PAPER NO.8 FINANCIAL MANAGEMENT

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to apply financial management principles in practice.

8.0 LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Analyse the sources of finance for an organisation and evaluate various financing options
- Evaluate various investment decision scenarios available to an organisation
- Evaluate the performance of a firm using financial tools
- Make appropriate capital structure decisions for a firm
- Value financial assets and firms
- Make appropriate liquidity and dividend decisions for a firm
- Evaluate current developments in business financing strategies.

CONTENT

8.1 Overview of financial management
- Nature and scope of finance
- Finance functions
- Goals of a firm; financial and non-financial objectives, overlaps and conflicts among the objectives
- Agency theory, stakeholder’s theory and corporate governance
- Measuring managerial performance, compensation and incentives
- Ethical issues in financial management
- Corporate social responsibility (CSR) and financial management

8.2 The financing decision
- Nature and objectives of the financing decision
- Factors to consider when making financing decisions
- Sources of finances for enterprises; internally generated funds and the externally generated funds, long term sources, medium term and short term sources of finance
- Evaluation of financing options
- Methods of issuing ordinary shares - public issue, private placement, bonus issue, employee stock option plans (ESOPS) and rights issues

8.3 Financial institutions and markets
- Nature and role of financial markets
- Classification of financial markets: primary and secondary securities market, money and the capital markets, over-the-counter and organised market, derivatives market, mortgage market, forex market
- The security exchange listing and cross border listing
- Market efficiency - efficient market hypothesis
- Stock market indices
- The financial institutions and intermediaries: commercial banks, savings and loans
associations and co-operative societies, foreign exchange bureaus, Unit trusts and mutual funds, insurance companies and pension firms, insurance agencies and brokerage firms, investment companies, investment banks and stock brokerage firms, micro-finance institutions and small and medium enterprises (SMEs)
- The role of regulators in financial markets
- Central depository system and automated trading system
- Timing of investment at the securities exchange - Dow theory and Hatch system of timing

8.4 Time-value of money
- Concept of time value of money
- Relevance of the concept of time value of money
- Time value of money versus time preference of money
- Compounding techniques
- Discounting techniques

8.5 Valuation models
- Concept of value; book value, going concern value, substitution value, replacement value, conversion value, liquidation value, intrinsic value and market value
- Reasons for valuing financial assets/business
- Theories on valuation of financial assets; fundamental theory, technical theory, random walk theory and the efficient market hypothesis
- Valuation of redeemable, irredeemable and convertible debentures and corporate bonds
- Valuation of redeemable, Irredeemable and convertible preference shares
- Valuation of ordinary shares; net asset basis, price earnings ratio basis, capitalisation of earnings basis, Gordon’s model, finite earnings growth model, Super-profit model, Marakon model, Walter’s model, Discounted free cash flow, residual income model
- Use of relative measures such as Economic Value added (EVA) and Market Value Added (MVA)
- Valuation of unit trusts and mutual funds
- Valuation of private companies: income and market based approaches

8.6 Cost of capital
- Firms capital structure and factors influencing capital structure decisions
- Factors influencing firms cost of capital
- Relevance of cost of capital
- Component costs of capital
- The firm’s overall cost of capital
- Weighted average cost of capital (WACC)
- Weighted marginal cost of capital (WMCC)
- Introduction to break-points in weighted marginal cost of capital schedule
- Operating and financial leverage - degree of operating leverage and operating risk; degree of financial leverage and financial risk
- Combined leverage - degree of combined leverage and total risk

8.7 Capital budgeting decisions
- The nature and importance of capital investment decisions
- Capital investment’s cash flows - initial cash outlay, terminal cash flows and annual
net operating cash flows, incremental approach to cash flow estimation
- Capital investment appraisal techniques
- Non-discounted cash flow methods - payback period and accounting rate of return
- Discounted cash flow methods - net-present value, internal rate of return, profitability index, discounted payback period and modified internal rate of return (MIRR)
- Strengths and weaknesses of the investment appraisal techniques
- Expected relations among an investment’s NPV, company value and share price
- Capital rationing - evaluation of capital projects and determination of optimal capital budget in situations of capital rationing for a single period rationing
- Capital investment options - timing option, strategic investment option, replacement option and abandonment option
- Problems/difficulties encountered when making capital investment decisions in reality

8.8 Financial analysis and forecasting
- Users of financial statements and their information needs
- Ratio analysis; nature of financial ratios, classification and calculation of financial ratios and limitation of financial ratios
- Common size statements - Vertical and horizontal analysis
- Financial forecasting; cash budgeting and percentage of sales method of forecasting

8.9 Working capital management
- Introduction and concepts of working capital
- Working capital versus working capital management
- Factors influencing working capital requirements of a firm
- Importance and objectives of working capital management
- Working capital operating cycle; the importance and computation of the working capital operating cycle
- Working capital financing policies aggressive, conservative and matching financing policy
- Management of stock, cash, debtors and creditors

8.10 Dividend decision
- Forms of dividend
- How to pay dividends and when to pay dividends
- How much dividend to pay
- Firms dividend policy and factors influencing dividend decision
- Why pay dividends
- Dividend relevance theories; Bird in hand, Clientele effect, Information signaling theory, Walter’s model, Tax differential theory, Modigliani and Miller dividend irrelevance theory

8.11 Introduction to risk and return
- Risk-return trade off/relationship
- Distinction between risk free and risky assets
- Expected return of an asset
- Total risk of an asset
- Relative risk of an asset
- Expected return of a 2 asset-portfolio
8.12 Islamic finance

- Justification for Islamic Finance; history of Islamic finance; capitalism; halal; haram; riba; gharar; usury
- Principles underlying Islamic finance: principle of not paying or charging interest, principle of not investing in forbidden items such as alcohol, pork, gambling or pornography; ethical investing; moral purchases
- The concept of interest (riba) and how returns are made by Islamic financial securities
- Sources of finance in Islamic financing: muhabaha, sukuk, musharaka, mudaraba
- Types of Islamic financial products:- sharia-compliant products: Islamic investment funds; takaful the Islamic version of insurance Islamic mortgage, murabahah.; Leasing - ijara; safekeeping - Wadiah; sukuk - islamic bonds and securitisation; sovereign - sukuk; Islamic investment funds; Joint venture - Musharaka, Islamic banking. Islamic contracts, Islamic treasury products and hedging products, Islamic equity funds; Islamic derivatives
- International standardisation/regulations of Islamic Finance: case for standardisation using religious and prudential guidance, National regulators, Islamic Financial Services Board

8.13 Emerging issues and trends
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TOPIC 1

OVERVIEW OF FINANCIAL MANAGEMENT

Introduction
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.

NATURE AND SCOPE OF FINANCE

1. Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets is 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.

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**FINANCE FUNCTIONS**

The following explanation will help in understanding each finance function in detail

1. **Investment Decision**

   One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision

   a. Evaluation of new investment in terms of profitability
   b. Comparison of cut off rate against new investment and prevailing investment.

   Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the
expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

2. Financial Decision

Financial decision is yet another important function which a financial manager must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm’s capital structure.

A firm tends to benefit most when the market value of a company’s share maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds.

A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

3. Dividend Decision

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manager performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It’s the financial manager’s responsibility to decide a optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability Another way is to issue bonus shares to existing shareholders.

4. Liquidity Decision

It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm’s profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not
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