GENERAL OBJECTIVES
This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to apply advanced financial management techniques in an organization

15.0 LEARNING OUTCOMES
A candidate who passes this paper should be able to:
- Evaluate capital investment decisions under uncertain economic conditions
- Design an optimal capital structure for an organization
- Predict corporate failure
- Apply derivatives in financial risk management
- Apply financial management skills in the public sector

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15.1 Nature and purpose of financial management
- Introduction to financial management
- Stakeholders theory
- Conflicting stakeholders interest and corporate governance
- Corporate social responsibility (CSR) and financial management
- Ethical issues in financial management

15.2 The investment Decision
- Investment decision under capital rationing: multiperiod
- Investment decision under inflation
- Investment decision under uncertainty/risk
- Nature and measurement of risk and uncertainty
- Techniques of handling risk: sensitivity analysis; scenario analysis; simulation analysis; decision theory models; certainty equivalent; risk adjusted discount rates; utility curves
- Special cases in investment decision: projects with unequal lives; replacement analysis; abandonment decision
- Real options in investment decisions: types of real options; evaluation of a capital project using real options
- Common capital budgeting pitfalls
- Bond refinancing/refunding

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- Risk return trade off, mean-Variance Analysis
- Capital efficient portfolios
- Capital asset pricing models (CAPM)
- Arbitrage pricing model (APT) and other multifactor models
- Beta estimation
- Portfolio performance measurement: Treynor’s measure, Sharpe’s measure and Jensen’s measure
15.4 The financing decision
- Introduction to financing decision
- Nature and significance of financing decision
- Cost of capital and significance: specific cost of capital, weighted average cost of capital (WACC), Marginal cost of capital (MCC), MCC-IOS/MCC-IRR schedules
- Capital structure theories: Traditional theories; Net Income (NI) Approach, Net Operating Income (NOI)
- Fanco Modigliani & Merton Miller (MM) propositions: MM without taxes, MM with corporate taxes, MM with corporate capital structure theories
- Special topics in financing: EBIT_EPS analysis, financial and operating leverage, financial and operating leverage combined, geared and ungeared betas, lease versus purchase
- Impact of financing on investment decisions-adjusted present value
- Financial distress: signs of financial distress, forms of financial distress, predicting organization failure, Solution to financial distress

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- Use of free cash flows in valuation
- Use of relative measures: economic value added (EVA)
- Use of enterprise value

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- Reasons for mergers and acquisitions
- Acquisition and mergers versus organic growth
- Valuation of acquisition and mergers
- Financing acquisitions and mergers
- Takeover and defense tactics
- Regulatory framework for mergers and acquisition
- Valuation and analysis of corporate restructuring, leveraged buy outs (LBO) divestitures, strategic alliances, liquidation and recapitalization
- Mergers and acquisition in the global context

15.7 Derivatives in financial risk management
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- Foreign currency risk management: Types of forex risks, hedging currency risks, forward rate agreement, interest rate futures, interest rate swaps, interest rate options
- Derivatives in risk management: meaning and purpose of derivatives; types of derivatives; forwards, options, futures and swaps
- Valuations of derivatives: options;- Black Scholes options pricing models Greeks (definitions)
15.8 International financial management
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- International financial institutions
- Dividend policy for multinationals
- Availability and timing of remittances
- Transfer pricing: Impact on taxes and dividends

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Revised on: July 2018
TOPIC 1

NATURE AND PURPOSE OF FINANCIAL MANAGEMENT

INTRODUCTION TO FINANCIAL MANAGEMENT

Meaning of Financial Management

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Scope/Elements

1. **Investment decisions** includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.

2. **Financial decisions** - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.

3. **Dividend decision** - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
   a. Dividend for shareholders- Dividend and the rate of it has to be decided.
   b. Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.
Functions of Financial Management

1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

2. **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short-term and long-term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.

3. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
   - a. Issue of shares and debentures
   - b. Loans to be taken from banks and financial institutions
   - c. Public deposits to be drawn like in form of bonds.

   Choice of factor will depend on relative merits and demerits of each source and period of financing.

4. **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.

5. **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
   - a. Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
   - b. Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.

6. **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintenance of enough stock, purchase of raw materials, etc.

7. **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

**STAKEHOLDERS THEORY**

Stakeholder theory states that a company owes a responsibility to a wider group of stakeholders, other than just shareholders. A stakeholder is defined as any person/group which can affect/be affected by the actions of a business. It includes employees, customers, suppliers, creditors and even the wider community and competitors.

Edward Freeman, the original proposer of the stakeholder theory, recognised it as an important element of Corporate Social Responsibility (CSR), a concept which recognises the responsibilities of corporations in the world today, whether they are economic, legal, ethical or even philanthropic. Nowadays, some of the world’s largest corporations claim to have CSR at the centre of their
corporate strategy. Whilst there are many genuine cases of companies with a “conscience”, many others exploit CSR as a good means of PR to improve their image and reputation but ultimately fail to put their words into action.

Within an organisation there are a number of internal parties involved in corporate governance. These parties can be referred to as internal stakeholders.

A useful definition of a stakeholder, for use at this point, is 'any person or group that can affect or be affected by the policies or activities of an organization.

The basis for stakeholder theory is that companies are so large and their impact on society so pervasive that they should discharge accountability to many more sectors of society than solely their shareholders demonstrated in the diagram below;

Stakeholder theory may be the necessary outcome of agency theory given that there is a business case in considering the needs of stakeholders through improved customer perception, employee motivation, supplier stability, shareholder conscience investment.

Each internal stakeholder has:

- An operational role within the company
- A role in the corporate governance of the company
- A number of interests in the company (referred to as the stakeholder 'claim').
<table>
<thead>
<tr>
<th>Operational role</th>
<th>Corporate governance role</th>
<th>Main interests in the company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company secretary</td>
<td>Stakeholder</td>
<td></td>
</tr>
<tr>
<td>Responsible for the actions of the corporation.</td>
<td>Control company in best interest of the stakeholders</td>
<td>- pay</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- performance linked bonus</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- share options</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- status</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- reputation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- power</td>
</tr>
<tr>
<td>Sub-board management</td>
<td>Directors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Identify and evaluate risks faced by a company.</td>
<td>- Job stability</td>
</tr>
<tr>
<td></td>
<td>- enforce controls.</td>
<td>- career progression</td>
</tr>
<tr>
<td></td>
<td>- monitor success.</td>
<td>- status</td>
</tr>
<tr>
<td></td>
<td>- report concerns.</td>
<td>- working conditions</td>
</tr>
<tr>
<td>Employees</td>
<td>Carry out orders of management.</td>
<td>- performance linked bonus</td>
</tr>
<tr>
<td></td>
<td>- Comply with internal controls</td>
<td></td>
</tr>
<tr>
<td>Employee representatives e.g trade unions</td>
<td>Protect employee interests</td>
<td>- Power</td>
</tr>
<tr>
<td></td>
<td>Highlight and take action against breaches in governance requirements e.g. protection of whistle blowers.</td>
<td>- Status</td>
</tr>
</tbody>
</table>
External corporate governance stakeholders

A company has many external stakeholders involved in corporate governance. Each stakeholder has:
- a role to play in influencing the operation of the company
- its own interests and claims in the company.

<table>
<thead>
<tr>
<th>External party</th>
<th>Main role</th>
<th>Interests and claims in company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditors</td>
<td>Independent review of company’s reported financial position.</td>
<td>- Fees</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Reputation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Quality of relationship</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Compliance with audit requirements</td>
</tr>
<tr>
<td>Regulators</td>
<td>Implementing and monitoring regulations</td>
<td>- Compliance with regulations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Effectiveness of regulations</td>
</tr>
<tr>
<td>Government</td>
<td>Implementing and maintaining laws with which all companies must comply</td>
<td>- Compliance with laws</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Payment of taxes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Levels of employment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Levels of imports/exports</td>
</tr>
<tr>
<td>Stock exchange</td>
<td>Implementing and maintaining rules and regulations for companies listed on the exchange</td>
<td>- Compliance with rules and regulations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Fees</td>
</tr>
<tr>
<td>Small investors</td>
<td>Limited power with use of vote</td>
<td>- Maximisation of shareholder value</td>
</tr>
<tr>
<td>Institutional</td>
<td>Through considered use of their votes can (and should) beneficially influence corporate policy</td>
<td>- Value of shares and dividend payments</td>
</tr>
<tr>
<td>investors</td>
<td></td>
<td>- Security of funds invested</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Timeliness of information received from company</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Shareholder rights are observed.</td>
</tr>
</tbody>
</table>

CONFLICTING STAKEHOLDERS INTERESTS AND CORPORATE GOVERNANCE

Agency theory

Agency theory is part of the bigger topic of corporate governance.
It involves the problem of directors controlling a company whilst shareholders own the company. In the past, a problem was identified whereby the directors might not act in the shareholders (or other stakeholders) best interests. Agency theory considers this problem and what could be done to prevent it.

A number of key terms and concepts are essential to understanding agency theory.
- An agent is employed by a principal to carry out a task on their behalf.
- Agency refers to the relationship between a principal and their agent.
- Agency costs are incurred by principals in monitoring agency behaviour because of a lack of trust in the good faith of agents.
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TOPIC 9

REAL ESTATE FINANCE

NATURE OF REAL ESTATE

Many of the legal terms used currently used in real estate business have evolved from English common law, which serves as the basis for much of the property law currently used in the Kenya. For example, the term real in real estate comes from the term realty, which has, for centuries, meant land and all things permanently attached (the latter would include immovable things such as buildings and other structure). All other things not considered realty have been designated as personalty, which includes all intangibles and movable things (for example, automobiles, shares of stock, bank accounts, patents and so on). The term estate has evolved to mean “all that a person owns,” including both realty and personalty. Hence the portion of a person’s estate that consists of realty has come to be known as real estate. However, in current business practice, although the term realty is sometimes used, we generally use the term real estate to mean land and all things permanently attached.

It is important to distinguish between physical real estate assets and ownership rights in real property because many parties can have different ownership rights in a given parcel of real estate. Our legal system offers ways for the person financing or investing in real estate to be creative and to apportion these various interests among parties.

We generally refer to property rights as the right of a person to possession, use, enjoyment, and disposal of his or her property. With respect to the application to real estate, interest is a broad legal term used to denote a property right. The holder of an interest in real estate enjoys some rights, or degree of control or use, and, in turn, may receive payment for the sale of such an interest. This interest, to the extent that its value can be determined, may also be bought, sold, or used as collateral for a loan.

The value of a particular parcel of real estate can be viewed as the total price individuals are willing to pay for the flow of benefits associated with all of these rights. An individual does not have to be an owner per se to have rights to some of the benefits of real estate. For example, a person who leases land, a lessee, may have the right to possession and exclusive use of a property for a period of time. This right of use has value to the lessee, even though the term of the lease is fixed. In exchange for the right to use the property, the lessee is willing to pay a rent for the term of the lease.

A holder of a mortgage also has some rights as a non-owner in real estate pledged as security for a loan. These rights vary with state law and the terms of the mortgage, but, in general, the lender (or mortgagor) has a right to repossess or bring about the sale of a property if the borrower defaults on the mortgage loan. Although the lender may not possess or use the real estate, the mortgage
DEFINITION OF ESTATE

The term estate means “all that a person owns” The term real estate means all realty owned as a part of an individual’s estate. The term estate in real property is used to describe the extent to which rights and interests in real estate are owned.

CLASSIFICATIONS OF ESTATES

1) Based on Rights: Estates in Possession versus Estates Not in Possession (Future Possession)

Two broad categories of estates can be distinguished on the basis of the nature of rights accompanying the ownership of such estates. An estate in possession (a present state in land) entitles its owner to immediate enjoyment of the rights to that estate. An estate not in possession (a future estate in land), on the other hand, does not convey the rights of the estate until sometime in future, if at all. An estate not in possession, in other words, represents a future possessory interest in property. Generally, it does not convert to an estate in possession until the occurrence of a particular event. Estates in possession are by far the more common. When most people think of estates, they ordinarily have in mind estates in possession. Obviously, lenders and investors are interested in the nature of the estate possessed by the owner when considering the purchase or financing of a particular estate in property.

2) Based on Possession and Use: Freehold versus Leasehold Estates

Estates in possession are of two general types: freehold and leasehold estates. These types of estates are technically distinguished on the basis of the definiteness or certainty of their duration. A freehold estate, last for indefinite period of time; that is, there is no definitely ascertainable date on which the estate ends. A leasehold estate, on the other hand, expires on a definite date. Aside from this technical distinction, a freehold estate connotes ownership of the property by the estate holder, whereas a leasehold estate implies only the right to possess and use the property owned by another for a period of time.

Examples of Freehold Estates

There are many types of freehold estates. The two most common examples of freehold estates are:

a) Fee Simple Estate

A fee simple estate, also known as a fee simple absolute estate, is the freehold estate that represents the most complete form of ownership of real estate. A holder of a fee simple estate is free to divide up the fee into lesser estates and sell, lease, or borrow against them as he or she wishes, subject to the laws of the state in which the property is located. Apart from government restrictions, no special conditions, limitations, or restrictions are placed on the right of a holder of a fee simple estate to
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