance would be? Will it be N50,000, N75,000? Or N100,000? The answer is none of the above. Mr. Andrew's N40,000 would have grown to nearly N12,000. Why? Because the time value of money allows the deposits to earn interest that is compounded over the 40 years. Time Value of Money refers to the fact that as long as an opportunity exists to earn interest, the value of money is affected by the point in time when the money is expected to be received. Because opportunities to earn interest on funds are readily available, the sooner you receive a return on a given investment, the better.

3.3.1 Interest: The Basic Return to Savers

A savings around at a bank is one of the most basic forms of investment. Then saver receives interest in exchange for placing idle funds in an account. Interest can be viewed as a "rent" paid by a borrower for the use of the lender's money. The saver will experience neither a

capital gain nor a capital loss, because, the value of the investment (the initial deposit) will increase only by the amount of interest earned.

Simple interest: The income paid on such instruments as Certificates of Deposit (CDs), bonds, and other forms of investment that pay interest is most often calculated using the simple interest method: Interest is paid only on the initial deposit for the amount of time it is held. For example, if you hold a N100 initial deposit in an account paying 6 per cent interest per annum, you will earn N6 interest at the end of the year, that is (1 yr x 0.06 N100).

Using the simple interest method, the stated rate of interest is the true rate of interest (or return), which is, the actual rate of interest earned. In our example, the true rate of interest is 6 per cent. Because the interest rate reflects the rate at which current income is earned regardless of the size of the deposit, it is a useful measure of current income.

3.3.2 Compound Interest

Compound interest is paid not only on the initial deposit but also on any interest accumulated from one period to the next period. This is the method usually used by savings institutions. When interest is compounded annually over a single year, compound interest and simple interest provide similar results. In this case the stated interest rate and the true interest rate are equal. Note that this is only in the first year. In subsequent years, the interest earned in the first year is compounded or added to the principal and both of them earn interest on the stated rate of interest.

4.0 CONCLUSION

In this unit we dealt with returns on investment instruments. We noted that return means the level of profit from an investment, that is, the reward for investing. What motivates an investor to invest in a given instrument is the expected return. We also talked about the current income and capital gains (or losses).

5.0 SUMMARY

This unit clearly demonstrates that it is only one factor that motivates investors to invest in instruments. That single factor is the expected return from the investment. Return on

investment comes from sources such as dividend and interest payment. Return can also be earned from capital gain, that is when we sell an investment instrument for more than its original purchase price.

6.0 TUTOR-MARKED ASSIGNMENT

* Discuss what you understand by "current Income"
* Why is return so important in investment practice?

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
Published by McGraw-Hill Company Inc., 1221 Avenue, New York, U.S.A.

Cohen, J. (1977) Investment Analysis & Portfolio Management (Third Edition)
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Rufus, I.A. (2004) Investment Decisions, Concepts, Analysis and Management
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UNIT 2 RISK: THE OTHER SIDE OF THE INVESTMENT COIN

CONTENTS

1.0 INTRODUCTION

The investment coin has two sides like any other coil. One side represents the earning of returns and the other side embodies the risks and dangers of not realizing our investment expectations. In essence, we cannot consider return without also looking at risk, the chance that the actual return from an investment may differ from what is expected. In this unit, we shall consider the various types of risks in different investment instruments.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with:

* The relationship between risk and return called the “Risk-Return Trade-off”
* Various risks associated with different investment instruments

3.0 MAIN CONTENT

3.1 The Concept of Risk

As earlier mentioned, we cannot consider return without also looking at risk, the chance that the actual return from our investment may differ from our expectation. The risk associated with a given investment is directly related to its expected return. In general, the broader the range of possible returns associated with a given investment, the greater its risk, and vice versa. Expressed in another way, riskier investments tend to provide higher levels of return or the higher the risk the higher the reward. Otherwise, why would an investor risk his capital?

In general, investors attempt to minimize risk for a given level of return or to maximize return for a given level of risk. This relationship between risk and return is usually referred to as the “risk-return trade-off.”

3.1.1 Sources of Risk

The risk associated with certain investment instrument may result from a combination of a variety of possible sources. A Prudent investor considers how the major sources of risk might affect potential investment instruments. Of course, currency exchange rate should also be considered when investing internationally.

3.1.2 Business Risk

In general, business risk is concerned with the degree of uncertainty associated with the earnings of an investment and the ability of that investment to pay interest, principal, dividends, and any other returns owed investors. For example, a business firm may experience

poor earnings and, as a result fail to pay investors fully. In this case, business owners may receive no return if earnings are not adequate to meet obligations. Debt holders, on the other hand, are likely to receive some, but not necessarily all, of the amount owed them, because of the preferential treatment legally accorded to debt instrument holders.

Much of the business risk associated with a given investment instrument is related to its kind of business. For example, the business risk of a public utility common stock differs from that of a high-fashion clothing manufacturer. Generally, investments in similar kinds of firms have similar risk although differences in management, costs, and location.

3.1.3 Financial Risk

The degree of uncertainty of payment attributable to the mix of debt and equity used to finance a firm or property is financial risk. The larger the proportion of debt used to finance a firm or property, the greater its financial risk. Debt financing obligates the firm to make interest payments as well as to repay the debts, thus increasing the firm's risk. These fixed-payment obligations must be met before the distribution of any earnings to the owners of such firms or properties. Inability to meet obligations associated with the use of debt could result in business failure and in loss for bond-holders as well as for stock-holders.

3.2 Purchasing Power Risk

The chance that changing price levels within the economy (inflation or deflation) will adversely affect investment returns in purchasing power risk. Specifically, this risk is the chance that generally rising prices (inflation) will reduce purchasing power, that is, the amount of a given commodity that can be purchased with Naira. For example, if last year one Naira could buy ten oranges. This year, if orange sellers start selling ten oranges for N2, it means that N1 can buy only five oranges this year. In period of rising price levels, the purchasing power of the Naira decreases and vice versa.

In general, investments whose values move with general price levels have low purchasing power risk and are most profitable during periods of rising prices. Those that provide fixed returns have high purchasing power risk and are most profitable during periods of declining price levels or low inflation. The returns on real and tangible personal property investments, for example, tend to move with the general price level, whereas returns from deposit accounts and bonds do not.

3.2.1 Interest Rate Risk

Securities are especially affected by interest rate risk. This is particularly true for those securities that offer purchasers a fixed periodic return. Interest rate risk is the chance that changes in interest rates will adversely affect the value of a security. The interest rate changes themselves result from changes in the general relationship between the supply of and the demand for money. As interest rates change, the prices of many securities fluctuate. They decrease with increasing interest rates, and increase with decreasing interest rates. . The price of fixed income securities, such as, bonds and preferred stock drop when interest rates rise. They thus provide purchasers with the same rate of return that would be available at prevailing rates. The reverse is the case when interest rates fall.

The other aspect of interest rate risk is related to investing in short-term securities such as Treasury bills, certificates of deposit, commercial paper, and bankers' acceptances.
Some investors include these securities in their portfolios rather than investing in long-term securities. Investors face the risk that when short-term securities mature, their proceeds may have to be invested in lower yielding, new short-term securities. By initially making a long-term investment, you can lock-in a return for a period of years rather than face the risk of declining the returns from a short-term security investment strategy are adversely affected. Most investment instruments are subject to interest rate risk. However, fixed-income securities are most directly affected by interest rate movements followed by other long-term securities such as common stock and property.

3.2.2 Liquidity Risk

Liquidity risk is the risk of not being able to liquidate an investment conveniently and at a reasonable price. The liquidity of a given investment instrument is an important consideration for an investor. In general, investment instruments traded in a thin market, where demand and supply are small, tend to be less liquid than those traded in broad markets.

One can generally sell an investment instrument merely by significantly reducing its price. However, to be liquid, an investment instrument must be easily sold at a reasonable price.

3.2.3 Tax Risk

The chance that the Federal Government will make unfavourable changes in tax laws , driving down the after-tax returns and market values of certain investments. The greater the chance that such changes will drive down the after –tax returns and market values of certain investments, the greater the tax risk. Undesirable changes in tax laws include elimination of tax exemptions, limitation of deductions, and increase in tax rates. Virtually all investments are vulnerable to increases in tax rates, certain investments, such as municipal and other bonds, real estate, and natural resources generally have greater tax risk.

3.3 Market Risk

Market risk is the risk of a decline in investment returns because of market factors independent of the given security or property investment. Examples of market risk include political, economic, and social events as well as changes in investor tastes and preferences. Market risk actually embodies a number of different risks; purchasing power risk, interest rate risk, and tax risk.

The impact of market factors on investment returns is not uniform. Both the degree and the direction of change in turn differ among investment instruments. For example, legislation placing restrictive import quotas on foreign automobiles and electronic goods may result in a significant increase in the value of domestic automobiles and electronics. Essentially, market risk is expressed in the price volatility of a of a security. The more volatile the price of a security, the greater its perceived market risk.

3.3.1 Event Risk

Event risk implies the risk that comes from a largely (or totally) unexpected event that has a significant and usually immediate effect on the underlying value of an investment. This risk occurs when something happens to a company or property that has a sudden and substantial impact on its financial condition. Event risk goes beyond business and financial risk. It does not necessarily mean the company or market is doing poorly. Instead, it involves a largely unexpected event that has a significant and usually immediate effect on the underlying value of an investment. Event risk can take many forms and can affect all types of investment instruments.

3.3.2 Components of Risk

The risk of an investment consists of two components. Diversifiable and Non-diversifiable risks. Diversifiable risk, sometimes called unsystematic risk, results from uncontrollable or random events, such as labour strikes, lawsuits, and regulatory actions. Such risk affects various investment vehicles instruments differently. It represents the portion of an investment's risk that can be eliminated through diversification.

Non-diversifiable risk, also called systematic risk, is attributed to forces such as war, inflation, and political events that affect all investments and therefore are not unique to a given instrument. The sum of non-diversifiable risk and diversifiable risk is called total risk.

4.0 CONCLUSION

Under this unit, we discussed risk, that is the chance that the actual return from an investment may differ from what is expected. We made the point that, the risk associated with a given Investment is directly related to its expected return. We have many types of risk and they include; business risk, financial risk, purchasing risk, interest rate risk, etc.

4.0 SUMMARY

The issue of risk is important to every investor because risk affects the returns on investment. It is sometimes the assumption in investment studies that, the higher the risk in a particular investment instrument, the higher the returns, but that is not always the case. A wise investor thoroughly weighs the risk and returns in each investment move he makes.

6.0 TUTOR-MARKED ASSIGNMENT

* What do you understand by risk and how does it affect return?
* Explain what you understand by "Event Risk"?

7.0 REFERENCE/FURTHER READING

Bodie, Z. et al. (2001) Essentials of Investment (Fourth Edition)
Published by McGraw-Hill Company Inc., 1221 Avenue, New York, U.S.A.

Cohen, J. (1977) Investment Analysis & Portfolio Management (Third Edition)
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UNIT 3 INVESTING IN COMMON STOCK S

CONTENTS

1.0 INTRODUCTION

Investing in common stock is about taking educated risk. It is also about receiving returns, sometimes spectacular ones too. It looks so easy to invest in common stock but it goes with big risk because common stock ownership makes you part owner of the firm and for this reason, you are carrying the most risk. Investors who risk their money in common stock must learn as much as possible about the company in which they are investing and the industry to which it belongs.

2.0 OBJECTIVES

After studying this unit, you will be familiar with

* Common stocks and dividends payable to common stock holders.
* Learn something about the characteristics of common stocks

3.0 MAIN CONTENT

3.1 What Stocks have to Offer

The basic investment attribute of common stocks is that they enable investors o participate in the profits of the firm. Every shareholder is a part owner of the firm and, as such, is entitled to a piece of the firm's profit. This claim on income is not without limitations, however, because common stockholders are really the residual owners of the company. That is, they are entitled to dividend income and a share of the company's earnings only after all other corporate obligations have been met. Equally important as residual owners, holders of common stock have no guarantee that they will ever receive any return on their investment.
The challenge, of course, is to find stocks that will provide the kind of return you are looking for. As anyone who has ever purchased stock can attest, it is not really easy to settle at common stock for there are literally thousands of actively traded stocks to choose from.

3.1.1 The Appeal of Common Stocks

Common stocks are a popular form of investing, used by millions of individual investors. Their popularity stems from the fact that they offer investors an opportunity to tailor their investment programmes to meet individual needs and preferences. Given the size and diversity of the stock market, it is safe to say that no matter what the investment objective, there are common stocks to fit the bill. For retired people and others living on their investment holdings, stocks provide a way of earning a steady stream of current income, common stocks can serve as the basis for long-run accumulation of wealth. With this strategy, stocks are used very much like a savings account. Investors buy stock for the long haul as a way to earn not only dividends but also a steady flow of capital gains. These investors recognize that stocks have a tendency to go up in price over time, and they simply position themselves to take advantage of that fact. Indeed, it is this potential for capital gains that is the real incentive for investment in common stocks. Whereas dividends can provide a steady stream of income, the big returns come from capital gains. And few securities can match common stocks when it comes to capital gains.

3.1.2 Putting Stock Price Behaviour in Perspective

By the special nature of common stock, when the market is strong, investors can generally expect to benefit from steady price appreciation. On the other hand, when the market falters, that is, when the market is weak, stock price will begin to dwindle. The rise and fall characteristic of the stock market dictated by stock market condition gave rise to the concept of "Bull" and "Bear" situation in the stock market.
Bull Market: The stock market is said to be in bull shape when there is general rise in the price of stocks traded on it. There is active buying and selling, and investors are making money.
Bear Market: The stock market is said to be in bear shape when the general stock price is on the decline. There are not lively transactions and investors are losing money.

3.1.3 From Stock Price to Stock Return

So far, we have centred our discussion on stock prices, but what is even more important to investors is stock returns, which take into account, not only price behaviour, but also dividend income and capital gains.

Generally, when a firm is performing well and earning good profits, the chances are that it will declare high figure of dividend to be paid to common stock-holders. The market price of shares of a high-performing firm will always be on the increase. This means too that stockholders can make capital gains when they sell their stock in the stock exchange market.

3.2 The Pros and Coins of Stock Ownership

One reason why common stocks are so attractive to investors is the substantial return opportunities they offer. Stocks generally provide attractive highly competitive returns over the run. Indeed, common stock returns compare favourably to alternative investment outlets such as long-term corporate bonds and treasury bills.

The special advantage of equity securities (common stocks) is that stock holders are entitled to participate fully in the residual profit of the firm. In good times they earn higher dividends greater than the interest payable to bondholders.

3.2.1 Other Benefits of Common Stock

Common stocks offer some other special benefits. They are easy to buy and sell, and the transaction costs are modest. Moreover, price and market information is widely disseminated in the news and financial media. A final advantage of stock ownership is that the unit cost of share of common is usually within the reach of most individual investors. A final advantage of stock ownership is that the unit cost of share of common stock is usually within the reach of most individual investors. Unlike bonds, which carry minimum denomination of at least N100, N150 or N200 a share and any number of shares, no matter how few, can be bought or sold.

3.2.2 Disadvantages of Holding Common Stock

Looking at the other side of the coin, there are some disadvantages, too, associated with holding common stock. The major disadvantage has to do with risk. Common stocks are subject to a number of different types of risk. These risk include business and financial risk, purchasing power risk, market risk, and possibly event risk. All of these can adversely affect a stock's earnings and dividends, its price appreciation, and, of course, the rate of return earned by an investor.

Even the best of stocks possess elements of risk that are difficult to overcome, because company earning are subject to many factors, including government control and regulation, foreign competition and state of the economy. Because such factors affect sales and profits, they also affect the price behaviour of the stock and even dividends. All of these lead to another disadvantage: The earnings and performance of a stock are subject to wide swings so it is difficult to value common stock adequately.

3.3 Basic Characteristics of Common Stocks

Each share of common stock represents equity (ownership) in a company. Indeed, it is this equity position that explains why common stocks are often referred to equity securities or equity capital. Every share entitled the holder to an equal ownership position and participation in the corporation's earnings and dividends, and equal vote, and equal voice in management. Together, the common stockholders own the company, and the more shares an investor owns, the bigger his or her ownership position. Common stock has no maturity date; I remain s in position and in power indefinitely unless the holder decides to sell it to another investor.

3.3.1 Common Stock as a Corporate Security

All business firms (private and public) issue common stock. However, only the common stocks of publicly quoted corporate bodies are traded in the stock market. These are the shares that are readily available to the general public and which are bought and sold in the open market.

Shares of common stock can be issued in several different ways. The most widely used procedure today is the "public offering" of new shares, whereby the corporation, working with an underwriter, offers the investing public a certain number of shares at a certain price. New shares can also be issued using what is known as a "rights offering." In a rights offering, existing shareholders are given the first opportunity to buy the new issues and can purchase new shares in proportion to their current ownership position. For instance, if a stockholder currently owns one per cent of a firm's stock and the firm issues 10,000 additional shares, the rights offering will give that stockholder the opportunity to purchase one percent of 10,000 shares which boils down to 100 shares.

3.3.2 Classified Common Stock

For the most part, all the stockholders in a corporation enjoy the same benefits of ownership. Occasionally, (though not a common feature in the developing countries), a company can issue different classes of common stock, each of which entitles the holder to different privileges and benefits. These issues are known as Classified Common Stock." Hundreds of publicly traded companies, especially in the developed economies, have created such stock classes. Even though issued by the same company, each class of common stock is different in a way.

Classified common stock is customarily used to denote either different voting rights or different dividend obligations. For instance, class A stock could be used to designate non-voting shares, and class B could carry normal voting rights. Ford Motor Company in U.S.A. is known for issuing two classes of common stock (ordinary shares). Class A stock is owned by the investing public, and class B stock is owned by the Ford family . The two classes of stock share equally in the dividends, but class A stock has one vote per share and the voting rights of the class B stock are structured to give the Ford Family a 40 per cent absolute control of the company.

4.0 CONCLUSION

In this unit, we have discussed common stock and what it has to offer investors. We noted that common stock, also referred to as ordinary share or equity share gives the holder ownership right in the firm according to the number of shares each investor holds. An investor in the stock of a firm is interested in the earnings. This earning comes in form of dividend payable to him at the end of every year when the company makes profit. The investor can also benefit from capital through the sale of his shares.

5.0 SUMMARY

Investment in common stock can be said to be the best investment so long as the company is performing profitably. The common stock holder in a well-performing company receives dividend at the end of the year. He can sell his shares to make capital gains, and he has voting right and by voting right, h is indirectly participating in the running of the organization. In good times, the investor makes capital gains out of his shares, and in bad periods he will incur capital losses.

6.O TUTOR-MARKED ASSIGNMENT

* Why is the common stock holder referred to as Residual Owner of the company?
* When can a common stock holder incur capital loss?

7.0 REFERENCE/FURTHER READING

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UNIT 4 BUYING AND SELLING OF COMMON STOCKS

CONTENTS

1.0 INTRODUCTION

In the stock market investors engage in the buying and selling of stocks. The buying and selling of stocks demand that the investor should be familiar with the way stocks are quoted and the costs of executing common stock transactions. This unit will introduce the student to the requirements for successful buying and selling of common stocks.

2.0 OBJECTIVES

After studying this unit, the student should be familiar with :

* Knowledge and wisdom required for successful buying and selling of common stocks
* How to determine the “par value” and “book value” of common stocks

3.0 MAIN CONTENT

3.1 Buying and Selling of Common Stocks

Whether buying or selling stocks, investors should be familiar with the way stocks are quoted and with the costs of executing common stock transactions. Certainly, keeping track of current prices is an essential element in the buying and selling decisions of investors. They are the link in the decision process that lets the investor decide when to buy or sell a stock. They also help investors monitor the market performance of their security holdings. Similarly, transaction costs are important because of the impact they can have on investment returns. Indeed, the costs of executing stock transactions can sometimes consume most (or all) of the profits from an investment. These costs should not be taken lightly.

3.1.1 Reading the Quotes

Investors in the stock market have come to rely on a highly efficient information system that quickly disseminates market prices to the public. The stock quotes that appear daily in the financial press are a vital part of that information system. To see how price quotations work and what they mean, consider the quotes that appear daily in the Financial Times and other Newspapers. These quotes give, not only the most recent price of each stock, but also a great deal of additional information.

3.1.2 Transaction Costs

Common stock can be bought and sold in round or odd lots. A round lot is 100 shares of stock. An odd lot is a transaction involving g less than 100 shares. The sale of 400 shares of stock would be a round lot transaction; the sale of 75 shares would be an odd lot transaction. Trading 250 shares of stock would involve a combination of two round lots and an odd lot.

An investor incurs certain transaction costs when buying or selling stock. In addition to some modest transfer fees and taxes paid by the seller, the major cost is the brokerage fee paid by both the buyer and the seller at the time of the transaction. As a rule, brokerage fees amount to one per cent to five per cent of most transactions, though they can go much higher particularly for very small trades. This is so because the purchase or sale of odd lots requires the assistance of a specialist known as an odd-lot dealer. This usually results in an odd-lot differential of 12.5 to 25 kobo per share.

3.2 Common Stock Value

The worth of a share of common stock can be described in a number of ways. Terms such as par value, book value, market value, and investment value are all found in the financial media. Each designates some accounting, investment, or monetary attribute of the stock in question.

3.2.1 Par Value

The term "par value" refers to the stated, or face value of a stock. It is not really a measure of anything, and except for accounting purposes, it is relatively useless. In many ways, par value is a throwback to the early days of corporate law, when it was used as a basis for assessing the extent of a stockholder's legal liability. Because the term has little or no significance for investors, many stocks today are issued as no-par or low-par stocks, that is, they may have par values of only a penny o two.

3.2.2 Book Value

"Book Value," another accounting measure, represents the amount of stock-holder's equity in the firm. It is commonly used in security analysis and stock valuation. Book value indicates the amount of stockholder funds used to finance the firm. It is calculated by subtracting the firm's liabilities and preferred stock from its assets.

Let us assume that a corporation has N10 million assets, owes N5 million in various forms of short- and long-term debt, and has N1 million worth of preferred stock outstanding. The book value of this firm would be N4 million. This amount can be converted to a per-share basis (book value per share) through dividing it by the number of common shares outstanding. For example, if this firm has 100,000 shares of common stock outstanding, then its book value per share is N40. As a rule, most stocks have market prices that are above their book values.

3.2.3 Market Value

"Market value" of a stock is one of the easiest stock values to determine. It is simply the prevailing market price of an issue. In essence, market value indicates how the market participants as a whole have assessed the worth of a share of stock. By multiplying the market price of the stock by the number of shares outstanding, we can also find the market value of the firm itself, or what is known as the firm's market capitalization. For example, if a firm has N1 million shares outstanding and its stock trades at N50 per share, the company has a market value (or market cap) of N50 million. Because investors are always interested in an issue's market price, the market value of a share of stock is generally of considerable importance to stockholders as they formulate their investment policies and programmes.

3.2.4 Investment Value

Investment value is probably the most important measure for a stockholder. It indicates the worth investors place on the stock, that is to say, what they think the stock should be trading for. Determining a security's investment worth is a complex process based on expectations of the return and risk behaviour of a stock. Every stock has two potential sources of return. The first one is annual dividend payments and the second is possible capital gains that could accrue if the stock is sold after the market price of that stock has appreciated.

In establishing investment value, investors try to determine how much money they will make from these two sources and then use that estimate as the basis for formulating the return potential of the stock. At the same time, they try to assess the amount of risk to which they will be exposed by holding the stock. Such return and risk knowledge helps them place an investment value on the stock. This value represents the maximum price an investor should be willing to pay for the issue.

3.3 The Dividend Decision

By paying out dividends on annual or half-yearly basis, companies share with their stockholders the profits they earn. Actually, the question of how much to pay in dividend is decided by a firm's board of directors. The directors evaluate the firm's operating results and financial condition to determine whether dividends should be paid and, if so, how much. If the directors decide to pay dividends, they also establish several important payment dates.

3.3.1 Corporate Versus Market Factors

When the board of directors assembles for a regular dividend meeting, it weighs a variety of factors in making the dividend decision. First, the board looks at the firm's earnings. Even though a company does not have to show a profit to pay dividends, profits still are considered a vital link in the dividend decision.
With common stocks, the annual earnings of a firm are usually measured and reported in terms of earnings per share (EPS). Basically, EPS translates total corporate profits into profits on a per-share basis and provides a convenient measure of the amount of earnings available to stockholders. Earning per share is found by using the following simple formula:

$$EPS = \frac{\text{Net profit after taxes} - \text{Preferred dividends}}{\text{Number of shares of common stock outstanding}}$$

3.3.2 Components of Risk

Let us assume the directors decide to declare a dividend. They then must indicate the date of payment and other important dates associated with the dividend. Normally, the directors will issue a statement to the press indicating their dividend decision, along with the dividend payment dates. These statements are widely published in the Financial Times and other print media.

Three dates are particularly important to the stockholder: The date of record, ex-dividend date, and payment date. The "date of record" is the date on which the investor must be a registered shareholder of the firm to be entitled to a dividend. These stock holders are usually referred to as "holders of record." When the board specified the date of record, all the investors who are official stock holders of the firm as of the close of business on that date will receive the dividends that have just been declared.

The "Payment date" is also set by the board of directors. Generally, the payment date follows the date of record after one week. The payment date is the actual date on which the firm will mail dividend cheques to holders of record.

Because of the time needed to make book-keeping entries after a stock is traded, the stock will sell on an “ex-dividend” basis for three business days prior to the date of record. That is, the ex-dividend date will dictate whether you were an official shareholder and therefore eligible to receive the declared dividend. If you sell your stock before this date, the new shareholder will receive the recently declared dividend.

4.0 CONCLUSION

In this unit, we studied the process of buying and selling common stocks. We noted that it is advisable for an investor to get familiar with the way stocks are quoted and the costs of executing common stock transactions. We also looked at common stock values and discussed the par value, book value, market value and investment value of common stock.

5.0 SUMMARY

Keeping track of current prices is an essential element in the buying and selling of common stock. Similarly, transaction costs are important because of the impact they can have on investment returns since the ultimate aim of every investor is to earn the highest possible returns. Common stock holders receive dividend on their holdings. They are interested in receiving high figures of dividend hence the way a firm makes investment decision is of interest to them.

6.0 TUTOR-MARKED ASSIGNMEN T

* Explain the meaning of “par value” and “market value” of common stock
* How does a publicly quoted firm make dividend decision?

7.0 REFERENCE/FURTHER READING

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MODULE 4

Unit 1 Security Analysis
Unit 2 Investing in Fixed-Income Securities
Unit 3 Bond Valuation and Analysis.
Unit 4 Preferred Stock and Convertible Securities

UNIT 1 SECURITY ANALYSIS

CONTENTS

1.0 INTRODUCTION

Just about everywhere you look, there is a product or service created by a company that issues common stock. Think of Coca Cola Company, Seven Up firm or the Liver Brothers, all of them

have one product or another to sell. Your satisfaction with a product or your attraction to its design may lure you into investing in its stock. But, wait a minute! Do not invest yet. Carry out security analysis to determine the value of the stock, the risks inherent and the potential returns before you stick out your neck to invest.

2.0 OBJECTIVES

After studying this unit, the student should be familiar with the:

* Principles followed in Security Analysis
* Application of Security Analysis in an Efficient Market

3.0 MAIN CONTENT

3.1 Principles of Security Analysis

The obvious motivation for investing in stocks is to watch your money grow. Unfortunately some of the investments we make end up in losses rather than profits. Most of the disasters in our investment can be traced to bad timing, greed, poor planning, or failure to use common sense in making investment decisions. That is why every investor needs to carry out security analysis of stocks before deciding to invest.

Security analysis consists of gathering information, organizing it into a logical framework, and then using the information to determine the inherent or intrinsic value of a common stock. Given a rate of return that is compatible with the amount of risk involved in a proposed transaction, intrinsic value provides a measure of the underlying worth of a share of stock. It provides a standard for helping you judge whether a particular stock is undervalued, fairly priced, or overvalued.

In investment, the question of value centres on returns. In particular, a satisfactory investment candidate is one that offers a level of expected return commensurate with the amount of risk involved. As a result, not only must an investment instrument be profitable, it must be sufficiently profitable, that is, you expect it to generate a return high enough to offset the perceived exposure to risk.

3.1.1 What Security Analysis Particularly Address

If you could have your way, you would probably like to invest in something that offers you a complete preservation of your capital, along with sizeable current income and capital gains. The problem, of course, is in finding such a security. One approach is to buy whatever that strikes your fancy. A more rational approach is to use security analysis to look for promising investment candidates. Security analysis therefore specifically addresses the question of "what to buy" by determining the "worth of a stock." Presumably, an investor will buy a stock only if its prevailing market price does not exceed its worth. The worth of a stock means the intrinsic value put on it as perceived by the investor. However, intrinsic value depends on several factors:

1. Estimates of the stock's future cash flows , that is, the amount of dividends you expect to receive over the holding period and the estimated price of the stock at time of sale.

2. The discount rate used to translate these future cash flows into present value.

3. The amount of risk embedded in achieving the forecasted level of performance.

3.1.2 Focus of Traditional Security Analysis

Traditional security analysis usually takes a "top-down" approach: It begins with economic analysis and the moves to industry analysis and finally to fundamental analysis.
Economic analysis is concerned with assessing the general state of the economy and its potential effects on security returns.
Industry analysis deals with the industry within which a particular company operates, how the company is measuring up with the major competitors in the industry, and the general outlook for that industry.

Fundamental analysis looks in depth at the financial condition and operating results of a specific company and the underlying behaviour of its common stock. In essence, it looks at the "fundamentals of the company," that is, the company's investment decisions, the liquidity of its assets, its use of debt, its profit margins and earnings growth and ultimately, it looks at the future prospects of the company and its stock. Fundamental analysis is closely linked to the notion of intrinsic value because it provides the basis for projecting a stock's future cash flows.

A key part of this analytical process is company analysis, which takes a close look at the actual financial performance of the company. Such analysis is not meant simply to provide interesting information about how the company has performed in the past, rather, it is done to help investors formulate expectations about the future performance of the company and its stock. Make no mistake about it, in the field of investment, it is the future that matters. But in order to understand the future prospects of the firm, an investor should have a good handle on the company's current conditions and its ability to produce earnings.

3.1.3 Who Needs Security Analysis in an Efficient Market?

The concept of security analysis is general and fundamental analysis in particular is based on the assumption that investors are capable of formulating reliable estimates of a stock's future behaviour. Fundamental analysis operates on the broad premise that some securities may be mispriced in the market place at any given point in time. Furthermore, fundamental analysis assumed that, by undertaking a careful analysis of the inherent characteristics of each of the firms in question, it is possible to distinguish those securities that are correctly priced from those that are not.

To many, those two assumptions of fundamental analysis seem reasonable. However, there are others who just do not accept the assumptions of fundamental analysis. These are the so called "Efficient Market" advocates. They believe that the market is so efficient in processing new information that securities trade so close to or exactly at their correct values at all times. Thus, they argue, it is virtually impossible to outperform the market on a consistent basis.
In its strongest form, the efficient market hypothesis asserts that:

(1) Securities are rarely, if ever, substantially misplaced in the market place.
(2) No security analysis, however detailed, is capable of identifying misplaced with a frequency greater than that which might be expected by random chance alone.

Is the efficient market hypothesis correct? Is there a place for fundamental analysis in modern investment theory? Interestingly, most financial theorists and practitioners would answer yes to both of these questions.

3.2 Solution to the Paradox

The solution to this apparent paradox is really quite simple. Basically, fundamental analysis is of value in the selection of alternative investment instruments for two important reasons. First, financial markets are as efficient as they are because a large number of people and powerful financial institutions invest a great deal of time and money in analyzing the fundamentals of most widely held investments. In other words, markets tend to be efficient, and securities tend to trade at or near their intrinsic values, simply because a great many people have done the research necessary to determine what their intrinsic values should be. Second, although the financial markets are generally efficient, they are by no means perfectly efficient. Pricing errors are inevitable, and those individuals who have conducted the most thorough studies of the underlying fundamentals of a given security are the most likely to profit when errors do occur.

3.2.1 Economic Analysis

If we live in a world where economic activity had absolutely no effect on the stock market or no security prices, we could avoid studying the economy altogether. The fact is, of course, that we do not and cannot live in such a world. Stock prices are heavily influenced by the state of the economy and by economic events. As a rule, stock prices tend to move upwards when the economy is strong, and downwards when the economy starts to dwindle.

The reason why the economy is so important to the market is simple: The overall performance of the economy has a significant bearing on the performance and profitability of the companies that issue common stock. As the fortunes of the issuing firms change with the economic conditions, so do the prices of their stocks. Of course, not all stocks are affected in the same way or to the same extent. Some sectors of the economy, like food retailing, may be only mildly affected by the economy, others, like the construction and auto industries, are often hard hit when times get rough.

A general study of the economy should not only give an investor a grasp of the underlying nature of the economic environment but also enable him to assess the current state of the economy and to formulate expectations about its future course. It can go so far as to include a detailed examination of each sector of the economy, or it may be done on a very informal basis. Regardless of how it is performed, however, the purpose (from security analysis perspective) is always the same: To establish a sound foundation for the valuation of common stock.

3.2.2 Economic Analysis and the Business Cycle

Economic analysis sets the tone for security analysis. If the economic future looks bleak, you can probably expect most stock returns to be equally dismal. If the economy is buoyant, stocks prices will be high. The behaviour of the economy is sometimes captured in the business cycle, which reflects changes in total economic activity over time. Two widely followed measures of the business cycle are:

(a) Gross Domestic Product (GDP), which represents the market value of all goods and services produced in a country over the period of a year.

(b) Index of Industrial Production which measures the activity/output in the industrial or productive segment of the economy.

Normally, gross domestic product and the index of industrial production move up and down following the dictates of the business cycle.

3.3 Key Economic Factors

Several parts of the economy are especially important because of the impact they have on total economic activity. These would naturally include:

Government fiscal policy:
Taxes
Government spending
Monetary policy:
Money supply
Interest rates
Other factors:
Consumer spending
Business Investments
Foreign trade and foreign exchange rates

Government physical policy tends to be expansive when it encourages spending, that is, when the government reduces taxes and increases the size of the budget. Similarly, monetary policy is said to be expansive when money is readily available and interest rates are relatively low. An expansive economy also depends on a generous level of spending by consumers and

business concerns. These same variables moving in a reverse direction can have a recessionary impact on the economy, as for example, when taxes and interest rates increase or when spending by consumers and businesses falls off.

The impact of these major forces filters through the system and affects several key dimensions of the economy. The most important of these are industrial production, corporate profits, retail sales, personal income, the unemployment rate, and inflation. For example, a strong economy exists when industrial production, corporate profits, retail sales, and personal income are moving up and unemployment is moving down. Thus, when conducting an economic analysis, an investor should keep an eye on fiscal and monetary policies, consumer and business spending, and foreign trade for the potential impact they have on the economy. At the same time, he must stay abreast of the level of industrial production, corporate profits, Retail sales, personal income, unemployment, and inflation in order to assess the state of the business cycle.

3.3.1 Developing an Economic Outlook

Conducting an economic analysis involves studying fiscal and monetary policies, inflationary expectations, consumer and business spending, and the state of the business cycle. Often investors do this on a fairly informal basis. As they form their economic judgments, many rely on one or more of the popular published sources as well as on periodic reports from major brokerage houses. These sources provide a convenient summary of economic activity and give investors a general feel for the condition of the economy.

Once you have developed a general economic outlook, you can use the information in one of two ways. One approach is to construct an economic outlook and then consider where it leads in terms of possible areas for further analysis. For example, suppose you uncover information that strongly suggests the outlook for business spending is very positive. On the basis of such an analysis, you might want to look more closely at capital goods producers, such as machine tool manufacturers, as investment candidates.

A second way to use information about the economy is to consider specific industries or companies and ask, “How will they be affected by expected developments in the economy?” Take an investor with an interest in gold trinkets stocks. Because of the nature of the business (durable fashion goods), these stocks are susceptible to changing economic conditions.

Especially important here is the level of discretionary consumer spending: Normally spending on such goods tends to accelerate when the economy picks up and slackens when the economy slows down. In this instance, our imaginary investor would first want to assess the current state of the business cycle. Using insight, he would then formulate some expectations about the future of the economy and the potential impact it holds for the stock market in general and a gold trinket stocks in particular.

3.3.2 Industry Analysis

Looking at securities in terms of industry groupings is a popular way of viewing stocks and is widely used by both individual and institutional investors. This is a sensible approach because stock prices are influenced by industry conditions. The level of demand in an industry and other industry forces set the tone for individual companies. Clearly, if the outlook is good for an industry, then the prospects are likely to be strong for the companies that make up that industry.

The first step in industry analysis is to establish the competitive position of a particular industry in relation to others. It is clear that not all industries perform alike.
The next step is to identify companies within the industry that hold particular promise. This sets the stage for a more thorough analysis of individual companies and securities. Analyzing an industry means looking at such things as its makeup and basic characteristics, the key economic and operating variables that drive industry performance, and the outlook for the industry. The investor will also want to keep an eye out for specific companies that appear well suited to take advantage of industry conditions. Companies with strong market conditions should be favoured over those with less secure positions. Such dominance confers the ability to maintain pricing leadership and suggests that the firm will be in a position to enjoy economies of scale and low-cost production. Market dominance also enables a company to support a strong research and development effort, thereby helping it secure its leadership position for the future.

Normally, an investor can gain valuable insight about an industry by seeking answers to the following questions:

(1) What is the nature of the industry? Is it monopolistic, or are there many competitors? Do few set the trend for the rest?

(2) To what extent is the industry regulated? Is it a public utility?
If the industry is regulated, then find out how friendly the regulatory authority is.

(3) What role, if any, does labour play in the industry? How important are labour unions? Are there good labour relations within the industry? When is the next round of contract talks.

(4) How important are technological developments? Are any new developments taking place, and what impact are potential breakthroughs likely to have?

(5) Which economic forces are especially important to the industry?
Is the demand for the industry's goods and services related to key economic variables? If so, what is the outlook for those variables?
How important is foreign competition to the health of the industry?

(6) What are the important financial and operating considerations? Is there an adequate Supply of labour, material, and capital?
What are the capital spending plans and needs of the industry?

4.0 CONCLUSION

In this unit, we studied security analysis which we pointed out is the process of gathering and organizing information and then using it to determine the value of a share of common stock. In essence, security analysis addresses the question of "what to buy" by determining what a stock ought to be, in terms of its value. Determining the intrinsic value of a stock depends on several factors among them is the risk inherent in achieving the forecasted performance.

5.0 SUMMARY

We carry out security analysis in order to determine the value of a common stock.
Security analysis provides a standard for helping us determine whether a particular stock is undervalued, fairly prices or overvalued. In investment practice, the question of value centres on return. In particular, a satisfactory investment instrument is one that offers a level of expected return commensurate with the amount of risk involved.

6.0 TUTOR-MARKED ASSIGNMENT

* What is the main objective of security analysis?
* What are the two assumptions of fundamental analysis of securities?

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MODULE 4

UNIT 2 INVESTING IN FIXED-INCOME SECURITIES

CONTENTS

1.0 INTRODUCTION

Under this unit, we shall be studying investment in fixed-income securities. Some securities such as bonds carry fixed-income payable at maturity. Other investments instruments, such as, common stock has no fixed-income. An investor in common stocks receives dividend and dividend payment is dependent on the earnings power of the issuing firm.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with:

* The process of investing in fixed-income securities
* The advantages and disadvantages in fixed-income investment

3.0 MAIN CONTENT

3.1 Investment in Fixed-Income Securities

The oil industry is one of the world's most capital intensive businesses today. It requires billions of Naira worth of equipment for exploration and production of natural resources. One of the largest oil companies operating in Nigeria is Mobil, which searches for oil and natural gas throughout the world. Much of Mobil's equipment is financed through the issuance of long-term bonds. Because Mobil is such a strong company, investors in its bonds are confident that the debt will be paid. Mobil, of course, must pay investors interest on these bonds, but because it has a strong credit rating, it does not have to pay as high an interest rate as some other less well-established companies.

3.1.1 Why Invest in Bonds?

In the past, investment in bonds was viewed as rather dull investment that produced current income and little else. It is no longer true today, instead bonds are regarded as highly competitive investment instruments that offer the potential for attractive returns.
Bonds are publicly traded long-term debt securities whereby the issuer agrees to pay a fixed amount of interest over a specified period of time and to repay a fixed amount of principal at maturity. Bonds are issued in convenient denominations and by a variety borrowing companies, government corporations, states and local governments. Bonds are referred to as fixed –income securities because the debt-service obligations of the issuer are fixed. That is, the issuing organization agrees to pay a fixed amount of interest periodically and to repay a fixed amount of principal art maturity.

Like any other type of investment instrument, bonds provide investors with two kinds of income:

(1) They provide a generous amount of current income.
(2) They can often be used to generate substantial amounts of capital gains.

The current income is, of course, derived from the interest payments received over the life of the issue. Capital gains, in contrast, are earned whenever market interest rates fall. A basic trading rule in the bond market is that interest rates and bond prices move in opposite directions. When interest rates rise, bond prices fall, and when interest rates drop, bond prices move up. Thus, it is possible to buy bonds at one price and to sell them later at a higher price. Of course, it is also possible to incur a capital loss, should market rates move against you. 3Taken together, the current income and capital gains earned from bonds can lead to attractive investor returns.

3.1.2 Bonds as Versatile Investment Outlet

Bonds are also a versatile investment outlet. They can be used conservatively by those who primarily (or exclusively) seek high current income, or they can be used aggressively by those who go after capital gains. Although, bonds have long been considered attractive investments for those seeking current income, it is only since the advent of volatile interest rates that they have also been recognized as outstanding trading instruments. Investors found that, given the relation of bond prices to interest rates, the number of profitable trading opportunities increased substantially as wider and more frequent swings in interest rates began to occur.

In addition, certain types of bonds can be used for tax shelter. Municipal obligations are perhaps the best known in this regard, but certain federal agency issues also offer some tax advantages. Finally, because of the general high quality of many bond issues, they can also be used for preservation and long-term accumulation of capital. With quality issues, not only do investors have a high degree of assurance that they will get their money back at maturity, but the stream of interest income is also highly dependable.

3.1.3 Putting Bond Market Performance in Perspective

The bond market is driven by interest rates. In fact, the behaviour of interest rates is the single most important force in the bond market. These rates determine not only the amount of current income investors will make but also the amount of capital gains (or losses) bondholders

will incur. It is not surprising, therefore, that bond market participants follow interest rates closely and that bond market performance is generally portrayed in terms of market interest rates.

3.2 Total Returns in the Bond Market

As with stocks, total returns in the bond market are made up of current income and capital gains (or losses). Not surprisingly because rising rates mean falling prices, the drawn-out bear market in bonds mean depressing returns for bondholders. For investors just entering the market, the higher market yields were welcomed, because they meant higher levels interest income. But for those already holding bonds, the implications were much different, as returns fell way below expectations and, in many cases resulted into outright losses.

Some market experts go so far as to question whether bonds should have any place at all in an investment portfolio. They reason that if interest rates have bottomed out, then blonds will not have a lot to offer investors (other than relatively low returns.

3.2.1 Exposure to Risk

Like any other type of investment instrument, fixed-income securities should be viewed in terms of their risk and return. Generally speaking, bonds are exposed to five major types of risks; interest rate risk, purchasing power risk, business/financial risk, liquidity risk, and call risk.

Interest Rate Risk: Interest rate risk is the number one source of risk to fixed-income investors, because it is the major cause of price volatility in the bond market. In the case of bonds, interest rate risk translates into market risk: The behaviour of interest rates, in general affects all bonds and cuts across all sectors of the market including the government treasury bills market.. When market interest rates rise, bond prices fall, and vice versa. And as interest rates become more volatile, so do bond prices.

Purchasing Power Risk: Purchasing power risk accompanies inflation. During periods of mild inflation, bonds do pretty well, because their returns tend to outstrip inflation rates. Purchasing power risk really hits up when inflation takes off. When that happens, bond yields start to lag behind inflation rates. The reason: You have a fixed coupon rate on your bond, so even though market yields are rising with inflation, your return is locked-in during the inflation period.

3.2.2 Other Risks Associated with investment in Bonds

Business/Financial Risk: This is basically the risk that the issuer will default on inter5est and/or principal payments. Business/financial risk has to do with the quality and financial integrity of the issuer; the stronger the issuer, the less business/financial risk there is to worry about. This risk does not even exist in some securities. For example, the government treasury bills do not have business/financial risk.

Liquidity Risk: Liquidity risk is the risk that a bond will be difficult to unload if you want or have to sell it. In certain sectors of the market, this is a far bigger problem than a lot of investors realize. Even though the bond market may be enormous, the market is chiefly over-the-counter in nature, and much of the activity occurs in the primary/new issue market. Therefore, with the exception of the Treasury market and good deal of the agency market, relatively little trading is done in the secondary markets.

Call Risk: Call risk is sometimes referred to as prepayment risk, and this is the risk that a bond will be "recalled," that is, retired long before its scheduled maturity date. Issuers are often given the opportunity to prepay their bonds, and they do so by calling them in for prepayment. When issuers call their bonds, the bondholders end up getting cashed out of their deal and have to find another place for their investment funds, and there lies the problem. Because bonds are nearly always called for prepayment after interest rates have taken big fall, comparable investment instruments will just not be available. Thus the investor will ne forced to replace a high-yielding bond with a much lower-yielding issue.

3.3 Essential Features of a Bond

A bond is a negotiable, long-term debt instrument that carries certain obligations (including the payment of interest and the repayment of principal) on the part of the issuer. Because bondholders, unlike holders of common stock, are only lending money to the issuer, they are not entitled to an ownership position or to any of the rights and privileges open to the common stock holders. But bond holders and well as bond issuers do have a number of well defined rights and privileges that together help to define the essential features of a bond.

Bonds Interest and Principal: In the absence of any trading, a bond investor's return is limited to fixed interest and principal payments. That is because bonds involve fixed claim on the

issuer's income and a fixed claim on the assets of the issuer. As a general rule, bonds pay interest every six months. There are sometimes exceptions. Some issues carry interest payment intervals as short as two months and others as long as one year. The amount of interest due is a function of a "coupon." A coupon is the feature on a bond which defines the amount of annual interest income due to an investor. For example, a N1,000 bond with an 8 per cent coupon pays N80 interest to the investor. Also, the principal amount of a bond, known as an issue's par value, specifies the amount of capital that must be repaid to the investor at maturity.

3.3.1 Maturity Date

Unlike common stock, all debt securities have limited lives and will expire on a given date in the future which is called the issue's "maturity date." Although, a bond carries a series of specific interest payment dates, the principal is repaid only once; on or before maturity. Because the maturity date is fixed (and never changes), it not only defines the life of a new issue but also denotes the amount of time remaining for older, outstanding bonds.

Two types of bonds can be distinguished on the basis of maturity; term and serial issues.
A "term bomb" has a single, fairly lengthy maturity date and is the most common type of issue.
A "serial bond" has a series of different maturity dates, perhaps as many as 15 to 20 within a single issue. For example, a 20-year term bond issued in 1995 has a single maturity date of 2015, but that same issue as a serial bond might have 20 annual maturity dates that extend from 1996 through 2015. At each of these annual maturity dates, a certain portion of the issue would come due and be paid off.

Maturity is also used to distinguish a note from a bond. That is, a debt security that is originally issued with maturity of 2 to 10 years is known as a note, whereas a bond technically has an initial term of maturity of more than 10 years. In practice, notes are often issued with maturities of 5 to 7 years, whereas bonds normally carry maturities of 20 to 30 years or more.

3.3.2 Call Features – Let the Buyer Beware

Consider the following situation: You have just made an investment in a high-yielding, 25-year bond. Now all you have to do is sit back and let the cash flow-in. Well, perhaps that may happen for a few years. However, if market interest rates drop, it is also likely that you will

receive a notice from the issuer that the bond is being called. This means that the issue is being retired before its maturity date. There is really nothing you can do but to turn in the bond and to invest your money elsewhere. The practice is all perfectly legal because every bond is issued with a call feature which stipulates whether and under what conditions a bond can be called-in for retirement prior to maturity. Basically, there are three types of call features:

(1) A bond can be "freely callable" which means that the issuer can prematurely retire the bond at any time.
(2) A bond can be "non-callable" which means that the issuer is prohibited from retiring the bond prior to maturity.
(3) The issue could carry a "deferred call" which means that the issue cannot be called until after a certain length of time has passed from the date of issue. In essence, the issue is non-callable during the deferment period and then becomes freely callable thereafter.

Call features are placed on bonds for the benefit of the issuers. They are used most often to replace one issue with another that carries a lower coupon payment, and the issuer benefits by realizing a reduction in annual interest cost. Thus, when market interest rates undergo a sharp decline, bond issuers retire their high-yielding bonds and replace them with lower-yielding obligations.
The net result is that the investor is left with a much lower rate of return than anticipated.

In an attempt to compensate investors who have lost some earnings as a result of bond call, a "call premium" is tacked onto a bond and paid to investors along with the issue's par value at the time the bond is called. Thus, the sum of the par value plus call premium represents the issue's "call price" which becomes the amount the issuer must pay to retire the bond prematurely.

4.0 CONCLUSION

Under this unit, we noted that most big firms finance their operations through the issuance of long-term debt instrument. The issuance of corporate bonds is one of the most popular debt instruments. Investors in bonds are confident that they will get their money back when investing in well-established company like Mobil oil and others. Investors in bonds are paid fixed interest usually annually and the return of their capital at maturity.

5.0 SUMMARY

No business organization can have enough capital for all its operational needs. What companies do is to borrow money from lenders. What well-established companies do is to issue long-term bond to investors and make money available for their operations. Bonds are publicly traded long-term debt securities. They are issued in convenient denominations to investors. Bonds are exposed to many kinds of risks including interest rate risk, purchasing power risk, business risk, liquidity risk and call risk.

6.0 TUTOR-MARKED ASSIGNMENT

* What benefit does an investor in long-term corporation bond derive?
* Discuss two types of risk to which a bond instrument is exposed

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MODULE 4

UNIT 3 BOND VALUATION AND ANALYSIS

CONTENTS

1.0 INTRODUCTION

It is a common practice for companies to finance their operations by the issuance of bonds to investors. A number of factors determine a bond's price including credit quality and the general level of interest rates. Investors must evaluate these factors when deciding whether the market value of a bond will provide the kind of return they need. We shall examine, in detail, the factors that determine a bond's price under this unit.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with:

* Basic principles guiding the valuation of bonds
* The forces that push up the price of bonds

3.0 MAIN CONTENT

3.1 Bond Valuation and Analysis

Every rational investor tries to earn a return that full compensates them for risk. In the case of bondholders, that required return has three components; the real rate of return, an expected inflation premium, and a risk premium.

The real rate of return and the inflation premium are external economic factors, and together, they equal the risk-free rate. Now, to find the required return, we need to consider the unique features and properties of the bond issue itself. We can do this by adding the bond's risk premium to the risk-free rate. A bond's risk premium will take into account key issue and issuer characteristics, including such variables as the type of bond, maturity, call features, and bond rating. The three components, that is, the real rate of return, the expected inflation premium and the risk premium, work together to determine interest rate levels at a given point in time.

Because interest rates have such a significant bearing on bond prices and yields, they are closely monitored by both conservative and aggressive investors. Interest rates are important to conservative investors because one of their major objectives is to lock in high yields. Aggressive traders also have a stake in interest rates because their investment programmes are often built on the capital gains opportunities that accompany major swings in rates.

3.1.1 Keeping Tabs on Market Interest Rates

Just as there is no single bond market but a series of different market sectors, so too there is no single interest rare that applies to all segments of the market. Rather, each segment has its own, unique level of interest rates. Granted, the various rates tend to drift in the same direction over time and to follow the same general pattern of behaviour, but it is also common for yield spreads (that is interest rate differentials) to exist in the various market sectors. We can summarize the more important market yields and yield spreads as follows:

(1) Local government bonds usually carry the lowest market rates because of the tax-exempt feature of these obligations. As a rule, their market yields are about two-thirds those of corporate organizations. In the taxable sector, treasuries have the lowest yields because they have the least risk, followed by agencies and then corporate bodies, which provide the highest returns.

(2) Issues that normally carry official ratings generally display similar behaviour. That is to say, the lower the rating, the higher the yield.

(3) Bonds that are freely callable generally provide the highest returns, at least at date of issue. These are followed by deferred call obligations and then by non-callable bonds, which yield the least.

(4) As a rule, bonds with long maturities tend to yield more than short issues. However, this rule does not hold all the time; sometimes short-term yields exceed the yield on long-term bonds.

3.1.2 Higher Yielding Segments of the Bond Market

As an investor, you should pay close attention to interest rates and yield spreads, and try to stay abreast, not only of the current state of the market, but also of the future direction in market rates. For example, if you are a conservative (income-oriented) investor and think that rates have just about peaked, that should be a clue to you to try to lock in the prevailing high yields with some form of call protection. In contrast, if you are an aggressive bond trader who thinks rates have peaked (and are about to drop), that should be a signal to buy bonds that offer maximum price appreciation potential (example, low-coupon bonds that still have a long time before they mature). Clearly, in either case, the future direction of interest rates is important.

But how does a bond investor formulate such expectations? Unless you have considerable training in economics, you will probably have to rely on various published sources. Fortunately, a wealth of such information is available. Your broker is an excellent source for such reports, as are investor services. Finally there are widely circulated business and financial publications that regularly address the current state and future direction of market interest rates. Make no mistakes about it. Prediction of future direction of interest rates is not an easy task. The best you can offer is experienced educated guesswork, and guesswork, like you know it, lacks exactitude.

3.2 What Causes Rates to Move

Although, the subject of interest rates is a complex economic issue, we do know that certain forces are especially important in influencing the general behavioour of market rates. Serious bond investors should make it a point to become familiar with the major determinants of interest rates and try to monitor those variables, at least informally.

And in that regard, perhaps no variable is more important than inflation. Changes in the inflation rate (or even expectations about the future course of inflation) have direct and pronounced effect on market interest rates and have been a leading cause of wide swings in interest rates. Clearly, if expectations are for inflation to slow down, then market interest rates should fall as well.

In addition to inflation, there are at least five other important economic variables that can significantly affect the level of interest rates. These are:

1. Changes in the Money Supply. An increase in the money supply pushes rates down (as it makes more funds available for loans), and vice versa. This is true only up to a point, however. If the growth in the money supply becomes excessive, it can lead to inflation, which, of course, means higher interest rates.

2. The Size of the Federal Budget Deficit. When the Federal Government must borrow large amounts to cover the budget deficit, the increased demand for funds exerts an upward pressure on interest rates. That is why bond market participants view the prospect of a balanced federal deficit so favourably. That is, as the federal budget deficit declines/disappears, so will a lot of the pressure on bond interest rates (which usually brings with it the potential for falling market rates).

3. The Level of Economic Activity. Businesses need more capital when the economy expands. This need increases the demand for funds, and rates tend to rise. During a recession, economic activity contracts, and rates typically fall.

4. Policies of the Federal Reserve. Actions of the Federal Reserve to control inflation also have a major effect on market interest rates. For example, when the Federal Government wants to slow real or perceived inflation down, it usually does so by driving up interest rates.

Unfortunately, such action can also have the nasty side effect of slowing down business activities as well.

5. The Level of Interest Rates in Major Foreign Markets. Today, investors look beyond national borders for investment opportunities. If rates in major foreign markets rise, that puts pressure on rates in the country to rise as well. If they fail to rise, local investors may be tempted to withdraw their Naira to buy high-yielding foreign securities in order to make more profits.

3.2.1 The Term Structure of Interest Rates and Yield Curves

Although, many factors affect the behaviour of market interest rates, one of the most popular and widely studied is bond maturity. The relationship between interest rates (yield) and time to maturity for any time of similar-risk securities is called the "term structure of interest rates." This relationship can be depicted graphically by a yield curve which relates a bond's term maturity to its yield to maturity at a given point in time. A particular yield curve exists for only a short period of time; as market conditions change, so do the yield curve's shape and location.

3.2.2 Plotting Your Own curves

Yield curves are constructed by plotting the yields for a group of bonds that are similar in all respects except maturity. Treasury securities (bills, notes, and bonds) are typically used to construct yield curves.

There are several reasons for this: Their yields are easily found in financial publications, they have no risk of default, and they are homogeneous with regard to quality and other issue characteristics. Investors can also construct yield curves for other classes of debt securities, such as A-rated Local Government bonds, A-rated corporate bonds, or even certificates of deposit.

3.3 Explanations of the Term Structure of Interest Rates

As we noted earlier, the shape of the yield curve changes over time. Three commonly cited theories explain the reasons for the general shape of the yield curve. These three theories are: The expectations hypothesis, the liquidity preference theory, and the market segmentation theory.

3.3.1 Expectation Hypothesis

The expectation hypothesis suggests that the yield curve reflects investor expectations about the future behaviour of (short-term) interest rates. The relationship between rates today and rates expected in the future is due primarily to investor expectations regarding inflation. If investors anticipate higher rates of inflation in the future, they will require higher long-term interest rates today, and vice versa.

Generally, under the expectations hypothesis, an increasing inflation expectation results in an upward-sloping yield curve, a decreasing inflation expectation results in a downward-sloping yield curved, and a stable inflation expectation results in a relatively flat yield curve.

3.3.2 Liquidity Preference Theory

More often than not, yield curves have at least a mild upward slope. One explanation for the frequency of upward sloping yield curves is the liquidity preference theory. This theory states that, intuitively, long-term bond rates should be higher than short-term rates because of the added risks involved with the longer maturities. In other words, because of the risk differential (real or perceived) between long-term and short-term
debt securities, rational investors prefer the less risky, short-term obligations unless they can be motivated, via higher interest rates, to invest in the longer bonds.

Actually, there are a number of reasons why rational investors should prefer short-term securities. To begin with, they are more liquid (more easily convertible to cash) and less sensitive to changing market rates, which means there is less risk of loss of principal. For a given change in market rates, the prices of long-term bonds will show considerably more movement than the prices of short-term bonds. Simply put, uncertainty increases over time, and investors therefore require a premium to invest in long maturities. In addition, just as investors tend to require a premium for tying up funds for longer periods, borrowers will also pay a premium in order to obtain long-term funds. Borrowers thus assure themselves that funds will be available and they can avoid having to roll over short-term debt at unknown and possibly unfavourable rates. All of these preferences and market forces explain why higher rates of interest should be associated with longer maturities and why it is perfectly rational to expect upward-sloping yield curves.

3.3.3 Market Segmentation Theory

Another often-cited theory is the "market segmentation theory." This theory suggests that the market for debt is segmented on the basis of maturity preferences of different types of

financial institutions and investors. According to this theory, the yield curve changes as the supply and demand for funds within each maturity segment determines its prevailing interest rate. The equilibrium between the financial institutions that supply the funds for short-term maturities, for example, the banks and the borrowers of those short-term funds, for example, businesses with seasonal loan requirement, established interest rates in the short-term markets. Similarly, he equilibrium between suppliers and demanders in such long-term markets as life insurance and real estate determines the prevailing long-term interest rates.

The shape of the yield curve can be either upward-sloping or downward-sloping, as determined by the general relationship between rates in each market segment. When supply outstrips demand for short-term loans, short-term rates are relatively low. If, at the same time, the demand for long-term loans is higher than the available supply of funds, then long-term rates are high, and the yield curve slopes upward. Simply stated, low rates in the short-term segment and high rates in the long-term segment cause an upward-sloping yield curve, and vice versa.

4.0 CONCLUSION

We know that rational investors try to earn a return on their investment that compensates for then risk. In the case of bondholders, that return has three components which are; the real rate of return, the expected inflation premium and the risk premium. However to obtain the best of returns, an investor should be familiar with the technicalities of bond valuation. It is the knowledge of bond valuation that will arm the bond investor with trends and expected rates which are essential factors that affect his ultimate returns.

5.0 SUMMARY

To the bond investor, it is essential to watch the behaviour of market interest rates because interest rates have such a significant bearing on bond prices and yields. Interest rates are closely monitored by both conservative investors and aggressive investors. Interest rates are important to conservative investors because their major objective is to lock-in high yields. Aggressive investors are also concerned with in interest rates behaviour because their investment programmes are often built around the desire to exploit capital gain opportunities.

6.0 TUTOR-MARKED ASSIGNMENT

* Discuss the three components in the returns on bondholding.
* Discuss the three commonly cited theories that explain the reasons for the general shape of the yield curve.

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MODULE 4

UNIT 4 PREFERRED STOCK AND CONVERTIBLE SECURITIES

CONTENTS

1.0 INTRODUCTION

In turbulent investment periods especially when it is difficult to get enough investors to invest in corporate common stocks, business organizations issue securities with special features to attract attention. Preferred stocks and convertible securities are popular investment instruments issued to investors.

2.0 OBJECTIVES

After studying this unit, the student will be familiar with:

* The nature of preferred stocks and the advantages and disadvantages in them.
* The rights of preferred stockholders

3.0 MAIN CONTENT

3.1 Preferred Stocks

What would you think of a stock that promised to pay you a fixed annual dividend for life, nothing more nothing less? If you are an income-oriented investor, this offer would certainly sound pretty. However, it is not possible to find such an investment in real life. Here we will study the features of two fixed income securities called then "preferred stocks" and "convertible debentures."

Preferred stock is a stock that has a prior claim (ahead of common stockholders) on the income and assets of the issuing firm. Preferred stocks carry fixed dividends that are usually paid quarterly and are expressed either in Naira terms or as a percentage of the stock's par (or stated) value. They are used by companies that need money but do not want to raise debt instruments to get it. In effect, preferred stocks are widely viewed by issuers as an alternative to debt instrument. Companies like to issue preferred stocks because they do not count as common stock and therefore do not affect Earnings Per Share (EPS). However, being a form of equity, they do not count as debt either and therefore do not add to the company's debt load. There are today so many Over the Counter (OTC) and listed preferred stocks issued by public utilities, industrial and financial establishments.

3.1.1 Preferred Stocks as Investment Instruments

Preferred stocks are available in a wide range of quality ratings, from investment-grade issues to highly speculative stocks. Some high-yielding preferred stock can pay investors as high as N20 per share, annual dividend. Less high-yielding preferred stock pay not less than N14 per share annually.

As earlier stated, one interesting thing about preferred stock is that it carries fixed dividend payment. Of course, if a company does not earn any profit in a particular year, it may be unable to pay the dividend of the preferred stockholder. However, in future years, the arrears of all the preferred stockholders must be cleared before the common stockholder can receive any dividend.

3.1.2 Advantages and Disadvantages of Holding Preferred Stocks

Advantages:
Investors are attracted to preferred stocks because of the current income they provide. Moreover, such dividend income is highly predictable, even though it can, under certain circumstances, be temporarily discontinued. Note that there is the tendency for preferred stocks to generate yields that are slightly less than those of high-trade bonds. This is due to the fact that 70 per cent of the preferred dividends received by a corporation are exempt from federal income taxes. Since corporations are big investors in preferred stocks, the net effect of this favourable tax treatment is reduced preferred dividend yields.

Another reason for investing in preferred stocks is the level of safety they offer investors. That is, despite a few well-publicized incidents, high-grade preferred stocks have an excellent record of meeting dividend payments in a prompt and timely manner.

A final advantage of preferred stocks is the low unit cost (N25 to N50 per share) of many of the issues, which gives even small investors the opportunity to actively participate in preferred stocks.

Disadvantages:
A major disadvantage of preferred stocks is their susceptibility to inflation and high interest rates. Like many other fixed-income securities, preferred stocks simply have not proved to be satisfactory long-term hedges against inflation. Another disadvantage is that preferred dividends may be suspended, if the earnings of the corporate issuer drop off. Thus, unlike coupon payments on a bond, dividends on preferred stocks have no legal backing, and failure to pay them does not lead to default.

Still another drawback is that most preferred stocks lack substantial capital gains potential. Although, it is possible to enjoy fairly attractive capital gains from preferred stocks when interest rates decline dramatically, these amounts generally do not match the price performance of common stocks. But perhaps the biggest disadvantage of preferred stocks is the yield give-up they incur relative to bonds. In essence, there is virtually nothing a preferred stock has to offer that cannot be obtained from a comparably rated corporate bond.

3.2 Source of Value for Preferred Stocks

With the exception of convertible preferred stocks, the value of high-grade preferred stocks is a function of the dividend yields they provide. Most specifically, the value (or market price) of a preferred stock is closely related to prevailing market rates: Thus, as the general level of interest rates moves up, so do the yields on preferred stocks, and their prices decline accordingly. When interest rates drift downward, the yield on preferred stocks also declines, but their prices will rise. Just like bond prices, therefore, the price behaviour of a high-grade preferred stock is inversely related to market interest rates. Moreover, its price is directly linked to the issuer's level of income. That is, other things being equal, the higher the dividend payment, the higher the market price of an issue. Thus the price of a preferred stock can be defined as follows:

$$\text{Price of a Preferred Stock} = \frac{\text{Annual Dividend Income}}{\text{Prevailing Market Yield}}$$

3.2.1 Risk Exposure

Preferred stock investors are exposed to both business and interest rate risks. Business risk is important with preferred stocks because these securities are a form of equity ownership and, as such, lack many of the legal protections of bonds. Annual operating costs and corporate financial strength, therefore, are of concern to preferred stockholders. Preferred stock ratings can be used to assess the amount of business risk embedded in an issue; higher-quality/higher-rated issues are believed to possess less business risk. Because of the fixed-income nature of these securities and the way they are valued in the market, interest rate risk is also important to preferred stockholders. That is, when market interest rates move up, the value of these securities (like that of bonds) falls. Indeed, such risk exposure can be very damaging if interest rates move against you in a big way.

3.2.2 Market Transactions

Preferred stocks are subject to the same transaction costs, that is, brokerage fees and transfer taxes, as shares of common stock. In addition, preferred stock investors use the same types of orders (market, limit, and stop-loss) and operate under the same margin requirements.

Quotes for preferred stock are interpreted exactly like those for common stock, except that the price/earnings ratios are not listed. Preferred stocks are also listed right after listing the common stocks of a company.

3.3 Issue Characteristics

Preferred stocks possess features that not only distinguish them from other types of securities but also help differentiate one preferred stock from another. For example, preferred stocks may be issued as convertible or non-convertible, although the majority fall into the non-convertible category.

Convertible feature allows the holder to convert the preferred stock into a specified number of shares of the issuing company's common stock. In addition to convertibility, investors should be aware of several other important features of preferred stocks; they include the rights of preferred stockholders and the special provisions (such as those pertaining to passed dividends or call features) that are built into preferred stock issues.

3.3.1 Rights of Preferred Stockholders

The contractual agreement of a preferred stock specifies the rights and privileges of preferred stockholders. The contractual agreement of a preferred stock usually contain information on; level of annual dividends, the claim on income, voting rights, and the claim on assets. The issuing company agrees that it will pay preferred stockholders a (minimum) fixed level of quarterly dividends and that such payments will take priority over common stock dividends. The only condition is that the firm generates income sufficient to meet the preferred dividend requirements. However, the firm is not legally bound to pay dividends. O course, it cannot pass dividends on preferred stock and then pay dividends on common stock, because that would violate the preferred stocks' prior claim on income.

Although, most preferred stocks are issued with dividend rates that remain fixed for the life of the issue, in the early 1980s, some preferred stocks began to appear with floating dividend rates. Known as "adjustable rate" (or floating rate) preferred stocks. These issues adjust dividends periodically in line with yields on specific Treasury issues, although minimum and maximum dividend rates are usually established as a safeguard for investors.

Even though the preferred stock investors hold an ownership position in the firm, they do not have voting rights. However, if conditions deteriorate to the point where the firm needs to defer or pass one or more consecutive quarterly dividends, preferred stockholders are usually given the right to elect a certain number of corporate directors so that their views can be represented. And if liquidation becomes necessary, the holders of preferred stocks are given a prior claim on assets. These preferred claims, limited to the par or stated value of the stock, must be satisfied before the claims of the common stockholders. Of course, this obligation does not always mean that then full par or stated value of the preferred stock will be recovered, because the claims of senior securities, like bonds, must be met first. That is, all bonds, including convertible bonds, have a higher claim on assets (and income) than preferred stock, whereas preferred stocks have a higher claim than common stock. Thus preferred stockholders have a claim that is somewhere between that of bondholders and common stockholders.

Finally, when a company has more than one issue of preferred stock outstanding, it sometimes issues preference (or prior preferred) stock. Essentially, this stock has seniority over other preferred stock in its right to receive dividends and in its claim on assets in the event of liquidation. Therefore, preference stocks should be viewed as senior preferred stocks.

3.3.2 Preferred Stock Provisions

There are three preferred stock provisions that investors should be well aware of before making an investment in a preferred security. Especially important is the obligation of the issuer in case any dividends are missed. In addition, the investor should determine whether the stock has a call feature and/or a sinking fund provision; Let us start by looking at how passed dividends are handled, which depends on whether the preferred stock is issued on a cumulative or a non-cumulative basis.

Fortunately for investors, most preferred stocks are issued on a cumulative basis. This means that any preferred dividends that have been passed must be made up in full before dividends can be paid to the common stockholders. As long as dividends on preferred stocks remain in arrears, a corporation cannot make any dividend payment to common stockholders.

If preferred stock carries a non-cumulative provision, the issuing company would not be under any obligation to make up any of the past (unpaid) dividends. Of course, the firm could not make dividend payments to common stockholders either, but all it would have to do is to meet the next quarterly dividend payment due to preferred stockholders before it can pay any dividends to the common stockholders.

Other things being equal, a cumulative preferred stock should be more highly valued than an issue without such cumulative provision, that is, the cumulative feature should increase the price (and, in so doing, lower the yield) of these issues.

Since the early 1970s, it has become increasingly popular to issue preferred stocks with call features. Today, a large number of preferred stocks carry this provision, which gives the firm the right to call the preferred stock for retirement. Callable preferred stocks are usually issued on a deferred-call basis, which means that they cannot be retired for a certain number of years after the date of issue. After the deferral period, which often extends for 5 to 7 years, the preferred stocks become freely callable. Of course, such issues are then susceptible to call if the market rate for preferred stocks declines dramatically, which explains why the yields on freely callable preferred stocks should be higher than those on non-callable issues. As with bonds, the call price of a preferred stock is made up of the par value of the issue and a call premium that may amount to as much as one year's dividends.

Another preferred stock feature that has become popular in the past 10 years is the sinking fund provision which denotes how all or a part of an issue will be paid off, amortized, over time. Such sinking fund preferred stocks actually have implied maturity dates. They are used by firms to reduce the cost of financing, because sinking fund issues generally have lower yields than non-singing fund preferred stocks.

4.0 CONCLUSION

Under this unit, we dealt with preferred stocks. We noted that preferred stocks carry fixed dividends and that these dividends are paid quarterly. Preferred stocks are issued by corporate organizations that need money but do not want to raise debt to get the funds. Investors are attracted to preferred stocks because of the current income they provide. One major disadvantage of preferred stocks is their susceptibility to inflation and high interest rates.

5.0 SUMMARY

Preferred stocks carry fixed dividend and they are usually available in a wide range of quality ratings from investment-grade issue s to highly speculative stocks. With the exception of convertible preferred stocks, the value of high-grade preferred stocks is a function of the dividend yields they provide. Preferred stock investors are exposed to both business and interest rate risks. Business risk is important with preferred stocks because these securities are a form of equity ownership and, as such, they lack many of the legal protections of bonds.

6.0 TUTOR-MARKED ASSIGNMENT

* What is the difference between dividend payment on preferred stocks and dividend entitlement to common stockholders.

* Explain what you understand by “cumulative provision” and “non-cumulative provision” in the payment of dividends to preferred stockholders.

7.0 REFERENCES/FURTHER READING

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