NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF BUSINESS AND HUMAN RESOURCE MANAGEMENT

**COURSE CODE: BHM 205**

**COURSE TITLE: Business Finance I**

**COURSE GUIDE**

# BHM 205
# BUSINESS FINANCE I


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## Introduction

Business Finance I (BHM 205) is a two-credit unit course. It is designed for you being a student of Business Education. This course is of great importance to you in your field of study and as future managers, entrepreneurs, stockbrokers, financial analysts and consultants.

## What You Will Learn in this Course

This course is made up of 15 units covering various areas such as the evolution of finance and study of finance as a discipline, goals of profit-oriented business, forms of business existing in Nigeria, concept of capitalisation, types of financial markets in Nigeria. Related areas such as financial institutions, types of finance in Nigeria financial system and relationship of finance to other functional areas of business are discussed. Such areas as sources of funds available to small businesses in Nigeria, preparation of feasibility study, and time value of money are also discussed in this course.

This Course Guide is meant to provide you with the necessary information about the course, the nature of the materials you will be using and how to make the best use of the materials towards ensuring adequate success in your programme as well as the application of finance in businesses. In this Course Guide, you will have information on how to make use of your time and information on how to tackle the tutor-marked assignment (TMA) questions. There will be a tutorial session during which your instructional facilitator will take you through your difficult areas; and have meaningful interaction with fellow students.

## Course Aims

The main aim of this course is to expose you to the basic ingredients of financing profit-oriented businesses, how to source for funds for a business and know how to prepare a feasibility study for a new venture. The course also aims at giving you the appreciation of the value of money you have today, and relationship of finance to other functional areas of business.

Other aims of the course include:

- to explaining the evolution of finance and the study of finance as a discipline
- to identify various forms of business in Nigeria
- to explain the concept of capitalisation
- to discuss types of financial markets in Nigeria

- to explain capital budgeting
- to discuss the importance of time value of money
- to discuss the preparation of feasibility study
- to explain types of finance
- to identify the Nigeria financial system.

## Course Objectives

On the completion of this course, you should be able to:

- discuss the evolution of finance as a discipline
- analyse the various forms of business in Nigeria
- state the goals of profit-oriented business
- discuss the financial markets and their instruments
- identify the financial institutions in Nigeria
- explain the time value of money
- identify the financing of small-scale business in Nigeria
- analyse the process of preparing a feasibility study
- identify various types of finance
- explain capital budgeting
- explain the structure of the Nigeria financial system.

## Course Materials

Major components of the course are:

1. Course guide
2. Study units
3. Textbooks
4. Assignment file

## Study Units

The course is subdivided into 15 units of three modules for easy study. They are as follows:

**Module 1**

Unit 1 Finance in an Economic System
Unit 2 Forms of Business in Nigeria
Unit 3 Goals of Profit-Oriented Business
Unit 4 Forecasting Financial Requirement of Capital Sourcing for Business Operations
Unit 5 Concept of Capitalisation

**Module 2**



**Module 3**



The first unit introduces you to the evolution of finance, finance as a discipline of study and the functions of finance in an organisation. The second unit discusses the various forms of businesses existing in Nigeria. The third unit presents the goals of a profit-oriented business. Unit four discusses the requirements for capital sourcing for various forms of business. Unit five explains the concept of capitalisation. Units six, seven and eight discuss financial markets and institutions in Nigeria as well as lending policies. Unit nine discusses the importance of time value of money while unit 10 throws light on capital budgeting analysis. Unit 11 focuses on financing small-scale business, while unit 12 gives an insight into the importance of feasibility study. Units 13 and 14 explain types of finance; relationship between finance and other areas of business. The last unit brings out the structure of the Nigeria financial system.

Each study unit is expected to last for, at least, two hours, and it includes introduction, objectives, main content, self assessment exercises, conclusion and summary as well as references. Other area borders on the tutor-marked assignment questions.

There are suggested textbooks for further reading, which are meant to give you additional information if only you can lay your hands on them. You are advised to practice the self assessment exercises and tutor-marked assignment questions for greater understanding and achieving the learning objectives of the course.

## Tutor-Marked Assignment

When doing your tutor-marked assignments, you are to apply the knowledge and you acquired from the contents of the study units. They constitute 30 per cent of the total score for the course.

## Final Examination and Grading

At the end of the course, you will write the final examination. It will account for 70 per cent. This together with the tutor-marked assignments mark makes the total final score to be 100 per cent.

## Conclusion

This course, Business Finance I, provides you with an insight into to the nature of finance, how finance is used in businesses, financial markets and institutions. On the successful completion of the course, you will be armed with the knowledge necessary for efficient running of business as well as understanding activities in the financial market in a world of finance.

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# MODULE 1



## UNIT 1 FINANCE IN AN ECONOMIC SYSTEM

**CONTENTS**



## 1.0 INTRODUCTION

Training in finance has served as a stepping-stone to a number of the top corporate positions in the country. Many students approaching the field of finance for the first time might wonder what career opportunities exist. For those who develop the necessary skills and training, job positions in the field include corporate financial officer, banker, stockbroker, financial analysts, portfolio manager etc. This unit centres on the origin of finance, finance as a discipline and the functions of finance.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- discuss the evolution of finance
- discuss finance as a discipline
- explain the functions of finance.

# 3.0 MAIN CONTENT

## 3.1 Evolution of Finance

At the turn of the century, finance, though closely linked with economics, emerged as a separate field from economics. The major focus of this study reflected the developments of finance, namely, the building of giant Industrial Corporation by Rockfeller, Carnegic, Du Pont, and others. As a student of finance, you would spend much time learning about the financial instruments that were instrumental to mergers and acquisitions.

With the development and implementation of antitrust, corporate consolidations became less important, and more patterns of growth were emphasised. Attention shifted to stocks and bonds and other securities used for raising capital. The role of the investment, banker or intermediary in a security offering also received much attention. No doubt, the great bull market of the 1920s contributed to the emphasis in raising capital.

In the 1930s, the shock of depression ushered in an era of conservatism, and attention shifted to such topics as preservation of capital, maintenance of liquidity, reorganisation of financially troubled corporations, and the bankruptcy process. The Federal Government assumed a much larger role in regulating business through the Securities Act of 1933 and the Securities Exchange Act of 1934. A by-product of this regulation was the development of published data related to corporate performance. The groundwork was laid for the sophisticated analysis of corporate information that would take place in later decades.

The 1940s and early 1950s offered new knowledge in the study or practice of corporate finance. However, in the mid-50s a major shift in finance took place. Up to that time, the study procedures of finance had been descriptive or definitional in nature. Furthermore, the orientation had been from the viewpoint of a third party or an outsider. All these changed in the mid-50s as a more analytical, decision-oriented approach began to evolve.

The first area of study to generate the newfound enthusiasm for decision-related analysis was capital budgeting. The financial manager was presented with analytical techniques for allocating resources among the various assets of the firm. The enthusiasm spread to other decision-making areas of the firm such as cash and inventory management, capital structure formulation, and dividend policy. The emphasis shifted from that of the outside looking in to that of the financial manager forced to make tough day-to-day decisions affecting the performance of the firm.

## 3.2 Finance as a Discipline

The focus of this course is on the financial management of business; however, the field of finance has broader perspective. Simply defined, finance is a body of facts, principles and theories dealing with the raising and using of money by individuals, businesses and governments. It covers essential areas of financial planning and financial institutions as well as managerial finances.

The individual's financial problem is how to maximise his or her well-being by appropriately using the available resources. Finance deals with how individual divide their income between consumption and investment; how they choose between consumption and investment; how they chose from among available investment opportunities; and how they raise money to provide for increased consumption or investment.

Like an individual, business also face the problem of allocating resources and raising money. Management must determine which investment to make and how to finance those investments. Just as the individual seeks to maximise his happiness, the firm seeks to maximise the wealth of its owners (Stockholders).

Finance also encompasses the study of financial market and institutions, and the activities of government, with emphasis on those aspects relating to financial decisions of individuals and companies. Limitation and opportunities provided by an institutional environment is crucial to decision-making process of individuals and firms. In addition, financial institutions and government have financial problems comparable to those of individuals and firms. The study of these problems is an important aspect in finance.

**SELF-ASSESSMENT EXERCISE 1**

1. Explain the concept of finance.
2. Discuss the areas covered by the study of finance as a discipline.

## 3.3 Functions of Finance

Functions of finance to individuals and departments in an organisation depend on the size of the company. The larger the company, the greater the degree of specialisation of task, and the greater the proliferation of positions and departments. A smaller firm would consolidate many departments into fewer departments.

Generally, the major finance-related functions in a firm include:

1. **Financing and Investment:** This includes supervising firm's cash and other liquid (holding) assets, raising additional functions when needed, and investing funds in projects.

2. **Accounting and Control:** This include maintaining financial records, controlling financial activities, identifying deviations from planned and efficient performance and managing payroll, tax matters, inventories, fixed assets, and computer operations.

3. **Forecasting and Long-term Planning:** This involves forecasting cost, technological changes, capital market conditions, funds needed for investment, demand for the firm's product, and using forecast and historical data to plan future operations.

4. **Pricing:** This entails determining the impact of pricing policies on profitability.

5. **Other functions:** This includes credit and collections, insurance and incentive planning.

**SELF-ASSESSMENT EXERCISE 2**

Outline the functions of finance in a firm.

## 4.0 CONCLUSION

The talents required of financial managers are rapidly expanding and there is an increasing demand for financial officers. These greater demands placed on financial executives emerged from two factors. First, financial analytic techniques and financial securities have become significantly more complex. Second, more companies now have operations or raise capital overseas. This unit also discussed functions of finance.

## 5.0 SUMMARY

In this unit, you have been introduced to the origin of finance and finance as a discipline. The functional aspects of finance were also discussed. You were told that the finance function includes a wide variety of responsibilities, including budgeting, vesting funds, accounting, product pricing and forecasting. Finance embraces many sub areas such as personal finance and financial institution.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. Explain the concept of finance.
b. Discuss the areas covered by the study of finance as a discipline.

2. Outline the functions of finance in a firm.

## 7.0 REFERENCES/FURTHER READING

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# UNIT 2 FORMS OF BUSINESS IN NIGERIA

## CONTENTS



## 1.0 INTRODUCTION

An entrepreneur is an important factor in the operation of any business enterprise. He is the investor who put his money into the running of a business. This makes him to be the sole decision-maker of which business to venture into. When he has decided which line of business to invest his money, he decides on what form of business organisation he needs to set up to make him realise his business objectives.

The way a business concern is organised usually has an implication for its growth and development, for instance, the way it can raise capital, as well as how benefits and losses of the business may be shared. All these have to do with the ownership form.

In this unit, we shall discuss the forms of business existing in Nigeria.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- discuss the various forms of businesses in Nigeria
- outline advantages and disadvantages of each of the forms of business in Nigeria.

## 3.0 MAIN CONTENT

### 3.1 Sole Proprietorship

This is sometimes called one-man business. This is a form of business owned and run by one person. The sole trading business has no legal requirements before it is established. With little capital or skill, a man can start a sole trading business. This form of business is very common in Nigeria today, especially with the economy down turn, which has necessitated many people to find a means of sustaining their lives.
Many factors has made people to start a sole proprietorship on their own, these factors include inheritance of business from a relative, desire to be independent, desire to build a fortune, unemployment and exploitation of ideas.

**Advantages of Sole Proprietorship**

1. It is easy to start with minimum cost and no legal intricacies.
2. All profits belong to the entrepreneur.
3. Sole trading does not pay tax like statutory companies. They only pay personal income tax.
4. The business can be liquidated easily if the need arises just as it was started.
5. Decision can be taken quickly since the owner need not consult anybody.
6. The owner enjoys privacy in the matters of his business affair.

**Disadvantages**

1. Unlimited liability of the owner, all loses are the responsibilities of the owner and if he fails to bear the losses his property may be forfeited.
2. The business lacks originality in that the owner may not be able to get expert ideas that may be required in running a modern business.
3. There is no continuity in the business as it may die with the owner.
4. Insufficiency of capital is one of the major drawbacks to this form of business.

**Conditions Favourable For Establishing a Sole Proprietorship Business**

1. When capital is small and there is a desire to go into business
2. When there is a need to start the business quickly and urgently in order to exploit an advantage.

3. When the skill of the owner is an important consideration in the operation of the enterprise
4. When risk is very low, such that it does not pose much threat to the economic survival of the entrepreneur

## 3.2 Partnership

When two or more persons come together to conduct a business enterprise, a partnership is said to exist. These people come together with the sole aim of sharing profits and losses arising from the partnership. It is formed to boost capital base of a business and benefits from the contributions of the owners. The nature of partnership is such that the partners are co-owners of the business. Partnership can operate under different degrees of formality ranging from an informal oral understanding to a written state.

**Formation of Partnership**

Common law provisions and other statutes guide formation of partnership in Nigeria. It can be oral or written working agreement. However, it must be stated that a written agreement witnessed by a Notary Public, is preferable to an oral agreement because of its reliability and dependability.

Some provisions in the partnership agreement include the following:

1. Name of the business including names of the partners and their addresses
2. Amount contributed by each partner and how it is to be paid
3. Other contributions to be made by partners such as personal service or property
4. Relative amount of authority or voting power of each partner
5. Methods by which partners are to be compensated for the services rendered.
6. How the business may be dissolved, if the need arises for instance, in the event of death, withdrawal of a partner, bankruptcy of a partner, and legal declaration of insanity
7. Life span of the business

**Forms of Partnership**

1. **General Partner (Active Partners):** Unless otherwise stated, all partners are regarded as general partners. Such partners have unlimited liability and may personally bear the responsibility of the debt of the business, especially in cases where others could not meet up with their liabilities.

2. **Special Partners:** These are partners whose liabilities are limited by the agreement. Such partners do not normally involve themselves in the management of the business.

3. **Sleeping or Dormant Partners:** These partners are not known by the public to be actively involved in the business. They are silent partners and do not involved themselves in the daily management of the business.

**Conditions Favourable for the Operation of Partnership**

1. When a moderate amount of capital is required and where diversified managerial talents could be got from partners.
2. Professionals who specialised in different areas could find an opportunity in partnership agreement.
3. When risk is relatively low and could be borne by the partner.

**Advantages of Partnership**

1. Partners could have diversified skills, which could be put to the business advantage.
2. The business has the opportunity of securing more capital in that there is more than one owner.
3. The operation of the business is relatively free from government control.
4. It is easy to form and organised in that there are no complicated legal requirements to meet before starting.

**Disadvantages**

1. Inability to transfer ownership in partnership business poses a drawback to this form of enterprise.
2. The partners are jointly and separately liable for business debt. This means that if a partner is unable to meet the claims resulting from the liquidation of the partnership, the remaining partners must take over the unsatisfied claims, drawing on their personal assets if necessary.
   It may be difficult to find compatible partners who could work together peacefully, especially in a situation where people do not trust each other.
3. Uncertainty of the lifespan of the business. If a partner withdraws or dies, the withdrawal or death of the partner dissolves the partnership.

**SELF-ASSESSMENT EXERCISE 1**

What are the advantages of partnership?

## 3.3 Limited Liability Companies

Limited liability companies are usually guided by statute (state laws) in their operations. The law recognises them as a legal entity, distinct from its owner and managers. It has an unlimited life and can continue after its original owners and managers are dead. The stockholders are not personally liable for the debt of the firm and it permits easy transferability of ownership interest in the firm.

In Nigeria, Company and Allied Matters Act of 1990 governs the formation of limited liability companies. The law states that such companies must be registered with the Corporate Affairs Commission (CAC). In addition to this, they must:

i. Apply formally to Registrar of Companies, at the Federal Ministry of Trade, Abuja.
ii. Be formed by at least two persons in the case of private companies (and a maximum of fifty persons) or at least seven persons (in the case of a public company with no maximum).
iii. Provide a Memorandum of Association, which will state details of external relationship of the company including:

a. Name of the proposed company
b. Nature of business and aims
c. Liabilities of shareholders
d. Objectives of the company
e. Amount and type of share capital
f. Number of directors
g. Names and addresses of directors

iv. Submit Article of Association, which will give details of internal operations of the company such as:

a. Time and schedule of meetings
b. Power(authority) of directors

The limited liability companies are usually divided into two basic types in Nigeria. They are:

i. Public limited liability companies whose shares are not quoted on the stock exchange market that is, the public do not subscribe to their shares.

ii. Public limited companies or Joint Stock Companies whose shares are quoted on the stock exchange and subscribed to by the public. Such companies usually add public limited company (PLC) to their name to distinguish them from the private companies.

**Advantages of Limited Liability Companies**

i. The company enjoys continuity in that the company is expected to exist forever (expect if dissolved by the law).
ii. Liabilities of owners are limited to the amount of capital contributed.
iii. It is easier to raise additional capital on identity of the company- either by issuing shares or borrowing.
iv. Shares can easily be transferred.
v. It gives wide scope to different investment.

**Disadvantages of Limited Liability Companies**

i. Limited liability companies suffer too much control from government.
ii. There are great difficulties in starting the company because of the legal requirements.
iii. They suffer from double taxation for example, companies pay tax on profit, dividend, properties, etc.
iv. The growth of bureaucracy can bring slow decision-making.
v. Possibility of impersonal relationship between management of the company and its workers.

**SELF-ASSESSMENT EXERCISE 2**

Distinguish between a private limited liability company and a public limited liability company.

## 3.4 Co-Operative Societies

As the name suggest, a cooperative society is a form of enterprise or organisational arrangement, which fosters cooperation among its members with the view to enhancing mutual and self-help; promote economic interest and welfare of the participating members. A co-operative society derives its strength from the interest and patronage of its members who provide nearly all its finance, own, manage and control its operations.

They are usually guided by statutes and sponsored by government especially because of their aim, which is to make life better for people in terms standard of living.

## Types of Co-Operative Society in Nigeria

The types of co-operatives Societies in Nigeria include:

i. **Producers' Co-operatives:** This form of co-operative society involves co-operation in production area to facilitate greater output, economies of scale, better pricing and improved marketing of product to minimised members' exploitation.

ii. **Consumers' Co-operatives:** This co-operative society is based on consumer ownership and control. Consumers' co-operative society involves co-operation in retail distributive trades. The society purchases consumer goods in bulk and at wholesale prices and sell to its members. Their objective is to eliminate intermediaries in the distribution of goods thereby enabling members to buy at lower cost.

iii. **Thrift and Credit Co-operatives:** These co-operatives societies are formed with the aim of promoting culture among members. In this form of co-operative society, members save money in the association based on their ability. The major objective of the thrift and credit or saving co-operatives is to discourage the habit of living from hand to mouth and encourage the habit of saving among members. Funds pooled together through savings are given as loan to members at lower interest rates than that of the financial market.
Members of these co-operatives are often drawn from the low-income people.

## Advantages of Co-Operative Societies

i. They facilitate easy access to some external sources of finance.
ii. Members obtain economies of scale.
iii. They serve as useful agents of economic development in that through the societies, incomes of members are raised and more businesses are established by obtaining capital from the co-operative.
iv. The thrift and credit societies have encouraged saving habit among people.
v. Co-operative societies enjoy less tax from government (since government sees them as agent of development).

**Disadvantages of Co-Operative Societies**

i. Co-operatives suffer from the lack of adequate finance. Insufficient funds can put severe limitations on the growth, development and expansion or range of activities of the society.
ii. Co-operative societies are mostly run by inexperienced managers who are not versed in the techniques of modern management.

## 3.5 Public Corporation

Public Corporation is a business organisation whose ownership is vested in the government who also owns the capital. The corporation has its own legal existence and; it is usually organised along a business line. It has no shareholders and it is not essentially established to make profits.

There are many corporations in Nigeria. For each corporation, a legislative (act of the government) determines the scope of activity and the broad policies; outlines the format of the organisation; and formulates the financial structure and other basic features. The management and control of a public corporation is vested in a Board of Directors whose members are appointed by a Commissioner/Minister of the State/Federal Government.

Public corporations in an economy are undertaken in areas of public utility such as electricity, telecommunication, water, steel development, television authority etc.

**Justification for Government Ownership of Business Organisation**

1. Some corporations provide services that cannot be left in the hands of private individuals. Examples are the services Central Bank of Nigeria and Nigerian Minting and Security Press.
2. The capital requirement for some projects is so enormous that an individual may not be able to afford it.
3. The desire for rapid economic development may necessitate the government to provide (through ownership), long-term capital projects such as infrastructures and basic services which require huge sums for their investments and which cannot, therefore, be profitably attractive to/and undertaken through private investment.
4. Government's ownership in business is necessary because, provision of certain goods and services by private enterprises may not be adequate in a way that can promote social justice.

## 4.0 CONCLUSION

Our discussion so far showed that there are many forms of businesses existing in the Nigerian economy. While sole proprietorship and partnership enterprises are easy to form, a limited liability company is not easy to form. Company profit and other earnings are taxed at the expense of the owners as regular income. Owners are also personally liable for the debt of the business. Limited Liability Companies has the advantage of limiting the liability of the participant, but it is generally more expensive to organise.

## 5.0 SUMMARY

In this unit, we have been able to look at the various forms of business enterprises and the conditions, for establishing each of them. We have examined the need for government's participation in business enterprises.

## 6.0 TUTOR MARKED ASSIGNMENT

1. Identify the reasons why government embarks in some businesses.
2. What are the advantages of partnership?

## 7.0 REFERENCES/FURTHER READING

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# UNIT 3 GOALS OF PROFIT-ORIENTED BUSINESS

## CONTENTS



## 1.0 INTRODUCTION

A profit-oriented business can only be successful only when it uses a goal-oriented financial structure. The financial manager performs certain task that helps achieve the goals of the finance department. The goals in turn help the firm achieve its overall operating objectives.

In line with this reality, the starting point for developing a goal-oriented financial structure is defining workable goals for the firm as a whole. Although they may be stated in general terms, properly defined and well-understood goals serve as the key to moving a firm to a desired position. Since private business is profit-oriented organisations, their objectives, which are frequently expressed in terms of money, are maximisation of profit and maximisation of wealth.

In this unit, therefore, goals of profit-oriented business and the main goals of profit-oriented businesses are considered.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain what profit-oriented businesses are
- discuss profit maximisation of businesses
- explain the wealth maximisation of businesses.

## 3.0 MAIN CONTENT

### 3.1 Profit-Oriented Businesses

Profit refers to an excess of receipts over expenses of a business for a trading period. This includes credit transactions and asset revaluations as well as cash transactions and changes in holdings of real assets. Profit for a period is equal to dividends and profit taxes plus the excess of net assets at the end of the period over net assets at its start. A business refers to all forms of industrial and commercial profit-seeking activity.

In light of the above, a profit-oriented business refers to all forms of activities both industrial and commercial, directed towards making profit. So long as a business is concerned, its profits are a matter of judgment rather than objective fact. Only when a business has been finally wound up and its assets converted into cash can profit be objectively measured. Until then, judgment is required as to the valuation of physical and financial assets, particularly if they are not traded on liquid markets, and as to the quality of debts due from credit customers.

**SELF-ASSESSMENT EXERCISE 1**

Explain the term “profit-oriented business.”

### 3.2 Goals of Profit-Oriented Business

As discussed earlier, a profit-oriented business can be successful only when its owner employs a goal-oriented financial structure for the running of the business. The starting point for developing a goal-oriented financial structure is defining workable goals. Therefore, for profit-oriented organisations, their goals are often expressed in monetary terms. The primary goals of profit-oriented organisations are maximisation of profit and maximisation of wealth.

#### 3.2.1 Maximisation of Profit

Profit maximisation stands as the first frequently stated goal of the firm. Many businesspersons believe that as long as they are earning high profit level, they have achieved this goal. Profit maximisation can be described as a rational goal of a business, which focuses the firm’s effort towards making money. Despite being widely professed, the concept of profit maximisation has several weaknesses.

Profit maximisation is vague and ignores timing. The problem here is the definition of the term “profits”. If a firm continues to operate a piece of machinery without proper maintenance, it may be able to lower this year's operating cost thereby improving short-run (current) profit. This firm will however, pay for the short-run saving in future years when the machine finally breaks down and is not capable of operating because of prior neglect. Apparently, maximising profits does not mean neglecting the long-term expenditure in favour of short-term considerations. In addition, money received today has a higher value than money received next year, a profit-oriented organisation must consider the timing of cash flows and profits (this is the timing aspect).

Profit maximisation also overlooks quality aspects of future activities. Businesses do not carry out their activities solely for the highest possible profit. Some businesses have placed a higher value on the growth of sales and are willing to accept lower profits in order to gain the stability provided by large volume of sales. Others recognise that diversification of their activities into different products or a market strengthens the firm even though it may result in short-term decline. Others engage in social responsibility thereby reducing their profit or undermining the goal of profit maximisation.

**SELF-ASSESSMENT EXERCISE 2**

Analyse profit maximisation as a goal of profit-oriented firms.

### 3.2.2 Maximisation of Wealth

The second goal of profit-oriented business is to maximise the value of the firm over the long run. This may also be stated as the maximisation of wealth while wealth is defined as the net present worth of the firm. Rather than focusing directly on profit, this goal emphasises the impact of profits on the current market value of the firm's securities, notably its common stock. Logically, there is a correlation between the present worth of a firm and its value over the long run. If the firm will be highly valuable in the forceable future, it has a high current value. The result would be true for a firm with prior prospects for instance, if an investor is considering purchasing a firm, desires a return of 15 per cent on money invested and the firm expects a net income after tax of N150,000.00 per year for many years, the firm would have a present worth of ₦1 million.

Maximisation of wealth implies other factors in addition to profits. Long run value is affected by the firm's growth, the amount of risk acceptable to investors, the market price of the stock and the cash dividends paid.

A firm maximising wealth must do the following:

1. **Avoid high risk:** If a firm is taking a long-term perspective on its business operations, it must avoid unnecessary or high level of risk; profits with relatively high level of risk are not accepted. Accepting these projects over the long run means that a single major failure may jeopardise the firm's continuous operation.

2. **Pay dividends:** Dividends are payments from the firms to shareholders. They must be consistent with both the firms and shareholders' needs. At the early stages of growth, need for expansion is inevitable hence, dividends may be small. As the firm reaches maturity and needs less cash to finance expansion, it will be able to finance expansion; it will be able to pay out a larger share of profits as dividends. By doing so, the firm attracts investors seeking cash income, which maintain the market value of the stock, and keeps up the present stock.

3. **Seek Growth:** As a firm increases sales and develops new markets for products, it protects itself against a business set back that might drive it from the market place. A large stable and diversified volume of sales provides a cushion for the firm against economic recessions, changes in consumer preferences or other reductions in the demand for the firm's products. For this reason, firms adopting wealth maximisation approach are continually seeking growth in sales earnings.

4. **Maintain Market Price of Stock:** The value of a firm's common stock in the market place is a matter of primary concern to its management. (Pursuing goal of the common stock, this in effect is being maximised.) A company's management can take a number of positive steps to maintain the market price of the stock at reasonable levels. By seeking sound investments, the firm will appear to have made a wise investment choice over the long-term. These and other actions can help draw attention to the firm and keep the present worth of its stock at high levels.

**SELF-ASSESSMENT EXERCISE 3**

Discuss the way(s) in which the wealth maximisation goal is superior to the goal of profit maximisation.

## 4.0 CONCLUSION

From the above discussion, we observed that a firm that wants to be successful needs to put in place a goal-oriented financial structure.

Under this, it should define, explicitly, workable goals that are well understood. By defining these goals, the firm will be in a better position to execute its goals to sustain itself not only in the short run but also in the long term.

## 5.0 SUMMARY

This unit examined what profit-oriented or businesses are. In addition, it stressed the need to put in place a goal-oriented financial structure for success. Furthermore, the unit identified profit maximisation and wealth maximisation as the frequently stated goals: the wealth maximisation is superior to wealth profit maximisation. It also encompasses the latter.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. Explain the term "profit oriented business".
b. Analyse profit maximisation as a goal of profit-oriented firms.
2. Discuss the way(s) in which the wealth maximisation goal is superior to the goal of 'profit maximisation'.

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# UNIT 4 FORECASTING FINANCIAL REQUIREMENT FOR BUSINESS CAPITAL

## CONTENTS



## 1.0 INTRODUCTION

If we were to ask owners of businesses to identify their most pressing problem, there would be varied responses. This might include meeting the rising cost of health care of their employees, managing change, finding quality employees, reducing high turnover rate of staff, etc. Finance poses a critical problem to businesses; it is the most pressing for new company start-ups and those still growing.

This unit, therefore, examines financing of business venture under the following: profitability and financing a new venture, determining the nature of financial requirement, sources of finance and estimating the amount of funds required.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain profitability as it relates to financing a new venture
- discuss the nature of financial requirements
- discuss sources of business finance
- explain how to estimate the amount of funds required.

# 3.0 MAIN CONTENT

## 3.1 Profitability and Financing a New Venture

Acquisition of a new venture does require us to think carefully about the cash outflow: how we might raise money the new venture. In raising capital, some basic questions or issues that must be addressed prior to actual soliciting the funds. Among these issues are:

1. Forecasting a new company's profit and for a new firm, determining when it will achieve a breakeven point in terms of profits.
2. Understanding the nature of the asset and financing requirements for a new firm.
3. Estimating the amount and basic type of the assets needed and financing required for the new venture.

A key question for anyone starting a new business should be "How profitable is the opportunity?" There are two questions in this regard;

1. How do we project the firm's future profits?
2. At what point or sales volume will the venture breakeven (zero operating profit)?

**Forecasting Profit:** A company's profit is a primary source for financing future growth. The more profitable a company is, all things being equal, the more funds it will have for financing its growth. In the light of this, it becomes imperative to be aware of the factors that drive profits so that we may make the needed profit projections. In this regard, a company's net income or net profits are dependent on five variables.

1. **Amount of Sales:** The assumptions made from about five sales determine the protections about a company's future profit.

2. **Operating Expenses:** This includes expenses such as the cost of acquiring the product or the expenses related to marketing and distributing the product. It is classified into expenses that do not vary as sales increase or decrease (fixed operating expenses) and those that change proportion with sales (variable operating expenses).

3. **Interest Expenses:** This is the amount expressed as a percentage of the principal, paid to the owner plus the principal borrowed.

4. **Taxes:** The firm's taxes are, for the most part, a percentage of taxable income, where the rate increases as the amount of income increases.

**Breakeven Analysis:** If an investor is starting up a company, he would certainly want to know how long it would take the firm to become profitable. So it is with anyone investing in a new business. Of course, they might want to know how many units of the firm's product must be sold before it becomes profitable. Based on the sales forecast, an investor will or may easily draw a conclusion about the time required to reach profitability.

To measure a company's breakeven point, we can use this equation.

$Q_B = \dfrac{F}{P - V}$ where $Q_B$ = Number of units sold to break even
F = The total fixed operating costs
P = The unit selling price
V = The variable cost per unit

From the above equation, we can deduce that the value of breakeven sales = $Q_B$ x P. This is how to forecast profits and to measure the break-even point in terms of profits.

**SELF-ASSESSMENT EXERCISE 1**

Q. Given the following information about XYZ Company:
F = total fixed operating costs = ₦150, 000.00
P = unit selling price = ₦125.00
V = variable cost per unit = ₦62.50

Determine the units that must be sold and the value of sales to achieve a breakeven point in operating profits.

## 3.2 Determining the Nature of Financial Requirements

The specific need of a proposed business venture governs the nature of its initial financial requirements. If the firm is a food store, financial planning must provide for the store building, cash registers, shopping carts, inventory, office equipment and other items required in this type of operation. An analysis of capital requirements for this or any other type of business must consider how to finance the following:

1. The needed investments and expenses incurred to start and grow the company;
2. Any personal expenses if the owner does not have other income for living purposes.

### 3.2.1 Start-up Investment and Financing Requirements

To understand the financing requirements for a new company, visualise a balance sheet where the left-hand side of the balance sheet represents the assets owned by the company, such as cash, accounts receivable and equipment. The right hand side comprises the firm's sources of financing that is those that provided the needed capital for the business and how much.

A firm's assets are generally classified into one of these categories or types: (1) Current assets (2) Fixed assets, and (3) Other assets. A brief description of each of the asset categories is helpful in understanding the assts needed in starting a new business.

1. Current assets compose the assets that have relatively liquid nature; that is, within the firm's operating cycle, these assets can be converted into the following:

**Cash**: This the cash needed because of the uneven flow of funds into the business (revenue) and out of business (expenditure). Even though it is good, there is a limit to how much cash we want to keep in order to enjoy returns.

**Accounts receivable:** This consists of payments due from its customers. If the firm expects to sell on a credit basis, and in many lines of business, provision must be made for financing receivables.

**Inventories:** They constitute a major part of working capital. Seasonality of sales and production affects the size of the minimum inventory for instance, Christmas period.

**Prepaid Expenses:** When starting a company, we may need to prepay some of the expenses for instance, insurance premiums may be due before the business actually opens or utility deposits may be demanded before the electricity at the business can be turned.

In conclusion, current assets represent the company's working capital or quite often circulating capital.

2. Fixed Assets are the more permanent types of assets that are intended for use in the business. They include machinery, equipment, buildings and land. Type of business operation determines the nature and size of fixed asset investment.

3. Other assets include items such as intangible assets- patents, copyrights and goodwill. For a startup company, they could also

include organisational costs – cost incurred in organising and promoting the business.

### 3.2.2 Funds for Personal Living Expenses

In many startup businesses, we cannot limit planning to the business investments described in the previous discussions. Frequently, financial provision must also be made for the owners personal living expenses during the initial period of operation. Inadequate provision for personal expenses will inevitably lead to a diversion of business assets and a departure from the financial plan.

**SELF-ASSESSMENT EXERCISE 2**

Briefly discuss the components of a firm's assets.

## 3.4 Estimating Required Amount

The uncertainties surrounding an entirely new venture make estimation difficult. Even for established businesses, forecasting is never exact. Nevertheless, when seeking initial capital, the entrepreneur must determine how much capital is needed. The amount varies depending on the type or nature of business. High technology companies require higher capital while most service businesses require smaller amount.

## 3.5 Estimating required Asset

Understanding the relationship between projected sales and needed assets is vital for effective forecasting of asset requirement. As sales increases, there will be an increase in a firm's asset needs, which in turn results in a need for more financing. A company's asset needs may be estimated as some percentage of sales increases. Therefore, assets/sales if we believe that sales will be ₦1 million and we know that within our industry, assets tend to run about 50 per cent of sales, we could reasonably expect that the firm's asset requirements will be ₦500, 000 (50 per cent multiplied by ₦1million).

## 3.6 Estimating required Finance

We earlier provided a way to estimate the firm's asset requirement, but someone must provide the money to purchase these assets. Accurate forecasting of a company's financial requirements requires an understanding of certain guidelines or principles of finance. Five of such guidelines may be stated as follows:

1. The more assets needed by a firm, the greater the financial requirements.
2. A company should finance its growth in a way that allows it to maintain a certain amount of liquidity.
   Liquidity is the ability to meet maturing financial obligations as they become due. A conventional measure of liquidity is the currency ratio = Current Assets ÷ current liabilities.
3. There is a limit as to how much debt a firm can use in financing the business. The amount of debt is limited by the amount of equity provided by the owners. It can be 50 per cent each.
4. Some short-term debts become available spontaneously as the firm grows. Those debts are referred to as spontaneous financing.
5. There are two sources of equity capital: external and internal. External sources are initial investments in the firm by the owners while the internal sources are as a result of retention of profit.

**SELF-ASSESSMENT EXERCISE 3**

Differentiate between estimating asset requirement and estimating financial requirement. Is there any relationship between the two? Explain.

## 4.0 CONCLUSION

A prospective investor should estimate the profitability of a potential business, determine the nature of financial requirements, examine the types of financial sources available and estimate the amounts of funds required before embarking on any business venture.

## 5.0 SUMMARY

In this unit, we have examined a considerable amount of information regarding financial planning for the new company, thus it is helpful to review the major ideas we have developed.

A company's operating profitability is determined by the sales achieved and the firms' operating breakeven is when sales or revenue levels and when revenue exactly equal cost.

Again, there are two basic types of capital used for a business: debt financing and equity ownership. Debt can be long-term or short-term while equity comes from initial owners investments or retained profits.

Furthermore, there is a direct relationship between sales growth and asset needs. As sales increases, more assets are required.

Finally, we must blend equity with debt financing. As we increase the amount of debt, there must be a corresponding increase for equity.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. Given the following information about a company: total fixed operating cost = ₦150, 000.00; unit selling price = ₦125.00. The variable cost per unit = ₦62.50. Determine the units that must be sold and the value of sales to achieve a breakeven point in operating profits.

b. Briefly discuss the components of business financing.

2. Briefly discuss the relationship between estimating asset requirement and financial requirement.

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# UNIT 5 CONCEPT OF CAPITALISATION

**CONTENTS**



## 1.0 INTRODUCTION

We often hear companies or different mutual funds being categorised as 'Small Cap' 'Mid Cap' or 'Large cap'. What do these terms really mean? The "Cap" part of these terms is a short form for capitalisation.

Capitalisation is a measure by which we can classify a company's size. Although the criteria for the different classifications are not strictly bound, it is important for investors to understand these terms, which are not only ubiquitous but also useful for gauging a company's size and risk level.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain the concept of capitalistion
- discuss types of capitalisation
- explain the importance of capitalization.

## 3.0 MAIN CONTENT

## 3.1 Meaning of Capitalisation

Capitalisation refers to the market value of a company's outstanding shares. It is calculated by taking the stock price multiplied by the total number of shares outstanding. It is simply a fanciful name for a straightforward concept. For example, if Zenith Bank of Nigeria PLC was traded at ₦20.00 per share, and the bank had three billion shares outstanding, then the market capitalisation of Zenith Bank would be ₦20.00 x 3,000,000,000 = ₦60billion (₦60,000,000,000.00).

Therefore, we can conclude here that capitalisation is a product of two parts, the market price of stock and the number of shares outstanding. In the light of this, when the share price appreciates or depreciates (all other things remaining constant) the capitalisation also increases or decreases with respect to the share price.

**SELF-ASSESSMENT EXERCISE 1**

Explain the concept of capitalisation.

## 3.2 Types of Capitalisation

There are different types of capitalisation. While there is no single framework for defining the different market capitalisation, here are the widely published standards for each capitalisation:

1. **Mega Cap:** Based on information about the New York Stock Exchange, this group includes companies that have a market capitalisation of $200 billion and greater or more. They are largest companies, which sell their stocks to the public such as EXXON (NYSE:XOM). Not many companies will fit into this category; those that do are typically the leaders of their industries. In Nigeria, as of 2008 and 2009, companies like First Bank of Nigeria Plc have the highest capitalisation on the Nigerian Stock Exchange. Thus, based on the Nigerian situation, it can be regarded as a Mega Cap.

2. **Big/Large Cap:** These companies have a market capitalisation of between $10 billion to $200 billion. Many well-known companies fall into this category, including companies like Microsoft, Wal-mart (NYSE:WMT) and General Electric (NYSE:GE), and IBM. Typically, large cap stocks are considered relatively stable and secure. Both mega and large/big cap stocks are often referred to as blue chips.

3. **Mid Cap:** This group comprises companies whose capitalisation ranges from $2billion to $10billion. This group is considered more volatile than large and mega-cap companies. Growth stocks represent a significant portion of the mid caps. Some of the companies might not be industry leaders, but they are well on their way to becoming one.
4. **Small Cap:** These groups of companies are typically new or relatively young companies. Small caps have a market capitalisation between $300million and $2billion. Although their records of accomplishment will not be as lengthy as those of the

mid and mega caps, small caps do present the possibility of greater capital appreciation but at the cost of greater risk.

5. **Micro Cap:** This group comprise mainly of penny stocks. This category denotes market capitalisation between $50million and $300million. The upward potential of these companies is similar to the downside or downward potential; hence, they do not offer the safest investment. Concerning the Micro Caps, a great deal of research should be done before entering into such a position.

6. **Nano Cap:** This comprises companies having market capitalisation of below $50million. These companies are the most risky with a relatively small potential of gain.

**Note:** These ranges are not set in stone; they are prone to fluctuation depending on how the market as a whole is performing.

**SELF-ASSESSMENT EXERCISE 2**

Discuss the various types of capitalisation.

## 3.3 Importance of Capitalisation to Investors

A common misconception is that the larger the stock price, the larger the company. Stock price, however, may misrepresent a company's actual worth. There are actually companies that are extremely capitalised but their stock price is not among the highest.

If we look at two fairly large companies, IBM (NYSE:IBM) and Microsoft (Nasdag: MSFT), we can see that as of March 18, 2009, their stock prices were $19.75 and $16.75 respectively. Although IBMs stock price is higher. If it has about 1.34 billion shares outstanding, while MSFT has 8.89 billion. As a result of this difference, we can see that MSFT's market capitalisation of $148.91 billion is actually larger than IBM's $122.95 billion. If we compared the two companies solely by looking at their stock prices, we would not be comparing their true values. This is because their true values are affected by the number of outstanding shares each company has.

Again, the classification of companies into caps allows investors to gauge the growth versus risk potential. Historically, large caps have experienced slower growth with lower risk. Meanwhile, small caps have experienced higher growth potential, but with higher risk.

**SELF ASSESSMENT EXERCISE 3**

Discuss the importance of capitalisation to investors.

## 4.0 CONCLUSION

Understanding the market capitalisation is not just important if you are investing directly in stocks. It is also useful for mutual fund investors, as many funds will list the average ‘on’ median market capitalisation of its holdings. As the name suggests, this gives the middle ground of the fund’s equity investment, enabling investors know if the fund primarily invests in is large, mid or small cap stocks.

## 5.0 SUMMARY

This unit examined the concept of capitalisation. It also looked at the different types of capitalisation; mega cap, large cap, mid cap, small cap, micro cap and Nano cap. It then finally discussed at the importance of capitalisation.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. Explain the term “capitalisation”.
b. Discuss the importance of capitalisation to investors.

2. Discuss the different types of capitalisation.

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# MODULE 2



# UNIT 1 TYPES OF FINANCIAL MARKETS IN NIGERIA

## CONTENTS



## 1.0 INTRODUCTION

A financial market is an institutional arrangement that facilitates the exchange of financial assets including deposits, loans, corporate stocks and bonds, government bonds, and securities. The market may have a physical location such as the bank branches, or Nigerian Stock Exchange or it may not have a precise physical location such as over-the-counter (OTC) markets for stocks where transactions are carried out by brokers via computer and telecommunication lines.

In this unit, you will be taught the types of financial market, participants in the market as well as their instruments.

## 2.0 OBJECTIVES

By the end of the unit, you should be able to:

- explain the term "financial market"
- discuss the types of financial market
- identify participants in the market
- distinguish between money and capital market
- outline the advantages of the financial market.

## 3.0 MAIN CONTENT

### 3.1 Types of Financial Market

Two types of markets dominate the financial market. These are the money market and capital market. The distinction is based mainly on the maturity structure of the instruments traded in each market. Some instruments are of short-term maturity, usually not exceeding one year, while others are of considerable long period and could be classified as being medium or long time. The categorisation of money and capital markets can be further extended to primary and secondary markets; the primary market is the market for new issue of funds and securities. It provides a focal point for lenders and borrowers to transact businesses in contrast. The secondary market allows the existing holders of financial claims to sell them to other investors.

#### 3.1.1 The Money Market

The money market is that aspect of financial market that deals with the sale and acquisition of short-term financial assets and liabilities. It consists of short-term debt securities that are highly marketable. The term money market arises from the monetary or liquidity nature of instruments traded in the market. The relative liquidity of the instrument arises from the fact that they could be converted into cash through the discount window within a short period without appreciable loss of value. The various instruments in the money market include treasury bills, treasury certificates, bankers' acceptances, commercial papers, short-term credit, promissory note, bills of exchange, short-term bonds etc.

#### 3.1.2 Capital Market

Capital market is a market for long-term funds. It is the market, which finances long-term investments. It is an institutional arrangement that facilitates the transfer of medium and long-term funds from the surplus sector to the deficit sector of the economy. From the perspective of economic development, a well-developed capital market is essential in that it provides opportunity for long-term investment.

The factor that contributed to the development of capital market in Nigeria is the need for long-term finance. Most economic development projects require long-term finance, which commercial banks cannot provide. Hence, there was a need for institutions, which could provide this kind of finance.

## 3.2 Participants in the Financial Market

Participants in the financial market are classified based on the maturity structure of the instruments used in the two types of the financial market-monetary and capital markets. These include:

A. **Monetary Market Participants**

- Federal Government of Nigeria
- Central Bank of Nigeria
- Commercial Banks
- Discount houses
- Other players include non-banking financial institutions and individuals.

B. **Capital Market Participants**

- Nigeria Stock Exchange Commission
- Development Banks
- Insurance Companies
- Pension Funds
- Investment Companies
- Finance houses

**SELF-ASSESSMENT EXERCISE 1**

Distinguish between money market and capital market.

## 3. 3 Financial Market Instruments

### 3.3.1 Money Market Instruments

Financial instruments used in the money market include the following:

**Treasury Bills**

Treasury Bills are the most marketable and most riskless of all money instruments. Treasury Bills represent the simplest form of borrowing by the Federal Government. Public investors buy the bills at a discount for the stated maturity. At the maturity of the bills, the holder receives from the government a payment equal to the face value of the bill. The difference between the purchase price and ultimate maturity value constitutes the investor's earnings. Its maturity is usually 91 days. Treasury Bills were first issued in Nigeria in 1960.

**Treasury Certificates**

These are securities of larger maturity. Treasury certificates are similar to Treasury Bills except that they have longer-term of maturity, mostly over 180 days. Like the Treasury B ills, Treasury Certificates are of fixed deposits but could be discounted. They are not as popular as the Treasury Bills. They were first introduced in Nigeria in 1968.

**CBN Certificates**

This is a novel product introduced by CBN to create alternative short-term attractive investment avenue for the investing public. They attract banks' deposits. Like other instruments of the CBN, CBN Certificates are considered gilt-edged.

**Bank Deposits**

They are deposits from individuals, firms and governments accepted by depository institutions such as commercial banks, savings and loans institutions. These funds are used for making loans or purchasing other debt instruments such as Treasury bills after meeting the regulatory requirement such as the reserve ratio. Some deposits attract interest rates. The rates vary from bank to bank and from product to product. The bank deposits are insured by NDIC.

**Bill Discounting**

This is an instrument used for getting immediate value or future value of an instrument issued by a reputable buyer or debtors. This implies that the discount values are received immediately while no mind or face value is repaid at a fixed determinable date. It provides handy liquidity.

**Repurchasing Agreement (REPOS)**

This is usually an overnight borrowing. Repurchasing takes place when a dealer sells government securities to an investor on an overnight basis, with an agreement to buy back those securities the next day at a slightly higher price. The security serves as collateral for taking the loan. The increase in the price is called an overnight interest.

**Commercial Papers/Bankers' Acceptance**

Down the history lane, well-known companies prefer to issue their short-term unsecured debt notes rather than borrowing from the bank. The notes issued are referred to as commercial papers. This represents an unconditional promise to pay to or to the order of the lender a certain sum at a future determinable date. Issuing a commercial paper may not carry a bank's guarantee. When a bank guarantees or accepts the commercial paper to make it more marketable, it translates into a Banker's Acceptance. A Banker's Acceptance is more valuable than a commercial paper since a bank guarantees that a Bankers' Acceptance will be honoured.

### 3.3.2 Capital Market Instruments

The main instruments of the capital market are stocks and shares, debentures, loans, bonds, mortgages etc. Funds in this market are of long-term nature. They include loans raised by a company, government or parastatals for which interest is paid at a fixed rate.

Some of the capital market instruments are:

**Corporate Bonds:** These are debenture stocks representing a company's written acknowledgement of indebtedness. They are often of a long term of more than one-year maturity. This instrument is governed by a legal contract called indenture. An indenture specifies protective provisions that the company provides for investors.

**Mortgages:** A mortgage is a debt instrument used to finance the purchase of a home or other form of real estate with the underlying real estate serving as collateral for the loan. Mortgage instrument could be fixed rate or adjustable rate. A fixed rate mortgage specifies an interest rate during the term of the loan, whereas the rate on an adjustable-rate mortgage can change (usually every one or three years). Mortgage financing received a boost in Nigeria with the establishment of the National Housing Fund (NHF) in 1992.

**Government Development Bonds:** This is a device by the government to raise money from the public to finance its programmes. This can be at the Federal, State or Local Government levels. They are usually long-dated and possess the following:

- It is an interest income instrument
- It is redeemable
- As a government debt instrument, it is considered gill-edged. In other words, the chance of recovering the principal is very sure. To a large extent, it is risk free.

**Development Loans:** These are loans, which are of long-term given for the purpose of development. Development Banks in the country have been restructured to meet these goals.

**SELF-ASSESSMENT EXERCISE 2**

Outline the instrument used in the money market.

## 3.4 Advantages of the Financial Market

1. It mobilises funds from a surplus sector to a deficit of the economy.
2. It mobilises the savings of the economy for development.
3. The market allows the public to participate in the running of the private sector of the economy.
4. The market gives the government the opportunity to borrow long-term capital required for development.
5. The availability of mobilised funds and redirected to the deficit unit ensures greater production of goods and services and hence, greater wealth.
6 Transactions in the markets allay the fear of liquidity for investors.
7. The wide scope of opportunities in the money and capital market facilitates the issuance of instruments or securities of varying maturities.
8. It allows investors the opportunity to invest in a wide range of enterprises thus allowing them to spread their risks.

## 4.0 CONCLUSION

The main function of the financial market is the pooling of savings from investors scattered throughout the country and making funds available to worthy borrowers. The financial market is made up of money and capital markets. This unit explained the difference between money and capital markets. It discussed their functions and highlighted various instruments available in the financial market.

## 5.0 SUMMARY

In this unit, you were introduced to the Nigerian financial market. We discussed the types of markets in the financial sector and their various instruments. We also highlighted the advantages of the financial market.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Identify and explain the advantages of the financial market to an economy.
2a. Outline the instrument used in the money market.
b. Distinguish between the money market and the capital market.

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# UNIT 2 FINANCIAL INSTITUTIONS

**CONTENTS**



## 1.0 INTRODUCTION

In this unit, you shall be introduced to the various financial institutions in Nigeria, which include the Central Bank, Commercial Banks, Pension Funds, Development Banks, Cooperative Banks and Merchant Banks. You will also be introduced to the role of financial institutions and their benefits to the economy.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- discuss financial institutions
- identifying the banking and non-banking financial institutions
- state the economic benefit of financial institutions
- state the roles of financial institutions.

## 3.0 MAIN CONTENT

## 3.1 Banking Financial Institutions

The banking financial institutions play a major role in the financing business in an economy. This is a formal financial institution, which comprises of Central Bank of Nigeria, Commercial Banks, and Development Banks.

**Central Bank of Nigeria (CBN):** The CBN constitutes the pivot of the country's money and capital market. It is the principal regulatory body. It executes monetary policies on behalf of the Federal Government of

Nigeria. As the apex of the financial system, the CBN belongs to both the money and the capital market as the key operator without which the markets can scarcely exist. The CBN has a responsibility of establishing specialised institutions in Nigeria such as the Development Institutions. It has also played a major role in the establishment of the Securities and Exchange Commission. The CBN acts as the issue and underwriter of all Federal Government stocks.

**Commercial Banks:** They provide important financial services to industry and commerce**.** It is, however, a normal banking principle (that prudence requires) that they lend on short term that require a rapid repayment. The primary function of the banking system is the extension of credit to worthy borrowers. Generally, Commercial banks have a short term for most of the funds they hold. They are consequently constrained in their lending and investment policies. It is of course true that taken on aggregate, particularly in the growth situation, commercial streak of excess of deposits over short term loans, advances and withdrawals. They rely on funds, which they receive on time or fixed deposits for making medium term loans while the liquidity and safety reserves are traditionally placed on money market instruments such as Treasury Bills and commercial paper.

In making credit available, commercial banks in particular render a great social service, through their actions production is increased, capital investment are expanded, and a higher standard of living is realised.

**Development Banks:** These are institutions established for providing long-term finance for development. The genus usually referred to as development finance institutions occupies a wide band in terms of their constitutional arrangement and their specific areas of interest. One common feature of these institutions however, is that they are usually promoted by government and sometimes by international organisation.
Development Banks provide medium and long-term finance for the development of the economy. The need for this kind of finance has become necessary because commercial banks provide only short-term finance and this is not adequate for development. Development institutions bridged the gap by providing medium and long-term finance. Development institutions serve as catalyst to development through the provision of various forms of venture capital and technical advice on the setting up of an Industrial, Agricultural or other forms of business enterprise. Examples of development institutions are the Nigerian Industrial Development Bank (NIDB), Nigerian Bank for Commerce and Industry (NBCI) Nigerian Agriculture and Co-operative Bank (NACB).

**Co-operative Banks:** Co-operative Banks is an institution established for the purpose of providing greater access to saving and borrowing facilities for co-operative societies and their members at relatively cheaper rates than those provided by Commercial Banks, since they deal with small scattered severs and borrowers who ordinarily will not qualify for financial assistance of Commercial Banks. Finally, Co-operative Banks improves the well-being of their members.

**Merchant Banks:** This is also called investment bank. It is a wholesaler banker whose deposits are usually in large amounts. With such large deposits, its loans are equally large. Merchant Banks advise companies wishing to raise new capital and help to advertise the shares to the public and to the underwriter, unsold shares. They provide short and long-term finance to companies.

The Merchant Banks gives advice on mergers, acquisitions and capital structure of companies as well as arrange for companies wishing to hire equipment. In present day Nigeria, the universal bank performs the function of merchant banks.

**SELF-ASSESSMENT EXERCISE 1**

Identify various banking institutions in Nigeria.

## 3.2 Non-Banking Financial Institutions

The non-banking financial institutions consist of insurance companies, pension fund, mortgage houses, stock broking firms, daily collectors, and bureau de change. They are also important in the financial system of the Nigerian economy.

**Insurance Companies:** These are institutions established to spread the risks and losses of business. They cover all kinds of risks, ranging from life to property. They assume responsibility for all kinds of risk, which a single individual cannot afford. By the nature of their activity, insurance companies are in a position to accumulate funds, which could be conveniently applied in the financial markets. They pool financial resources from individuals and institutions throughout the country and make them available for whosoever suffers loss.

**Pension Funds:** They collect contributions from employees and/or employers to make periodic payment upon employer retirement. Large sum of money become regularly available to pension funds. Members make regular payments over a long period in order to obtain benefit either in lump sum or as an annuity upon the arrival of a specified date.

The management of the fund invest these payments as they are received so that they ultimate benefit shall be maximised.

**The Stock Exchange:** The stock exchange is an organisation, which provides a market for companies' shares and debentures and other securities. A stock exchange is a place where securities (bonds, stocks and shares) of varying types are traded openly and where one can purchase or sell any of such securities easily.

The stock exchange thus, provides the essential facilities for companies and government to raise money for business expansion and development projects for the ultimate economic benefit of the society.

The stock exchange is an institution, which sees to the efficient allocation of available capital funds to the diverse uses in the economy. Through its extremely sensitive primary mechanism, the stock exchange ensures that much of the total available capital resource is allocated to each firm within each industry as that firm and that industry deserves to have based on their relative contribution to the total societal wealth.

To the individual investor, the stock exchange is also a place to make a lose money quickly. It presents an ideal setting for the smart and daring speculator to make a fortune but also a remarkably easy means for the unwary to lose a fortune through false judgment.

Specialised institutions involved in the stock exchange include the Central Bank, Development Finance Institutions, issuing houses, stock broking firms, share registers, Commercial Banks, Insurance Companies and Pension Funds.

## 3.3 Banking Financial Institutions and Their Functions

Banking financial institutions play a major function in financing business of an economy. These comprise of Commercial Banks, Central Bank, Nigerian Agricultural Co-operation and Rural Development Banks, etc. Their functions include the following:

1. **Intermediating Function:** They receive funds from surplus spender to deficit spender.

2. **Saving Function:** They help conduct public saving such as bonds, stock, and ensure savings flow from the financial market to goods and services for increased the standard of living.

3. **Internal Function:** They provide us with excellent store of wealth that generate income; do not wear out in time and having low risk. These wealth are usually profitable and non-perishable.

4. **Liquidity Function:** Money being the ultimate liquidity earns little or no interest when not invested. Investing cash (money) in the instrument of wealth brings interest, which can be converted, immediately into cash.

5. **Credit Function:** They provide us with credit to finance our consumption and investment especially in form of loans.

6. **Payment Function:** They serve as mechanism for making payment for goods and services with other facilities such as credit cards, electronic fund transfer.

7. **Risk Function:** These institutions also offer protection against life, health, property and income risk through the sales of insurance premium to businesses, consumers and government.

8. **Policy Function:** They serve as the channel through which the government carries out its policies to establish the economy and avoid inflation. Government does this by manipulating interest rates and prices.

**SELF-ASSESSMENT EXERCISE 2**

Identify the roles of the formal banking financial institution in an economy.

## 3.4 Roles of the Non-Banking Financial Institutions

The non-banking financial institutions consist of insurance companies, pension fund, mortgage houses and co-operative bodies. They are important in the financial system of an economy because they perform the following functions:

1. They make use of household surplus fund, provide credit, loan and mortgage loan for consumers.
2. They help reduce hoarding. They encourage saving and loan through co-operatives. The insurance companies also reduce hoarding.
3. They promote saving and interest service among ordinary people.
4. They finance business by offering loan, mortgage, bond purchases, shares and thereby facilitating investment.
5. They distribute loans among different types of borrowers.

**SELF-ASSESSMENT EXERCISE 3**

Outline the activities of the non-bank financial institutions.

## 4.0 CONCLUSION

This unit has highlighted the financial institutions in Nigeria. Banking and non-banking financial institutions and their functions were also discussed.

## 5.0 SUMMARY

This unit has discussed the financial institutions in Nigeria. It also explained the various activities of the banking and non-banking financial institutions. The benefit of these institutions to the economy were also highlighted

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Identify the functions of banking financial institutions to the Nigerian economy.

2a. Outline and discuss the activities of the non-bank financial institutions.

b. Identify four banking financial institutions in Nigeria.

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# UNIT 3 CONDITIONS AND LENDING POLICIES OF VARIOUS FINANCIAL INSTITUTIONS

**CONTENTS**



## 1.0 INTRODUCTION

Financial institutions are always willing to lend to the economy but there are policies in place for such lending to materialise.

This unit, therefore, examines bank lending policies and conditions of international financial institutions.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain principles of bank lending policies
- discuss lending conditions of international financial institutions.

## 3.0 MAIN CONTENT

### 3.1 Principles of Bank Lending Policies

The main aim of a Commercial Bank is to seek profit like any other profit-oriented institution. Its capacity to earn profit depends on its investment policy. Its investment policy in turn, depends on the manner in which it manages its investment portfolio. Thus, Commercial Bank investment policy emerges from a straightforward application of the theory of portfolio management to the particular circumstance of commercial banks. Portfolio management refers to the product management of a banks assets and liabilities in order to seek some optimum combination of income or profit, liquidity and safety.

In line with the aforementioned, banks follows the following lending principles:

**Liquidity**

A bank chooses such securities in its investment portfolio which posses sufficient liquidity. It is essential because if the bank needs cash to meet the urgent requirement of its customers, it should be in a position to sell some of the securities at a very short notice with disturbing their market prices much.

**Safety**

Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without difficulty. Safety depends on the technical feasibility and economic viability of the project for which the loan is advanced.

**Diversity**

This principle ensures that a bank should not invest its surplus funds in a particular type of security but in different types of securities. Diversification aims at minimising risk of the investment portfolio of the bank.

**Stability**

The bank cannot afford any loss on the value of its securities. It should therefore invest its funds in the shares of reputed companies where the possibility of decline in prices is remote.

**Profitability**

This policy states that bank must earn sufficient profits and therefore, should invest in securities, which assure a fair, and stable returns on the funds invested.

**SELF-ASSESSMENT EXERCISE 1**

Discuss the principles of bank lending policies.

## 3.2 Lending Condition of International Financial Institutions

The idea of international liquidity is vital for interaction between countries hence the need for international financial institutions such as the International Monetary Fund (IMF). Among its objectives are the promotions of international monetary co-operation, promotion of exchange rate stability, exchange purposes, expansion of balance growth of international trade, establishment of multilateral system of payment, etc.

When Nigeria approached IMF for loan, the following conditions were given:

1. Reduction of public expenditure
2. Removal of subsidies on petroleum products and fertilizers
3. Devaluation of the Naira
4. Trade liberalisation
5. Privatisation of public enterprises
6. Export promotion
7. Rationalisation of credit guidelines
8. Reduction of grants, subventions and loans to parastatals
9. Review of industrial incentives and policy
10. Classification of projects into core and non-core projects
11. Rationalisation of tariff structure
12. Control of external borrowing
13. Reorganisation or abrogation of commodity board and river basin development authorities.

**SELF-ASSESSMENT EXERCISE 2**

Discuss the condition given to Nigeria by IMF when it approached the IMF for loan.

## 4.0 CONCLUSION

This unit has shed light on the credit policies of the Nigerian banking system. It also highlighted the IMF lending conditions.

## 5.0 SUMMARY

This unit has explained the lending policies of banks. The unit also looked at the lending conditions of the international finance.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the principles of bank lending policies.
2. List the conditions given to Nigeria by the IMF when Nigeria approached the IMF for loan.

## 7.0 REFERENCES/FURTHER READING

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# UNIT 4 TIME VALUE OF MONEY

**CONTENTS**



## 1.0 INTRODUCTION

One of the fundamental concepts in finance is that money has a 'time value'. This is to say that money in hand today is worth more than money expected to be received in the future.

The purpose of this unit is to introduce you to the concept, terminology and mathematics of the time value of money. Understanding this unit is crucial to understanding all sorts of solutions to financial problems in personal finance, investment, banking, insurance, etc.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain the term 'time value of money'
- identify the worth of a present value to the future value of money
- calculate the present and future values of money.

## 3.0 MAIN CONTENT

### 3.1 Definition and Meaning of Time Value of Money

The time value of money clearly shows that a naira paid out or earned today, is not equal to a naira paid out or earn one year from now. The reason is simple; a naira that you received today can be invested such that you will have more than a naira at some future time.

Money now is worth than money in the future, even after adjusting for inflation. This is because a naira now can earn interest or other appreciation until the time the naira in the future would be received.

The idea that money available now is worth than the same amount in the future is due to its potential earning capacity. This core principle of finance holds that available money can earn interest; any amount of money is worth more the sooner it is received.

**SELF-ASSESSMENT EXERCISE 1**

Explain the concept of Time Value of Money.

## 3.2 Reasons why a Present Value is Worth More Than a Future Value

Various reasons could be suggested as to why a present ₦1 is worth more than a future ₦1.

a. The businesses world is full of risk and uncertainty and although there might be the promise of money to come in the future, it can never be certain that the money will be received until it has actually been paid.
b. An individual attaches more weight to current pleasures than to future ones, and would rather have ₦1 in a years time. A justification of this is based on individuals who have the choice of consuming or investing their wealth. However, it has been argued that the return from investment must be sufficient to persuade individuals to prefer to invest now.
c. Money is invested now to make profits (more money or wealth) in the future.

## 3.3 Determining the Present/Future Values of Money

If you are given ₦100 and you deposited it in the bank at 10 per cent interest per annum for 2 years, then your:

present value = ₦100
future value = ₦121

We shall find out how to get both present and future value on monthly and annual basis.

To determine our values we will use the formula:

$FV = PV (1 + i)^n$
FV = Future value
PV = Present value
i = the interest rate per period
n = the number of compounding periods

**a. Determine future value compounded annually**

What is the future value of ₦500 in 7 years if the interest rate if 5%?

i = 0.05
n = 7
PV = 500
To get the future value
$FV = PV (1 + i)^7$
FV = ₦500 $(1+0.05)^7$
FV = ₦500 (1.407100)
FV = ₦703.55

**b. To determine the future value compounded monthly**

What is the future value of ₦500 in 5 years if the interest rate is 5% (i=0.05 divided by 12, because there are 12 months per year)

n = 84 (i.e. 7 x 12 (months in a year)
FV = ₦500 $(1+ 0.0041666)^{84}$
₦500 $(1.0041666)^{84}$
₦500 (1.418028)
₦709.014

**c. Determine present value compounded annually**

You can go backwards too. If I will give you ₦1, 000 in 5 years, how much money should you give me now to make it fair to me? You think a good interest rate would be 6%.

I=0.06
$FV = PV (1 + i)^n$
₦1000 = PV $(1 + 0.06)^5$
₦1000 = PV (1.338)
₦ = PV
1.338
PV= N747.38

So, if you give me ₦747.38 today, in five years time, I will give you ₦1000 assuming there is a six per cent interest rate on your money.

d. Determine present value compounded monthly here is how to determine the present value using the above question again, but this time with monthly compounding instead of annual compounding. We should note that with monthly compounding, we divide the interest rate by 12. This is because there are 12 months in a year.

$FV = PV (1 + i)^n$
₦1000 = PV $(1 + 0.06)^{60}$
₦1000 = PV (1+ 0.005)
₦1000 = PV (1.348) ₦
= PV
1.348

PV= ₦741.83
i=0.06/12 = 0.05
n=5 x 12 =60

**SELF-ASSESSMENT EXERCISE 2**

Determine the future value of ₦150 in 6 years if the interest rate is 8% using the annual compounding.

## 4.0 CONCLUSION

This unit has highlighted the importance of time value of money. It has also demonstrated the procedure for estimating the time value of money with examples.

## 5.0 SUMMARY

The unit has explained to us the meaning of 'time value of money'. This concept of time value of money was discussed along with illustrations of both present and future values of money. The reasons why the present values are more important than future value were discussed. The unit also shed light on the importance of the time value of money to financial decision in the organisation.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the concept of time value of money.
2. Determine the future value of ₦150 in 6 years if the interest rate is 8% using the annual compounding method.

## 7.0 REFERENCES/FURTHER READING

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# UNIT 5 CAPITAL BUDGETING ANALYSIS OF FINANCIAL STATEMENT

CONTENTS



## 1.0 INTRODUCTION

In modern times, the efficient allocation of capital resources is a most crucial function of financial management. This function involves organisation's decision to invest its resources in long-term assets. This is important to the firm because, in general, all the organisational profits are derived from the use of its capital investment in assets, which represent a large commitment of financial resources, and these funds usually remain invested over a long period. The future development of a firm hinges on the capital previously accepted, undertakings which turn out to be less attractive to the organisation than was originally thought, and divesting the resources to the contemplation of new ideas and planning.

In this unit therefore, we will consider the process, benefits and the key issues involved in capital budgeting.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain the term capital budgeting
- discuss the process involved in capital budgeting
- identify the benefits of capital budgeting.

## 3.0 MAIN CONTENT

### 3.1 Capital Budgeting Process

Capital budgeting (also known as investment appraisal) is the planning process used to determine whether a firm's long-term investments such as new machinery, replacement machinery, new plant; and new product and research development projects are worth pursuing. It is prepared for major capital or investment expenditure.

The process involved in capital budgeting include:

1. Identify required capital projects and alternatives
2. Analyse and evaluate all proposals and alternatives, emphasis should be given to validly of underlying data
3. Decide on and select best alternatives
4. Develop the capital expenditure budget
5. Strategic and tactical plans
6. Establish control of capital expenditures during the budget year by using periodic performance report by responsibility centre.

**SELF-ASSESSMENT EXERCISE 1**

Explain the term "capital budgeting."

### 3.2 Capital Expenditure and Key Issues in Capital Expenditure Budgeting

Capital expenditure refers to the use of funds to obtain operational assets that will help earn future revenues as well as reduces future cost. It includes fixed assets such as property, plant, equipment and major renovation. Investments require the outlay of resources now to earn benefits in future and this involve the planning and controlling phases.

An issue in planning capital expenditure is the problem of ensuring that a company has the capacity to produce, required or be able to deliver the goods and services that will be needed to meet its sales and services plans. Major issues in controlling the actual expenditure are consistent with the plans and that fund is available when the expenditure is needed.

#### 3.2.1. Key issues in capital expenditure budget

Project orientation
Time dimension
Classification

Major capital addition for example, acquisition of land and new building
Minor capital expenditure for example, recurring replacement

One of the important elements from capital expenditure budget perspective involves cash outflow and cash inflows.

Cash outflow include the cost of project in terms of cash outlay at various times during the life span of a project.
Cash inflow involves the expected cash revenues, net of cash operating expenses by period been carefully planned.

**SELF-ASSESSMENT EXERCISE 2**

Highlight the key issues involved in capital expenditure budget.

## 3.3 Benefits of Capital Expenditure Budget

1. It enables management to plan resources to be invested in capital additions to satisfying customers' demand and ensure growth.
2. Its planning process helps avoid:

   idle operating capacity
   excess capacity
   investment that earn less than an adequate
   returns on funds invested.

3. The rationing of capital among alternative projects
4. Focuses the attention of management on cash flows, a critical and often neglected problems
5. Increase co-ordination among responsibility centres.

## 4.0 CONCLUSION

The above discussion showed that capital budgeting is very crucial in a firm thus managers should take it seriously. The unit highlighted the process of capital budgeting, the key issues to capital budgeting and the benefits derivable from capital expenditure budgeting.

## 5.0 SUMMARY

This unit has highlighted the meaning of capital budgeting. The process of capital budgeting was considered alongside the benefits of capital budgeting expenditure. It was shown that capital expenditure is vital to an organisation.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Outline the importance of capital expenditure budgeting in an organization.
2. Mention the process involved in capital budgeting

## 7.0 REFERENCES/FURTHER READING

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# MODULE 3



## UNIT 1 FINANCING SMALL-SCALE BUSINESSES IN NIGERIA

CONTENTS



## 1.0 INTRODUCTION

Finance is one of the major areas of any enterprise usually given much attention. This is because Money is an essential part of an organisation. It even becomes an important consideration when the case of small-scale enterprises is considered. This is because they need little cash (compare to the large-scale), to finance their activities, the sources are limited with bottlenecks or constraints.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- discuss various sources of finance
- identify the difference between short-term and long-term capitals.

## 3.0 MAIN CONTENT

### 3.1 Sources of Short-Term Finance

Most small businesses will, at some stage seek funding or investment – for growth, starting up, or to see them through a transitional period (or a downturn). Enterprises need short-term finance to start-up a business or to cover day-to-day running costs. This short-term finance, which is repaid over a short period, provides the firm with working capital, which is paid back over a number of years. We shall discuss the sources of funds available to small-scale enterprise under these two types of capital.

1. Short-Term Capital
2. Medium-Term Capital

**Short-Term**

Short-term finance is usually taken to be for a period of one year.. These sources of finance include the following:

i. **Loans from friends and relatives:** A large number of start-up enterprises are self-financed either through, loans from friends or through existing sources of personal borrowings. Sometimes it can be difficult to raise funds from other sources especially, if third party does not easily understand your business plan. In a typical society like Nigeria, family and friends that are well placed and who share the vision of the entrepreneur, can tender considerable financial assistance to finance the business. It could either be a loan, which will be repaid with or without interest, or as a gift that will not required payment.

ii. **Borrowing from Banks:** Banks lending is a common source of financing business on a short-term basis. Overdraft and loans are forms of bank lending to small-scale enterprise. Overdraft is simple, flexible and cheap form of borrowing. The overdraft is an obligation or privilege granted to a familiar and regular customer of a bank to withdraw money above the deposit in his current account with the bank. Such withdrawn amount usually attracts an interest rate, which is calculated on daily basis.
Loans from banks are mostly obtained on a short-term basis usually one year. This is because of the need to promptly satisfy the cash needs of their depositor. Loans are payable within a year and interest is paid for the full period of the loan.

iii. **Trade Credit Facility:** When a business is experiencing temporary difficulty in connection with cash resources, it can improve its situation by the employing credit facilities. With good human relations, a supplier on credit could give an entrepreneur a supply of good/services. In this case, goods are to be paid for at the end of the month following the month in which goods are received.

Many companies and small businesses depend on trade credit facility at the early stage of growth when capital from normal sources is virtually unobtainable.

iv. **Personal Savings:** Most prospective entrepreneurs often solely back on personal savings when starting a business. It is important for the entrepreneur to commit a substantial portion of the needed finance to convince lenders and investors that the business idea is worth the trial.

v. **Retained Earnings:** This is the part of the ploughed back into the business for future use. Profit re-invested as retained earnings is profit that could have been paid to owners. The amount of earnings retained has a direct impact on the profit that could have been distributed. The major reason why enterprises uses retain earnings is that, it is a cheaper source of financing developments in a business since they will not have to look out for funds to developed projects. The management of an enterprise believes that retained earnings are funds, which do not cost anything (though this is not true). An enterprise must however control its self-financing through retained earnings to allow for payment of profit to the shareholders for their investment.

vi. **Factoring:** This involves raising funds on the security of the debt due to an enterprise so that the cash is received earlier than when the organisation could have expected the debtor to pay. A financial institution offers to buy the debtor’s account at a discounted rate for instance; a bank may approach Wazobia PLC to buy its debt at a discounted rate of 10 per cent. This is to say, if Wazobia debtor’s account is ₦100 million, the bank will buy the account for ₦90million. It will now be the responsibility of the bank to pursue the debtors to pay up their debt. This is a source of finance since the factor (the bank) will make an immediate payment of 90 per cent of the first value of the debt on buying the account. Generally, the circle of factoring is that, client sells good to debtors, client sells debt to factor, the factor now makes immediate payment to the company at the agreed discounted rate of the first value of debt, and finally, the debtor makes payment to the factor.

vii. **Loans from Government Agencies:** Small-scale enterprises have been recognised as a catalyst towards economic development. Because of this, various government (both state and federal) have come up with policies and schemes to aid in the financing of such enterprises. Soft loans are usually given to small-scale entrepreneurs without interest. These loans are usually repayable within a short period so that loan can be given to others other entrepreneurs. Examples of such government agencies include National Directorate of Employment (NDE), Small and Medium Enterprise Development Agency of Nigeria (SMEDAN).

**SELF-ASSESSMENT EXERCISE 1**

Outline the short-term sources of capital available to an entrepreneur.

## 3.2 Medium Term Finance

Medium term finance is usually taken to be for a period of more than one year. For a small-scale enterprise, it is usually between the periods of one and three years. These sources of finance include the following:

i. **Equipment Leasing:** Leasing is an agreement between two parties, the ‘lessor’ and the ‘lessee’. The lessor owns a capital asset, but allows the lessee to use it. The lessee makes payment under the terms of the lease to the lessor, for a specified period.
Leasing is, therefore, a form of rental. Leased assets usually include plant and machinery, car and commercial vehicles, but may also include computers and office equipments.
Under the lease agreement, the lessor has a complete legal title of the asset. However, the lessee, who has possession of the asset, has a complete use of the asset.
Under a finance lease, a finance company will agree to act as lessor in a finance leasing agreement, purchase the required equipment from the dealer, lease it to the entrepreneur who will take possession of the equipment and make regular payment to the finance company under the terms agreed in the lease.

ii. **Hire Purchase:** This is a form of indirect financing. It is an arrangement under which the hirer, in return for the use of the asset makes periodic/installment payments to the owner of the asset. The ownership of the asset does not pass on to the hirer immediately until the payment of the final credit installment. The hire purchase agreement usually involves a finance company and the hirer.

A company uses hire purchase as a source of finance because it is a useful and simple method of obtaining finance since the enterprise can get the equipment needed without outright payment of the equipment price.
However, a finance company will always insist that the hirer pay a deposit towards the purchase price.

**iii.** **Venture Capital:** This has become a vital aspect of the sources of finance. This is the contribution put in the early stage of a business which may all be lost if the enterprise fails but also have a significant chance of providing above average returns,
An entrepreneur starting up a business will invest venture capital of his own, but he will probably need extra funding from another source. Venture capital is more specifically associated with putting money in return for an equity stake, into a new business or a major expansion scheme.

A venture capital organisation recognises the high risk of loss involved in an investment if the enterprise fails; as a result of such gamble, the organisation will require a high-expected rate of return on investments to compensate for the high risk.

When an enterprise seeks for financial assistance from a venture capital institution, it must recognise that:

a. The institution will want an equity stake in the company.
b. It will need to be convinced that the company will succeed.
c. It may want to have a representative appointed to the company's board of directors, to look after its interests.

iv. **Franchising:** This is a method of expanding business on smaller capital than would otherwise be needed. It is an alternative to raising extra capital for growth. Under a franchising agreement, a franchisee pays a franchisor for the right to operate a local business under the franchisor trade name. the franchisor must bear certain costs (possibly for architect's work establishing cost, legal cost, marketing costs and the cost of other support services) and will charge the franchisee an initial franchise fee to cover set-up costs, relying on the subsequent regular payment by the franchisee for an operating profit. These regular payments will usually be a percentage of the franchisee's turnover.

The franchisor will probably pay a large part of the initial investment but the franchisee will also be required to contribute his share of the investment. The franchisor may also help the franchisee to obtain loan capital to pay for his share of the investment cost.

The advantage of a franchise to a franchisee is that he obtains ownership of a business for an agreed number of years (including stock and premises) together with the support of a large organisation's marketing effort and experience. The franchisee is able to avoid some of the mistakes of many small businesses, because the franchisor has already learned from its own past mistakes and develop a scheme that works.

**SELF-ASSESSMENT EXERCISE 2**

Distinguish between equipment leasing and hire purchase.

## 4.0 CONCLUSION

The discussion above showed that finance is an important ingredient to the survival of an enterprise. An entrepreneur has various sources of finance open to him from which he can obtain funds for his business. It is important that to note that a business idea without a means of financing will die in no time. These various sources of financial assistance help an entrepreneur and owner of small-scale business in Nigeria to bring business ideas to reality.

## 5.0 SUMMARY

In this unit, we have discussed how enterprises can raise funds by way of short-term and medium term borrowing. This unit identified and explained various sources of finance including factoring and leasing.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. Distinguish between equipment leasing and hire purchase.
b. Explain the advantages of franchise to a franchisee.
2. Outline the short-term sources of capital available to an entrepreneur.

## 7.0 REFERENCES/FURTHER READING

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# UNIT 2 PREPARATION OF FEASIBILITY STUDY

## CONTENTS



## 1.0 INTRODUCTION

Feasibility study is becoming increasingly important to entrepreneurs venturing into projects. When a prospective entrepreneur finds himself in a crucial decision as to whether or not to go into a particular business, he is carrying out what could be described as a feasibility study. A feasibility study is simply a possibility study conducted to determine if an envisaged project is possible and to ascertain its sustainability.

A feasibility study entails the total investigation plan for new business or of a proposed project to reveal and authenticate the viability, profitability as well as determine its economic desirability or values, technical, organisation and manpower profitability.

In this unit, therefore, we shall discuss the preparation of a feasibility study and see how useful it is to an entrepreneur.

The end product of feasibility study is a feasibility report that guides in taking investment decisions and could also be used in securing finance for the business.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain the term “feasibility study”
- discuss the process of preparing a feasibility study
- state the uses of a feasibility study
- identify the advantages of feasibility study
- identify the features of a good feasibility report.

## 3.0 MAIN CONTENT

### 3.1 Preparation of Feasibility Study

The process of undertaking a feasibility study will involve business and management consultants, professionals in the field and prospective beneficiaries or targeted customers of the proposed business. The prospective entrepreneur might also be involved. The problem or need that the business is expected to meet and solved should be properly captured, disserted and understood by all the parties involved in the study.

The major steps involved in preparing a feasibility study are:

i. **Social and Legal Analysis:** It is always very important to identify cultural factors that may likely affect the proposed business operations, and the legal analysis which deals with how local or national laws affect operations and consumption of products or services.

ii. **Analysis of the Economic Environment:** This entails checking the economic circumstances as it affects the local, national and international economic performance. Other economic variables to be examined include consumption patter, labour cost, price level, market potentials, and income and general industrial environment.

iii. **Market Analysis:** There is a strong need to evaluate the past and present demand and supply function to determine the future performance of the proposed product or services. The past, present and future growth, identification of target customer, and the influence of competitions should be analysed.

iv. **Financial/Profitability Analysis:** These include the analysis of the following key points:

a. The sourcing of the capital
b. Use of capital and cash flow
c. Initial capital requirement
d. Return on investment
e. Projected profit/loss
f. Break-even analysis

**v. Technical Analysis:** This includes the analysis of the following:

a. Type of equipment required
b. The stages the materials will pass through before the final product is produced
c. Equipment maintenance culture
d. Type and volume of raw materials
e. Numbers, qualification and experience of manpower requirement

**vi. Formulation of Goal and Strategy:** Mission, goal and objectives of the new business must be clearly stated. Strategy (both long and short) on how to go about achieving the desired results should be formulated to outwit the competitors and to be able to stay in the market.

**vii. Revaluation:** This involves going over and reassessment of the whole project plans. This is done in order to arrive at final decision whether to go ahead or not with the new project.

## 3.2 Features of a Feasibility Report

When a feasibility study has been carried out, a feasibility report will be drawn. A good feasibility report must be able to highlight the following:

**1. Background Information:** This should give the reader of the report such information as:

- Name of the organisation undertaking the business
- The location or contact address of the organisation
- The nature of the organisation such as legal status, objects of the organisation and previous experience of the organisation in related projects.
- The organisation’s profile highlighting core competence as relevant to the project.

**2. General Market Information Relating to:**

i. The problem or need that will be met using objectivity verifiable indications
ii. The target market and basis of segmentation
iii. Demand analysis
iv. Competitive position
v. Marketing position

3. **Production/Technical Consideration:** This should highlight the following:

i. Product(s) to be produced
ii. Manufacturing processes highlighting
iii. Plant size and production schedule
iv. Machinery and equipment layout
v. Plant location
vi. Building and facilities
vii. Raw materials required
viii. Utilities required

4. **Financial Analysis:** This includes:

i. Analysis of the needed funds, which will reflect the following:

total project cost
cash flow pattern
rate of return
alternative sources of capital

ii. General appraisal of the project, highlighting decision on whether or not to embark on the project showing:

capital needs of the project
income projection showing profit profile
total investments in capital and recurrent expenditure
rate of returns

**SELF-ASSESSMENT EXERCISE**

1. Explain the importance of a feasibility study.
2. Highlight the major steps involved in preparing a feasibility study.

## 3.3 Advantages of Feasibility Study

1. It helps to ascertain whether a project/business is worth undertaking by bringing out the expected returns and the risk involves.
2. It reduces chances of failures.
3. It is used to raise capital (source for fund) from financial institutions.
4. It is used in justifying the need for a proposed project
5. It serves as a guide for implementing a project

## 4.0 CONCLUSION

The above analysis showed the importance of a feasibility study to a proposed project/business. It is essential that an entrepreneur embark on a feasibility study before venturing into a business. The major importance of a feasibility study is that it brings out detailed estimates of the cost, technical, commercial, management and financial aspects of a project.

## 5.0 SUMMARY

In this unit, we have discussed the meaning of feasibility report. You were introduced to the process of preparing a feasibility study. The advantages and uses of feasibility study were highlighted.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. List the advantages of a feasibility study.
b. Discuss the features of a good feasibility report.

2. Highlight and explain the major steps involved in preparing a feasibility study.

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# UNIT 3 TYPES OF FINANCE

## CONTENTS



## 1.0 INTRODUCTION

In this unit, we are going to discuss various forms of shares as a form of long-term finance and as a means of raising new capital. These forms of financing take a long period before maturity from the beginning of a business. They could have maturity period of over 10 years, though some have a period of less than 10 years but above five years. We shall discuss how companies raise funds through equity, preference and debenture shares.

## 2.0 OBJECTIVES

By the end of this lecture, you should be able to:

- explain the various types of finance
- distinguished between equity and preference shares capital
- identify debenture stock and its features
- identify the activities of regulatory bodies.

## 3.0 MAIN CONTENT

### 3.1 Equity/Ordinary Shares

Ordinary shares are issued to the owners of a company. They have a nominal or 'face' value, typically ₦1 or 50k. Ordinary capital is the foundation of any company's financial structure. It is the traditional form of capital. The holders of this type of shares are the owners of the business. The market value of a quoted company's share bears no relationship to their nominal value, except that when ordinary shares are offered for cash, the issue price must be equal to or be more than the nominal value of the shares.

Shareholders of equity/ordinary shares bear a huge portion of the entire risks associated with the company; hence, they expect a higher rate of return than most other providers of funds do.

The ordinary share could be divided into the following:

**i.** **Preferred Ordinary Share:** This is a type of share which its holders have a prior right to a fixed non-cumulative dividend.

**ii.** **Deferred Ordinary Shares:** This is one in which the holders share in the profit only after preferred shareholders have been settled.

Generally, the features or ordinary capital include:

a. They must have nominal value.
b. Share may be offered at a price equal to their nominal value or at a price exceeding their nominal value.
c. Its income is the residual of the profit of the company.

## 3.2 Preference Share

A preference share is one, which confers preferential rights on holder over other holders, such that its holders have a fixed percentage dividend before any dividend is paid to the ordinary shareholders. The holders are also considered first in the case of liquidation of the organisation.

The preference share could be:

a. Cumulative
b. Participating
c. Redeemable

**Cumulative Preference Share:** The holders of this share are entitled to a fixed rate of dividend; such dividend is payable out of future profits in the event that the current year profit is insufficient. They could also have their dividend income accumulated and paid at future dates if the organisation has liquidity problems. All arrears of dividend of these shares must be paid before other shareholders can partake in the profit when the organisation’s profit is sufficient.

**Participating Preference Share:** Its holders are entitle to a fixed dividend income per year, plus a further share in any other profits. In some cases, this further share of profit could be after the ordinary shareholders might have taken their own.

**Redeemable Preference Share:** This is share issued on the authority of the company's article. It may be cumulative, non-cumulative or participating. However, such shares are subjected to certain conditions; the shares are to be redeemed only out of profits available for dividend or out of proceeds of a fresh issue of shares made for redemption purpose.

Because of their prior claim on assets and income, preference shareholders are not given a 'voice' in the management of the company.

**SELF-ASSESSMENT EXERCISE 1**

Explain three types of preference share.

## 3.3 Debenture Loan

These are loans of a long-term nature. They are a form of loan legally defined as the written acknowledgement of a debt incurred by a company. Every registered company is usually presumed to have the power to borrow money or take a loan to finance its operations. Debentures are documents issued by a company, usually under its seal, as evidence of a loan and of any charge securing it. It bears a fixed rate of interest, which must be paid before any dividends are distributed.

Debentures may take the form of fixed charge and floating charge.

**Fixed charge:** Security on fixed charge would be related to a specific asset or a group of assets, typically land and building. The company will be unable to dispose of the asset without providing a substantive asset as security, or without the lender's consent. When the company attempts to dispose of a asset charged, then a receiver may be appointed to take possession of the asset and sell it for the benefits of the debenture holder.

**Floating charge:** This covers all the assets of the company, as they exist from time to time excluding assets subjected to fixed charge. A floating charge does not prevent the company from buying and selling assets in the normal course of its business until a default took place. In the event of default, the lender would probably appoint a receiver to run the company rather than lay claim to a particular asset.

Debenture could also be redeemable or irredeemable. A redeemable debenture is one, which the loan is repayable at a fixed rate. The date for redemption is usually written in form of a range (for instance, 2005 – 2015). The date will be agreed upon at the time of negotiating the loan. An irredeemable debenture is one, which is repayable only in a contingency situation, such as when the organisation is winding-up or going bankrupt.

We should note that the debenture might be issued as debenture stock, in which case the loan is packaged as a whole and issued to interested holders who, after paying for the issued, are issued with debenture stock certificate.

Generally, the main features of debentures are:

i. They usually secured against specified assets of the business.
ii. They are not entitled to voting rights.
iii. They are fixed securities entitled to annual interest payments.
iv. The interest elements are tax deductible
vi. They could be redeemable or irredeemable
vii. They could take the form of floating charge or fixed charge.

**SELF-ASSESSMENT EXERCISE 2**

Distinguish between fixed charge and floating charge.

## 3.4 Government Development Stocks and Bonds

Development stock is a device by the Federal Government to raise money from the public to finance its programmes. The Federal Government issues these instruments usually annually; they are long-term loans with varying maturity periods between six years and 25 years. Development stock normally possesses the following features:

1. It is an interest income instrument.
2. It is redeemable.
3. It is considered gilt-edged that is, the chance of recovering the principal is sure, to a large extent, and it is risk-free.
4. It could be a measure for implementing fiscal policy.

Bonds are like the Federal Government Development stock but, in this case, it is a device of a State and Local Government for borrowing money from the public to finance their public work projects. They possess the following features:

1. It is usually tied to a project such as road construction, hospital, water, schools, etc.
2. Repayment is through a sinking fund account, which is built up for standing payment order (S.P.O) tied to a statutory allocation.
3. State's revenue base and corporate governance usually determine the success level.

## 3.5 Securities and the Financial Organisation

The regulatory and supervisory bodies of Nigeria capital market consist of the Security and Exchange Commission (SEC), Nigeria Stock Exchange (NSC), Central Bank of Nigeria (CBN) and Federal Ministry of Finance. The surveillance role of the regulatory supervisory authorities is critical to measuring the effectiveness and efficiency of financial institutions in order to build-up confidence and stability o the system.

SEC is the apex regulatory body in the capital market. It is empowered by the Securities and Exchange Commission Decree 1999 with the following functions:

i. To register and approve all securities, subscription, or sale to the public while ensuring that full disclosure is given in the prospectuses and other issued documentation in the case of a public offer.
ii. To ensure fair orderly and equitable dealing in securities.
iii. To register commodity and stock exchange investment.
iv. To advise all market operators with a view to maintaining an enviable standard of conduct and professionalism in the stock market.
v. To review approval and regulate merger and acquisitions
vi. To perform market oversight function, surveillance monitoring and site inspection with a view to assuring fair play and equitable dealing on the exchange.
vii. To promote investor education and all categories of intermediaries in the security market.

   Nigerian Stock Exchange (NSE) complements the effort of Securities and Exchange Commission and stand to regulate the activities of the capital market.

A Stock Exchange Market is a place where securities (bonds, stock and shares) of varying types are traded openly and where one can purchase or sell any of such securities easily. It is also a place where securities and capital required to operate huge industries and commercial activities can be raised on a large scale. Competitive by Nigerian Stock Exchange include the following:

i. Provision of machinery for mobilisation of private and public funds and channelling such funds to productive investment through stocks and shares.
ii. Provision of avenues for members to buy and sell as well as raise new funds.
iii. Facilitating the purchase and sale of securities.
iv. Dealing in government securities thereby generating funds for government development purposes.
v. Provision of rules and regulations, which prevent public from legal deals in quoted securities, thus, ensuring fair dealings
vi. Facilitating the transfer of enterprises from the public to the private sector.

Generally, the financial organisations relating to securities are meant to regulate its activities and ensure fair dealing on the capital market.

## 4.0 CONCLUSION

Several forms of finance are available in the capital market. However, these types of finance are of long-term. It is very essential that the trading of securities should be regulated thereby involving some financial bodies to ensure fair dealing in the trading of securities. The financial organisations are responsible for coordinating and regulating of the entire activities of the capital market.

## 5.0 SUMMARY

This unit has examined the various types of finance available at the capital market. It has also revealed that the trading of securities need to be done in an organised manner. It considered the functions of regulatory bodies of the market.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Identify the functions of the Nigerian Stock Exchange.
2a. Distinguish between fixed charge and floating charge.
b. Explain three types of preference share.

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# UNIT 4 RELATIONSHIP OF FINANCE TO OTHER FUNCTIONAL AREAS OF BUSINESS

## CONTENTS



## 1.0 INTRODUCTION

Every business organisation performs efficiently and effectively when all its departments work hand in hand with one another. There are many arguments about which functional area would be the most important department for the long-term development of a business organisation. There are four main functional areas in a business organisation and these are marketing, human resource, operations and finance.

This unit examines how these functional areas interrelate and interact with each other during the course of the operation of an organisation. In specific terms, it examines how finance relates to the other functional areas of business.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- discuss the main functional areas of a business organisation
- explain how finance is related to the other functional areas
- discuss strategic management in business organisation.

## 3.0 MAIN CONTENT

### 3.1 The Main Functional Areas of Business Organisation

As stated earlier, there are four main functional areas of a business organisation. These functional areas interact with each other for the smooth operation of the business. These areas are marketing, human resources, operations management and finance.

1. **Marketing:** Claire Capon (2000) says marketing is the first department of the whole organisation to be considered. That is to say, marketing is the most important part of an organisation activity. Marketing, which is an essential department of an organisation, can affect the business activity immensely. Relatively speaking, marketing, which is concerned with identifying customers' needs and wants, drives the whole organisation.

   This department is an internal area with regard to research, analysis, and supervisor and so on. Furthermore, it is related to the external environments as well. Thus, the marketing department plays important roles in both external and internal environments. What it does is to notice every change about the outside world and predict the kinds of products or services the clients may want. Michael Porter, of the Harvard Business (1980s) suggested that organisations should dominate specified markets, or segments of specified markets, and make it as hard as possible for others to enter the market (Colenso, P: 1980). This is a suggestion of a corporate strategy and; it is a means to enhancing competitive advantages of an organisation.

2. **Operations Management:** Operations management refers to making decisions on the design of products or services and the resource inputs needed. The operations department is responsible for the production of the goods. It is also responsible for the cost of producing those goods and the price at which the goods are to be sold.

3. **Human Resource Management:** Human resource management is an integrated general department that involves identifying the organisation's demand for human resources with particular skills and abilities. Human resource management should be concerned with the new workers at present. In other words, human resource management department should make a strategic plan in training, recruitment and selection of new staff.

4. **Finance Department:** Financial department is concerned with raising capital for smooth business operations and ensuring that sufficient revenue is guaranteed to cover the cost of any expenditure. The finance department is saddled with the responsibility of ensuring that there is enough money for the whole business organisation to function properly.

**SELF-ASSESSMENT EXERCISE 1**

What are the main functional areas of a business organisation.

## 3.2 Finance and the Other Functional Areas of Business

As far as the internal environment of the business organisation is concerned, the four main functional areas are integrated as a whole. They do not work along but work together towards the overall aim to plan for the future. How finance interrelates with the other functional areas is explained thus:

1. **Finance and Marketing:** As mentioned earlier, financial marketing is concerned with raising capital for the smooth operations of a business and ensuring that sufficient revenue is generated to cover the cost of any finance raised. On the other hand, after the finance is raised and the products are produced, the marketing department should bring the products to the market and do the best to sell enough goods in order to make large profits for the whole business organisation.
   Marketing demands creativity and innovation. Further, new product development is a method of creating, developing and keeping a competitive advantage of an organisation. The marketing department depends on the finance department for fund to carry out research and development without which creativity and product innovation become difficult.

2. **Finance and Operations Management:** Operations management is saddled with the responsibility of producing goods and services to satisfy consumer wants and needs. While finance department is required to make sure there is enough money for the whole organisation to function properly, the operations department is responsible for producing the goods considering the cost. The operations management could determine cost and sales price. It works with the finance department to reach a final decision on making profits according to the cost and the price.

3. **Finance and Human Resource Management:** Human resource management makes strategic plan in training, recruitment and selection of new staff. Since the aim of business is to make profit through the satisfaction of consumers' wants and needs, whenever there is the need for product innovation to target consumers, there is a corresponding need for staff to be trained or recruitment towards such area of experience or competence. This recruitment training and retraining can only be made possible through financing. Therefore, a strategic plan in training, recruitment and selection of new staff is realised through proper strategic management in finance.

**SELF-ASSESSMENT EXERCISE 2**

Briefly discuss the relationship between finance and other functional areas of business.

## 3.3 Strategic Management in a Business Organisation

As far as an organisation is concerned, each functional area has its own strategic management. Strategic management includes understanding the strategic position of an organisation, strategic choices for the future and turning strategy into action. Strategic management penetrates into different functional areas and helps the organisation enhance its own competitive advantages. Therefore, it is essential for an organisation to choose proper strategies in each functional area in order to form a corporate strategic plan.

### 3.3.1 Strategic Management in Marketing

Marketing is about identifying customers' needs and wants. It is important to use effective marketing strategy with regard to a certain organisation. Management should ensure that they are customer-oriented instead of being product-oriented. Therefore, we can conclude here that customer-oriented management is a sort of effective strategic management in marketing, which can keep the industry growing even if there are no obvious opportunities.

### 3.3.2 Strategic Management in Finance

As far as an organisation is concerned, strategic thinking is significant for the growth of an organisation. For finance, the capital is an essential element of a certain organisation. Hence, it is a good idea to issue ordinary shares to raise capital in order to think for the future.

### 3.3.3 Strategic Management in Operations

Strategic management in operations is essential as well. For instance, a sales of vegetables (cabbage, for example) can display it on his table alongside other ingredients needed for making salad (such as tomatoes, pepper, onions, etc). In addition, the seller can also put the profitable goods in such a place that customers can easily reach them. This will increase sales and also improve the overall profitability of the business. Therefore, choosing proper strategic management in operations management can help the organisation achieve success more easily.

### 3.3.4 Strategic Management in Human Resource Management

The recruitment of employees is crucial to an organisation as well. The staff with skills and abilities can provide customers with satisfactory products and services. The recruitment of employees also helps the organisation achieve its strategic goal efficiently. This is because recruitment process ensures that appropriate applicants are selected to work together to realise the objectives towards the strategic direction of an organisation.

**SELF-ASSESSMENT EXERCISE 3**

Discuss strategic management in each of the functional areas of business.

## 4.0 CONCLUSION

Finance is related to the other functional areas of a business hence, it is crucial for the realisation of business goals and objectives. Finance, should therefore, be properly managed as it provides the life wire of a business. Even though finance is crucial, achieving goals of an organisation needs the co-operation of the four main functional areas.

## 5.0 SUMMARY

This unit has examined the functional areas of business-finance, marketing operating management and human resource management. It also looked at the relationship between finance and the other functional areas of business. It also explained the importance to an organisation, the choice of proper strategies in each functional area in order to form a strategic corporate plan.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. Identify the main functional areas of a business organisation.
b. Discuss the relationship between finance and other functional areas of business.

2. Identify strategic management in each of the functional areas of business.

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# UNIT 5 THE NIGERIAN FINANCIAL SYSTEM

## CONTENTS



## 1.0 INTRODUCTION

The financial structure of Nigeria is the composite of the instruments and institutions. It consists of the present stock of various financial assets together with the pattern of financial institutions in existence. The institutions differ from one another by the kind of secondary claim they issue and the type of primary claim they buy. We will be looking at the structure of the Nigerian financial system and the various regulatory bodies.

## 2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain the structure of the Nigeria financial system
- identify the regulatory bodies of financial institutions.

## 3.0 MAIN CONTENT

### 3.1 The Structure of the Nigerian Financial System

The Nigerian financial system can be broadly divided into two, namely: the formal and the informal sector. The formal sector can be subdivided into money and capital market institutions and these comprises of banks, non-bank and specialised financial institutions.

i. The banking financial institutions are active agents in the money market. They mobilise short-term funds from the surplus sector of the economy to the deficit sector. This comprises of the following:

a. **Commercial Banks and Merchant Banks:** These institutions operate under the legal framework of the banks and other financial institutions decree 25 of 1991 (as amended). The commercial banks perform three major functions, namely: acceptance of deposits, granting of loans and the operation of payment and settlement mechanism.

The merchant banks take deposits and cater for the need of corporate and institutional customers by the way of providing medium and long-term financing. They also engage in equipment leasing, debt factoring, etc. However, following the adoption of universal banking policy, most merchant banks were converted to commercial banks.

b. **Micro Finance Banks (Community Banks):** A community bank in Nigeria is a self-sustaining financial institution owned and managed by the community to provide financial services to that community. National Board issues provisional license of community banks for Community Banks (NBCB) while the find license is issued by the CBN after operating for two years with the banking reforms, these banks have been transformed to micro finance banks and their capital based has been raised.

ii. The non-banking financials consist of insurance companies, pension funds, mortgage houses, stock broking firms, daily collection bureau de change. They are also of great importance to the Nigerian financial system. Most of them give long-term loans.

iii. The Specialised Banks or Development Finance Institutions (DFIS) was established to contribute to the development of specific sectors of the economy. They consist of the Nigeria Industrial Development Bank (NIDB), Nigeria Bank for Commerce and Industry (NBCI), Nigerian Agricultural and Co-operative Bank (NACB) and Urban Development Bank (UDB).

**SELF-ASSESSMENT EXERCISE 1**

Explain the structure of the Nigerian financial system.

## 3.2 The Regulatory Agencies of Financial Institutions

There are several financial institution regulatory agencies in Nigeria, among which are:

**The Federal Ministry of Finance (FMF):** The FMF advises the Federal Government on its fiscal operations and cooperates with CBN on monetary matters. It was at the top of the financial system until recently, the CBN was under its control. However, an amendment in 2006 to the laws of the CBN compels the CBN to report to the presidency through the Federal Ministry of Finance.

**The Central Bank of Nigeria:** The CBN is the apex regulatory authority in the financial system. Among its other primary functions, the bank promotes monetary stability and a sound financial system; acts as bank and financial adviser to the Federal Government; and act as banker of the last resort to other banks in the country. Enabling laws made in 1991, gave the CBN more flexibility in regulatory and overseeing the banking sector and licensing finance companies, which hitherto operated outside any regulatory framework.

**The Nigerian Deposit Insurance Cooperation (NDIC):** Although an autonomous entity from the CBN, NDIC complements the regulatory and supervisory role of the CBN. NDIC commenced operations in 1989 with the aim of providing deposit insurance and related services for banks to promote confidence in the banking industry. It examines the books of deposit money and financial institutions.

**The Securities and Exchange Commission (SEC):** Formally known as the Capital Issues Commission, SEC is the apex regulatory organ of the exchange market. Its major objective is to promote an orderly and active capital market by ensuring the adequate protection of securities, registering all securities dealers in order to maintain proper standard of conduct and professionalism, approving and regulating mergers and acquisitions and maintaining surveillance over the market to enhance efficiency.

**National Insurance Commission (NIC):** The NIC is charged with effective administration, supervision, regulation and control of the business of insurance in Nigeria, high technical expertise and judicious fund placement in the insurance industry.

**The Federal Mortgage Bank of Nigeria:** FMBN is the successor of the Nigerian Building Society. It provides banking and advisory services, and undertakes research activities pertaining to housing. With the adoption of National Housing Policy in 1990, FMBN was empowered to regulate primary mortgage institutions in Nigeria. The financing function of FMBN was carved out and transferred to the federal mortgage finance, while the FMBN retained the regulatory role. FMBN is under the control of the CBN.

**Financial Service Coordinating Committee (FSCC):** This is a committee established to coordinate the activities of all regulatory institutions in the financial system. The Federal Ministry of Finance chairs the committee.

**SELF-ASSESSMENT EXERCISE 2**

Outline the agencies that regulate the various financial institutions in Nigeria.

## 4.0 CONCLUSION

The above discussion has shown us that there are many institutions in the Nigerian financial system. These institutions have varying responsibilities, thus, there is need for different regulatory bodies to be set-up to cater and regulate their activities. This is to check abnormalities and ensure the smooth running of the financial system in Nigeria.

## 5.0 SUMMARY

This unit has explained to us the financial system of Nigeria. The classification of financial institutions was considered alongside with the regulatory bodies set up by government to monitor the activities of these institutions to keep them in check.

## 6.0 TUTOR-MARKED ASSIGNMENT

1a. Distinguish between the role of the Federal Ministry of Finance and the Central Bank of Nigeria.
b. Explain the activities of the Federal Mortgage Bank of Nigeria.

2. Outline the agencies that regulate the various financial institutions in Nigeria.

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