



Contents

<i>About the authors</i>	PAGE I-3
--------------------------	-------------

MODULE I **FINANCIAL STATEMENTS ANALYSIS**

1 **INTRODUCTION : ROLE OF FINANCIAL STATEMENTS**

1.1	Introduction : Role of Financial Statements	3
1.2	Understanding Auditors Report and other sources of information of financial information	5
1.3	Understanding Accounting Equation	7
1.4	Understanding Relationship between constituents of Financial Statements	9
1.5	Understanding the Structure of Financial Statements	11
1.6	Profit and Loss Appropriation Account	25
	SUMMARY OF THE CHAPTER	26
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	27

2 **RELEVANCE OF NOTES TO ACCOUNTS AND SCHEDULES TO FINANCIAL STATEMENTS**

2.1	Significant Accounting Policies	30
2.2	Disclosures	35
	SUMMARY OF THE CHAPTER	40
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	41

3**NUANCES OF ACCOUNTING: INVENTORIES, DEPRECIATION,
EPS, INTANGIBLE ASSETS**

3.1	Nuances of Accounting : Inventories, Depreciation, EPS, Intangible Assets	45
3.2	Valuation of Inventories	45
3.3	Methods of Depreciation	52
3.4	Earnings per Share	54
3.5	Intangible assets	57
3.6	Deferred Taxes	58
3.7	Foreign Exchange Gain/Loss	60
	SUMMARY OF THE CHAPTER	63
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	65

4**RATIO ANALYSIS**

4.1	Introduction to Ratio Analysis	69
4.2	Calculate and interpret ratios	70
4.3	Calculate and interpret certain ratios	76
4.4	Uses and limitations of ratio analysis	79
4.5	Trailing ratios, forward ratios	80
4.6	Valuation ratios	82
4.7	Credit specific ratios	85
4.8	Ratio's during Mergers and Acquisitions, Leverage Buyouts and Restructuring	87
4.9	Evaluate two companies using ratio analysis	88
4.10	DuPont Analysis and its importance	92
	SUMMARY OF THE CHAPTER	94
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	96

5**FINANCIAL MODELLING AND COVENANT TESTING**

5.1	Financial modelling	103
5.2	How to project financial statements	104
5.3	Covenant testing using financial projections	106
5.4	Elements of cost drivers, revenue drivers, etc.	107
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	108

6**NUANCES OF LEASES, HIRE PURCHASE, PENSION LIABILITIES AND
CLASSIFICATION OF INVESTMENTS IN FINANCIAL ASSETS**

6.1	Leases	109
6.2	Hire Purchase	112
6.3	Defined contribution and Defined benefit pension plans	115
6.4	Classification of Investments in Financial Assets	116
	SUMMARY OF THE CHAPTER	117
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	119

7 RED FLAGS

SUMMARY OF THE CHAPTER	132
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	133

8 INDIAN GAAP & IFRS - SIMILARITIES & DIFFERENCES

8.1	Components of financial statements	136
8.2	Format of presentation of financial statements	137
8.3	Statement of Changes in Equity	137
8.4	Important Constituents of Balance Sheet	137
8.5	Important Constituents of Statement of Profit and Loss Account	139
8.6	Statement of Cash flow	141
8.7	Consolidated financial statements	141
8.8	Others	142
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING		143

MODULE 2 CREDIT SPECIFIC ANALYSIS

9 LIQUIDITY ANALYSIS

9.1	Liquidity Defined	149
9.2	Solvency & Liquidity	150
9.3	Measures of Liquidity	151
9.4	Quick Ratio/Quick Assets	153
9.5	Liquidity Analysis & Credit Ratings	154
9.6	The Debt Maturity Schedule	155
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING		156

10 STRESS TESTING

10.1	Key steps in stress testing	159
10.2	Framework for Developing Scenarios	160
10.3	Revenue Drivers	161
10.4	Cost Drivers	162
10.5	Leveraged Balance Sheets	163
10.6	Impending Capital Raising Plans	164
10.7	Internal, Industry and Environmental Considerations	165
10.8	Commodities and Stressed Scenarios	166
10.9	Scenario - Base, Bear, Bull	167
10.10	Construct and Interpret of all three Scenarios	170
10.11	Base Scenario	170

	PAGE
10.12 Bear Case Scenario	174
10.13 Bull Case Scenario	177
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	178

11

COMPARISON : SECTOR VERSUS GLOBAL

11.1 Comparisons in Financials	180
11.2 Why Compare	181
11.3 Who is a Peer?	183
11.4 Peers by Industry	184
11.5 Peers by Size	185
11.6 Comparison at Industry Level	186
11.7 Peers around the World	187
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	188

12

LIQUIDATION SCENARIO

12.1 Senior & Subordination in Bonds/Debt	189
12.2 How the Hierarchy of Seniority Develops	191
12.3 Seniority/Subordination	192
12.4 Within Bondholders	193
12.5 Liquidation Scenarios	194
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	196

13

EVENT, M&A/LBO

13.1 Mergers & Acquisitions	200
13.2 Valuation of the Acquisition Target	201
13.3 Projecting Future Performance	202
13.4 The Analyst's Agenda	203
13.5 A Case	204
13.6 Key Ratios if Synergies work out	208
13.7 Key Ratios if Synergies do not work out	209
13.8 Leveraged Buyouts	210
SUMMARY OF THE CHAPTER	211
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	213

MODULE 3

UNDERSTANDING ON BONDS

14

COVENANTS

14.1 Covenants	217
----------------	-----

	PAGE
14.2 Goals of Covenant Testing	221
14.3 Example of a Covenant Breach	222
14.4 Types of Covenants	223
14.5 Debt incurrence covenant	224
14.6 Restricted payments (RP) covenant	225
14.7 Limitation on lien	226
14.8 Limitation sale-and-leaseback transactions	227
14.9 Limitation on asset sale	228
14.10 Change of control	229
14.11 Mergers & acquisitions (M&A)	230
14.12 Transactions with affiliates	231
14.13 Early redemption covenant	232
14.14 Default	233
14.15 Other covenants	234
14.16 Indenture Analysis	235
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	237

15

PRICING, SPREADS AND CURVES

15.1 Types of Bonds, Features & Characteristics	239
15.2 FIS types by original maturity and issuer	241
15.3 FIS instruments and regulation in India	248
15.4 FIS types by cash flow pattern	252
15.5 FIS types by interest rate	253
15.6 FIS types by credit rating	256
15.7 FIS types by seniority	258
15.8 FIS types by redemption feature	259
15.9 FIS types by market type	260
15.10 Yield Curve, Types, Shapes and Yield Spread	264
15.11 Interest rate and term structure	265
15.12 Term structure: shapes	267
15.13 Term structure of rates : shifts	268
15.14 Yield Spread	271
15.15 Periodic Rate, Spot Rate and Forward Rate	272
15.16 Valuation Curves	274
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	275

16

CREDIT DEFAULT SWAP (CDS)

16.1 Credit default swap (CDS) and its features	276
16.2 Credit default swap (CDS) Settlement	278
16.3 Credit events	279
16.4 Types of Credit default swap (CDS)	281

	PAGE
16.5 Basket CDS	281
16.6 Index and Tranching Index CDS	282
16.7 Total Return Swap	283
16.8 RBI guidelines on CDS in Indian market	285
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	287

17

SENIORITY RANKING

17.1 Senior & Subordination in Bonds/Debt	288
17.2 How the Hierarchy of Seniority Develops	290
17.3 Seniority/Subordination	291
17.4 Within Bondholders	292
17.5 Liquidation Scenarios	293
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	295

18

RICH CHEAP ANALYSIS

18.1 Rich Cheap Analysis	296
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	299

19

BOND VALUATION MEASURES INCLUDING SWAPS, OAS, YTW, YTM

19.1 Valuation of Bonds, Clean & Dirty Price, YTM	300
19.2 Measure of return	303
19.3 Coupon	305
19.4 Current Yield	306
19.5 Yield-to-maturity (YTM)	307
19.6 Holding Period Return (HPR)	308
19.7 Price/YTM is not a Judgment Tool	309
19.8 Clean price and Dirty Price	310
19.9 Term Structure and its theories	311
19.10 Interest rate and term structure	311
19.11 Theories on term structure shape	313
19.12 Duration	314
19.13 The Properties of Duration	315
19.14 The Effect of Changing Interest Rates on Bond Values	316
19.15 Modified duration	318
19.16 Price Value of a Basis Point (PVBP)	320
MODULE SUMMARY	320
ATTEMPT THE FOLLOWING QUESTIONS BASED ON THE LEARNING	323



Contents

<i>About the authors</i>	PAGE I-3
--------------------------	-------------

MODULE I **CREDIT RATING**

1 **BASICS OF RATING**

1.1	What are credit ratings?	3
1.2	History of ratings	4
1.3	Credit Rating Scale	5
1.4	Need and limitation of credit rating	7
1.5	A Typical Credit Rating Process	8
1.6	Types of Ratings	9
1.7	Other Rating Terminologies	10
1.8	Introduction to Credit Information Companies	11
1.9	Credit Information Companies	12
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	14

2 **CREDIT RISK MANAGEMENT**

2.1	Risk in debt securities	15
2.2	Credit risk	16
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	18

3 **5C CREDIT MODEL**

3.1	5C Model - Components	20
------------	-----------------------	----

4**ANALYTICAL FRAMEWORK FOR CREDIT ANALYSIS**

4.1	Understanding Business Model/Corporate structure	22
4.2	Evaluating Business Model	23
4.3	Risk Evaluation & Fundamentals of Credit Risk Assessment	25
4.4	Credit Analysis of Corporate Entities	26
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	30

5**INDUSTRY RISK**

5.1	Introduction	32
5.2	Relevance of Industry Analysis	33
5.3	Tools for Industry Risk Evaluation	34
5.4	Parameters for Industry Risk Evaluation	36
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	45

6**BUSINESS RISK (OR OPERATIONAL RISK)**

6.1	Evaluating production efficiency	47
6.2	Economies of Scale	48
6.3	Management of Operating Cycle	49
6.4	Diversification	50
6.5	Size	51
6.6	Cost structure	52
6.7	Break-even Analysis	53
6.8	Comparative Analysis	55
6.9	Raw material and utilities related risks	56
6.10	Locational impacts	57
6.11	Concentration risk	58
6.12	Technological issues and R&D activities	59
6.13	Marketing and distribution network	60
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	61

7**FINANCIAL RISK**

7.1	Logical Flow for Financial Risk Analysis	63
7.2	Common Size Statements	67
7.3	Projecting the financial statements	72
7.4	DSCR & Sensitivity analysis	73
7.5	Common Behavioural Biases for Analysts	74
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	75

8**DEALING WITH INTRICACIES OF CREDIT RATING**

8.1	Standalone versus consolidated view	79
8.2	Concept of standalone and consolidated view	80
8.3	Adjustments to financial statements	83
8.4	Debt Equity Continuum	87
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	88

9**MANAGEMENT RISK**

9.1	Importance of management risk	89
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	92

10**PROJECT RISK**

10.1	Type of the projects	93
10.2	Steps to Evaluate Project Risk	95
10.3	Step 1 : Evaluation of Project	96
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	102

11**RATING'S METHODOLOGY FOR MANUFACTURING COMPANIES**

11.1	Economy and industry risk analysis	103
11.2	Business risk analysis	104
11.3	Financial risk analysis	105
11.4	Management Evaluation	107

12**RATINGS FOR FINANCIAL INSTITUTIONS AND BANKS**

12.1	Introduction	108
12.2	Economic & Political Risk	110
12.3	Industry Risk	111
12.4	Ownership, parentage & systemic importance	112
12.5	Size and market presence	113
12.6	Capital Adequacy	114
12.7	Resources profile	115
12.8	Asset quality	116
12.9	Quality of management	117
12.10	Corporate Governance	118

	PAGE
12.11 Liquidity risk	119
12.12 Earning profile	120
12.13 Risk Management Framework	121
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	125

13

SOVEREIGN RATING

13.1 Introduction	129
13.2 Relevance of Sovereign Credit Rating	130
13.3 Main studies on determinants of Sovereign Ratings	131
13.4 Rating approach	132
13.5 Support in Sovereign Rating	141
13.6 Transfer and convertibility risk	142
13.7 Rating Gaps	143
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	145

14

CASE STUDY

14.1 Objective of the Case Study	156
14.2 History and Milestones	157
14.3 About Promoters	158
14.4 Board of Directors	158
14.5 Latest Shareholding Pattern	159
14.6 RISL Share Price Movement	159
14.7 About Joint Venture Partner	160
14.8 Current Product Portfolio	161
14.9 Expansion in facilities	162
14.10 Sales and Customers related INFO	163
14.11 Raw Materials	164
14.12 Monsoons in India	165
14.13 National Mission on Micro irrigation	166
14.14 Outlay on the NMMI	167
14.15 Industry Information	168
14.16 Number of Players in Indian Irrigation Market as per their Rankings	169
14.17 Framework for projections	181
14.18 Objective of the Case Study	184

MODULE 2
CREDIT STRATEGY

15

UNDERSTANDING YIELD CURVES

15.1	Interest rate and term structure	193
15.2	Term structure : Shapes	195
15.3	Theories on term structure shape	197
15.4	Term structure of rates : Shifts	198
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING		201

16

TRADING ON INTEREST RATE RISKS

16.1	Passive Management	203
16.2	Active Management	206
16.3	Parallel Shift : Rate Anticipation with Maturity Mismatch	208
16.4	Non-parallel Shifts : Yield Spread Anticipation	209
16.5	Volatility Trades : Barbell, Ladder and Butterfly	212
16.6	Basis Trading	215
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING		216

17

UNDERSTANDING CREDIT SPREADS

17.1	Credit risk	217
17.2	Credit spread : Nature and components	219
17.3	Credit spread : Term structure	220
17.4	Credit spread : Measures	221
17.5	Credit Default Swap (CDS) and its features	227
17.6	Credit indices	228
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING		238

18

TRADING ON CREDIT SPREADS

18.1	Credit basis : Definition	239
18.2	Credit basis : Drivers	241
18.3	Credit basis : Trading	244
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING		246

19**OTHER CONCEPTS ON CREDIT RISK**

19.1	Jump to Default Risk	247
19.2	Spread PV01	248
19.3	Single Name CDS	249
19.4	Basket Default Swaps & First to Default	250
19.5	Default Correlation	251
19.6	Delta Hedging	252
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	253

20**PREDICTING THE MARKET**

20.1	The impact of time on Credit Risk	255
20.2	Impact of Spreads on Borrowing Costs	259
20.3	Impact on Corporate Profitability	260
20.4	Implications for Default	261
20.5	Impact on M&A	262
20.6	M&A as an indicator of economic conditions	263
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	264

21**INTRODUCTION TO DISTRESSED DEBT**

21.1	Residual Values and Distressed Debt	266
21.2	Residual Values and Spreads	267
21.3	Probability and Expected Values	268
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	269

22**UNDERSTANDING SYSTEMIC RISK**

22.1	Systemic Risks and Contagion	270
22.2	Implications of Systemic Events for Trading Portfolios	272
22.3	Implications for Held To Maturity (HTM) Portfolios	273
22.4	Funding Issues resulting from Systemic Events	274
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	275

MODULE 3**CREDIT ENHANCEMENT AND SECURITIZATION****23****CREDIT ENHANCEMENT AND STRUCTURES**

23.1	Explicit Credit Enhancement	284
23.2	Implicit Credit Enhancement	291
23.3	Other forms of Structuring	293
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	298

24**RATING OF ASSET BACKED AND MORTGAGE BACKED
SECURITIZATION TRANSACTIONS**

24.1	Concept of Securitization	300
24.2	Transaction Structure	301
24.3	Credit Enhancement Forms	302
24.4	Motives behind Securitization	303
24.5	Risk Analysis and Credit Rating of Securitization Transactions	304
24.6	Rating Process	307
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	309

MODULE 4**CREDIT RISK MODELS AND REGULATIONS****25****CREDIT RISK MODELS & MISCELLANEOUS**

25.1	Credit Models - An Introduction	313
25.2	Concept of Credit Risk	314
25.3	Overview of Conceptual Approaches to Credit Risk Modelling	315
25.4	Estimation of parameters of Credit Risk Models	327
25.5	Validation	334
25.6	Examples of Credit Models	337
25.7	Conflict of interest in credit rating agencies' "issuer pays" business model	345
25.8	Gini coefficient and rating transition matrix	347
	ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	350

26**CRA REGULATIONS AND DEBT GUIDELINES**

26.1	CRAs - Regulatory aspects in India	351
26.2	General obligations of credit rating agencies	354
26.3	Debt market in India	357

	PAGE
26.4 RBI Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances	358
26.5 RBI Master Circular - External Commercial Borrowings and Trade Credits	362
26.6 RBI Master Circular - Guarantees and Co-acceptances	364
26.7 RBI Master Circular - Rupee/Foreign Currency Export Credit & Customer Service to Exporters	368
26.8 RBI Master Circular - Exposure Norms	371
26.9 RBI Master Circular - Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)	375
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	384

MODULE 5

UNDERSTANDING AND ANALYSIS OF CORPORATE BANKING FACILITIES

27

UNDERSTANDING TYPES OF CORPORATE BANKING FACILITIES

27.1 Fund based facilities for Capital expenditure	389
27.2 Fund based facilities	390
27.3 Fund based Export Credit	391
27.4 Fund-based Import Credit	394
27.5 Non-fund based working capital facilities	395
27.6 Bill Discounting	399
27.7 Supply Chain Finance	400
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	405

28

ASSESSMENT OF WORKING CAPITAL FINANCE

28.1 Assessment of Working Capital Finance	406
ATTEMPT THE FOLLOWING QUESTIONS BASED ON YOUR LEARNING	413