KEY CENTRE OF EXCELLENCE INSTITUTE

**KCE**

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## FINANCIAL MANAGEMENT

**FINANCE**- Is a branch of economics which deals with generating and allocation of the company's scarce resources amongst the competing needs of the company.

**OBJECTIVE OF THE BUSINESS ENTITY**

- Profit maximization
- Shareholders wealth maximization.
- Social responsibility.
- Business ethics.
- growth

The function of the finance manager can be categorized into 2 categories as follows:

1. Managerial functions.
2. Routine functions.

**1. Managerial function.**

They are functions that require technical expertise, knowledge of a finance manager and they include:

- Liquidity and working capital management.
- Financing function.
- Investment or capital budgeting functions.
- Dividend policy decision/ Profit allocation function.

**2. Routine functions**.

This functions o not requires technical skills and knowledge of the finance manager.



### Agency theory

An agency relationship exist where one party known as the principal appoints other known as the agent and gives him the authority to act on his behalf. There are various type of agency relationship which include;

(a) Shareholders vs. management.
(b) Creditors vs. shareholders
(c) Government vs. shareholders
(d) Auditors vs. shareholders.

**Shareholders VS Management/Shareholders versus Managers**

A Limited Liability company is owned by the shareholders but in most cases is managed by a board of directors appointed by the shareholders. This is because:

a) There are very many shareholders who cannot effectively manage the firm all at the same time.
b) Shareholders may lack the skills required to manage the firm.

c) Shareholders may lack the required time.

**Conflicts of interest usually occur between managers and shareholders in the following ways:**

1. Managers may not work hard to maximize shareholders wealth if they perceive that they will not share in the benefit of their labour.
2. Managers may award themselves huge salaries and other benefits more than what a shareholder would consider reasonable
3. Managers may maximize leisure time at the expense of working hard.
4. Manager may undertake projects with different risks than what shareholders would consider reasonable.
5. Manager may undertake projects that improve their image at the expense of profitability.
6. Where management buyout is threatened. 'Management buyout' occurs where management of companies buy the shares not owned by them and therefore make the company a private one**.**

**Solutions to this Conflict**

In general, to ensure that managers act to the best interest of shareholders, the firm will:

1. Incur Agency Costs in the form of:
    a. Monitoring expenses such as audit fee;
    b. Expenditures to structure the organization so that the possibility of undesirable management behaviour would be limited. (This is the cost of internal control)
    c. Opportunity cost associated with loss of profitable opportunities resulting from structure not permit manager to take action on a timely basis as would be the case if manager were also owners. This is the cost of delaying decision.
2. The Shareholder may offer the management profit-based remuneration. This remuneration includes:
    a. An offer of shares so that managers become owners.
    b. Share options: (Option to buy shares at a fixed price at a future date).
    c. Profit-based salaries e.g. bonus

3. Threat of firing: Shareholders have the power to appoint and dismiss managers which is exercised at every Annual General Meeting (AGM). The threat offiring therefore motivates managers to make good decisions.
4. Threat of Acquisition or Takeover: If managers do not make good decisions then the value of the company would decrease making it easier to be acquired especially if the predator (acquiring) company beliefs that the firm can be turned round.

**2. Debt holders versus Shareholders**

A second agency problem arises because of potential conflict between stockholders and creditors. Creditors lend funds to the firm at rates that are based on:

- Riskiness of the firm's existing assets
- Expectations concerning the riskiness of future assets additions
- The firm's existing capital structure
- Expectations concerning future capital structure changes.

**3. Government VS shareholders**.

The shareholders and the company within the environment using licenses or a charter issued by the government. However the government may be affected by the shareholders in the following ways:

- ✓ By engaging in illegal business.
- ✓ Avoiding investments in areas where business considers risky.
- ✓ Tax avoidance
- ✓ Not taking part in social responsibility.

## Financial forecasting

This involves the determination in advance the financial requirement of the company.

**Importance of financial forecasting**.

1. It forces the managers to plan in advance and allocate resources effectively.
2. It forces the management to avoid surprises which might occur in the course of operations.
3. It's used for control purposes.
4. It's used for motivation purposes.

**Functions of cash budget**.

- It ensures that the cash is available for revenue expenditure.
- It indicated when and how much cash will be required for a particular activity.
- It preserves liquidity during the period of expenditure.
- Planning purposes.
- Coordination of activities in the organization.
- Controlling of finance on the organization.

**Ways of financing cash deficit.**

1. Borrowing
2. Bank overdraft.
3. Sale of financial securities.
4. Sale of fixed assets.
5. Acquiring goods on credit.
6. Insist on cash sales.



## LEASING.

This is a contract between two parties where one party known as lessor (owner) gives another party known as lessee the right to use the asset and enjoy the benefits and risk associated with the utilization of the asset.

***Types of leases.***

(a) Operating lease.
(b) Finance lease.
(c) Sell and leaseback lease.
(d) Leverage lease

## Operating lease/off balance sheet lease.

This is a short term lease.it has the following characteristics:

- The lease period is very short relative to the economic life of the asset.
- The lease contract can be cancelled by either party any time before end of lease period.
- The owner (lessor) incurs maintenance, operating and insurance expenses of the asset.
- The lessee is not given an option to buy the asset at the end of lease period.

**(a) Finance lease/capital lease.**

This is long-term in nature and the lease period is almost equal to the economic life of the asset.

***Characteristics.***

- The lease period should be at least equal to 75% of the asset economic life.
- The lease contract cannot be cancelled by either party before lease period matures.
- The lessee incurs all maintenance cost.
- The lessee is given an option to buy the asset at the end of lease period.

**Advantages of leases**.

1. Lease does not involve strict terms and conditions associated with long term debts.
2. Leasing has lower effective cost compared to long term debts.
3. It does not require a significant initial capital investment compared with cost of buying new asset.
4. It reduces the risk of obsolescence.
5. It provides off-balance sheet financing i.e. operating lease are shown as foot notes to the financial statements.

## CAPITAL RATIONING.

This occurs when there is scarcity of the investment fund i.e. the company has no sufficient money to undertake all viable projects.

There are normally two types of capital rationing.

1. **Soft/internally generated capital rationing**.

This occurs when the shortage of the investment fund is as a result of actions of the management i.e. the shortage is within the control of the management.it occurs due to the following:

- Where the management may refuse to raise additional funds through issues of new shares to avoid dilution.
- To avoid commitment of large payment of interest or installment of the principle amount in case the company borrows funds.
- Where the management has set a limit on the budget.
- Where the project can only be financed by internally generated funds.

**2. Hard/externally generated capital rationing.**

This occurs due to factors not within the control of the management (external factors).it occurs as a result of the following:

- When the capital market is depressed thereby making it impossible to raise finances.
- Cost of capital of issuing new shares may be too high thereby affecting borrowing.
- High demand of investment fund by well established companies.
- Lack of security/collateral when borrowing funds.
- Due to credit policy of the government thereby restricting financial institution to lend money.

## OPTIONS IN CAPITAL BUDGETING.

An option is a financial contract which gives one party the right but not the obligation to buy/sell a given asset/underlying in some future date

**Types of options**

1. **Financial option**.
   - **Call option**-an option which gives the buyer the right but not obligation to buy an asset.
   - **Put option**- an option which gives the seller the right but not obligation to sell an asset.

2. **Real option**-this occurs when the manager has many alternatives to select from. The most common includes:
   1. Lease or buy option.
   2. Replacement decision.
   3. Abandonment decision.

## RISK ANALYSIS IN CAPITAL BUDGETING.

**RISK**-is a chance that some unfavorable event will occur in the future.

**Types of risks facing the company.**

1. **Financial risk**
   This risk arises as a result of company borrowing funds.
2. **Business risk**
   This refers to fluctuations of the companies' earnings/declining profits. It is grouped into 2 as follows:

   **(a). Systematic risk**- is a type of business risk that affects all the companies in the industry e.g. inflation, interest rate, political instability.
   (**b). Unsystematic risk**-this is a risk which affects a specific company in the industry e.g. strikes, weather.



## VALUATION OF BUSINESS SECURITIES.

Valuation is the process of determining the worth/value of security using financial information available.

***THEORETICAL VALUE/INTRISIC VALU***E-is the value attached to a security.

**Reasons for valuation of securities**.

1. For liquidation purposes
2. Listing or quotation in the stock exchange.
3. In order to use security as a collateral.
4. In case of selling the security.
5. For tax and insurance purposes.
6. For mergers and acquisition.

**Theories of valuations**.

1. **FUNDERMENTAL THEORY OF VALUATION**.

This theory states that that the theoretical value of the security is equal to the present value of all the future expected benefits to be realized from that security.

2. **TECHNICAL /CHARTIST THEORY**.

This theory states that the price pattern of the past could repeat itself in the future.

3. **RANDOM WALK THEORY**.

It states that it is not possible to predict the theoretical value of the security i.e. the value of the security moves in a random manner depending on the information given to the market.

**VALUATION OF ORDINARY SHARES**

Ordinary shares are classified into 3 categories for the purpose of valuation.

**(a) Zero dividend growth rate ordinary shares.**

In this case the company promises to pay constant dividend per share for each period ie

$D_0=D_1=D_2=D_3=D_n$

In this case the intrinsic value =PVAα=D/Ke

**(b)Constatnt dividend growth rate ordinary share.**

This is where the dividend will increase at a constant rate until infinity. In this case

Intrinsic value= $PVAg^{\alpha}=\frac{Do\ (1+g)}{Ke-g}$

**(c)Non-constant dividend growth rate shares**

This is where the dividend will increase at different rates during the earlier period of the economic life of the project before the growth rate becomes constant until infinity. The theoretical value in this case will be calculated as follows:

**Intrinsic value (Po**)=Pv of dividend during non-constant period + Pv of dividend during constant period

**Pv of dividend during constant period =** $\frac{Do\ (1+g)}{Ke-g}$

**Characteristic of efficient market**.

Market is said to be efficient if it has the following features.

- Information once received in the market, it's immediately incorporated in the security prices.
- The transaction cost like commission paid to brokers should be minimum to avoid discouragement.
- There should be continuous trading of securities.
- There should be no speculations in the market.
- No investor should receive information earlier than others i.e. no insider trading.

**FORMS OF MARKET EFFICIENCY**.

1. **WEAK FORM EFFICIENCY-**this is where the security price reflects all the historical information concerning the company's performance.
2. **SEMI-STRONG FORM EFFICIENCY-**In this case the share price will reflect all past and present information concerning the company's performance.
3. **STRONG FORM EFFICIENCY-**Security price reflects all the past, present and future information concerning the company's performance.

**Market anomalies.**

These are events which makes the market to be inefficient. They include:

1. **Insider trading-**this occurs when some investors gets information earlier than others by their position in the organization.
2. **January effect-**evidence suggest that market normally performs poorly during the month of January and therefore this makes the investor to buy securities at the end of December or at the start of January and sell them during the month of march to realize abnormal gains.
3. **Monday effect-**the market prices of the security are normally lower on Monday due to low demand of securities.
4. **Announcement effect-**evidence suggests that security prices changes for some time after the initial announcement.
5. **Size effect-**small companies' interms of total asset to the market value are normally affected by well established companies who dominate the market.

**Differences between WACC & WMCC.**

| **WMCC** | **WACC** |
|---|---|
| It's the average cost of new funds to be acquired. | It's the average cost of existing funds. |
| It is used as a discounting rate when evaluating the company's new project. | It is used as a discounting rate in evaluating the existing projects. |
| It considers floatation cost due to new funds. | It does not considers floatation cost. |
| It considers the cost of retained earnings. | It does not considers cost of retained earnings. |
| It uses optimal capital structure/target capital | It uses the market value to determine the proportion /weight. |

**<u>Factors to consider when making capital structure decision</u>**.

1. The component cost of each source of finance.
2. Business/total risk-a company with higher business risk may have a lower gearing level.
3. Size of the company-a large and established company has a wide access to the capital market.
4. Corporate tax rate-if the tax rate is high, companies are encouraged to use more debt.
5. Management and ownership
6. Industrial norms-A company will adopt a capital structure similar to industry it is operating.

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# DIVIDEND POLICY

## Factors which influence dividend policy.

1. Restriction by the debt or bond holders.
2. Expectation of the shareholders.
3. Availability of investment opportunities
4. Access to the capital market
5. Profitability of the company
6. Nature of the tax position of the company
7. Industrial norms
8. Inflation
9. Capital structure decisions

**Dividend policies**

The following are some of the dividend policies normally adopted by the company:

1. **Constant dividend payout ratio**-under this policy the company will pay a fixed proportion of its earnings available to the ordinary shareholders as dividends..
2. **Constant/fixed dividend per share**-this is where the company will pay a fixed amount as dividend per share irrespective of the company's earnings.
3. **Regular plus bonus/**surplus-this is where the dividend per share is set at a very low level and paid each period. However extra or bonus dividends will be paid during the period of high earnings.
4. **Residual dividend policy**-it is where dividend is paid out of the earnings left after all investment opportunities which are economically viable have been financed. Therefore in this case the company will pay dividends only if there are no profitable projects to invest in.

**ILLUSTRATION**

The management of JM ltd is in the process of evaluating the company's dividend policy.
The following information is provided:

1. The company paid sh 1.2 million as dividend in the last financial year.
2. The profit after tax for the last financial year was 3.6 million.
3. The company has not issued any preference shares.
4. The earnings growth rate has been consistent at 10% p.a for the past 10 year.
5. The expected profit after tax for the current financial year is sh. 4.8 million.
6. The company anticipates the investment opportunities of sh 1.4 million in the current financial year.
7. The capital structure of the company consists of 60% equity and 40% debt.

**Required:**

Determine the optimal dividend to be paid using the following dividend policy:

a) Pure residual policy.
b) Constant dividend payout ratio policy.
c) Stable predictable policy where the growth rate is equivalent to the earnings growth rate.
d) Regular plus extra dividend

**THEORIES OF THE DIVIDEND POLICY**

1. Agency theory.
2. Bird in hand theory.
3. Signaling theory.
4. Clientele theory.
5. MM dividend irrelevant theory.

1. **BIRD IN HAND THEORY**-This theory was developed by Myron Gordon and John Litner and it's based on certainty of income.
   The theory summarizes that investors are risk averse and therefore they fear risk and prefers assured income.
2. **SIGNALING THEORY**-The payment of high dividend will signal that the management expects high profits in the future to maintain their high dividend payment.
3. **CLIENTELLE THEORY**-This assumes that, if a group of shareholders has high income from others sources, they will prefer low or no dividend in order to avoid the additional tax burden.
4. **MM dividend irrelevant theory**-this theory was developed by Modigliani and Miller who argues that the company dividend policy does not affect the value of the company. This theory operated under the following assumptions.
   a. There is no transaction costs associated with floatation of the shares.
   b. There are no corporate and personal taxes on dividends.
   c. There are no uncertainties in the market and hence all the investors use the same discounting rate.
   d. The capital markets are efficient and perfect.
   e. The company investment policy is independent of its dividend policy.

**5.** **AGENCY THEORY**-this states that the payment of dividend is one of the measure available to managers for controlling agency behavior. This theory assumes that large scale retention of earnings encourages behavior by managers that does not maximize shareholders value. Dividends then are a valuable financial tool for these firms because they help avoid asset/capital structures that give managers wide discretion to market value reducing investments.

## MANAGEMENT OF WORKING CAPITAL

It refers to the management of the current assets and current liabilities.

**Importance's of working capital management.**

1. Because working capital represents the large portion of the company's total investment.
2. Because the current assets are exposed to the risk of fraud.
3. Working capital items are directly related to the sales volume.
4. It's important to manage the working capital items because the management spends most of their time on the routine decision making which are concerned with CA and CL.

**Ways in which a company can reduce working capital cycle**.

- Incentivize receivables.
- Meeting debt obligation.
- Choose vendors who offer discount.
- Manage inventory.

- Automate account receivable and payables.

**WORKING CAPITAL FINANCING POLICIES.**

- Aggressive financing policy.
- Conservative financing policy.
- Moderate/matching policy.

1. **Aggressive financing policy**.-under this policy the working capital items will be financed using the short term sources of finance. This is because short term source sources cheaper. The company's current assets are divided into 2:
    - **Permanent current assets**-are assets which stay in the company for a period of more than one year.
    - **Temporary/Floating current asset**-are assets which stays in the company for less than a year/they fluctuate above the optimal level.
2. **Conservative financing policy**-under this policy the working capital will be financed using long term sources of finance.
3. **Moderate/matching financing policy**-under this policy the permanent WC will be financed using long term sources and the temporary WC will be financed using short term sources of finance.

**Factors to consider when selecting financing policy**.

- Cost
- Availability of funds at the time of investment.
- Terms and conditions of borrowing.
- Borrowing capacity of the company.
- Management attitude toward the risk.

- **OVERCAPITALIZATION**-a company is overcapitalized if its working capital is in excess of its needs.
- **OVERTRADING**-It occurs when the company is growing too fast and trying to carry on a large volume of activities with its low level of capital.

**Reasons why company holds cash**.

- For transaction purposes.
- For emergency/precautionary measures.
- For speculative purposes.
- Financing the borrowed funds.

**Reasons why the company sells on credit.**

- In order to increase sales volume.
- In order to avoid stock being out of stock.
- In order to maintain new customers and existing customers.
- In order to avoid fluctuations of prices.
- In order to enable customers to take advantage of cash discount.

**Factors to consider when determining the credit worth of the customer/5 c's**

1. Character-such as honesty and integrity.
2. Capacity-it is the assessment ability to pay.
3. Capital-it involves assessment of capital resources of the customer.
4. Condition
5. Collateral/security

## LEVERAGE.

This refers to the use of the debt in the company's capital structure. There are normally 3 types of leverage:

- Operating leverage.
- Financial leverage
- Combined/total leverage

1. **OPERATING LEVERAGE**.
   This is the use of the operating costs in order to improve the profitability of the company
2. **FINANCIAL LEVERAGE**
   This is the use of the financing cost in-order to improve the EPS of the company.
3. **COMBINED /TOTAL LEVERAGE.**
   This is the use of both operating and financial leverage in-order to increase the profitability of the company.

**DEFINITION OF TERMS**.

1. **Financial engineering** –this is the application of mathematical tools and technical methods in computation in finance.
2. **Financial contagion**-this is the shock in a given economy or region i.e. economic crisis.
3. **Financial innovation**-is the act of creating and then populizing new financial instruments, technology, processes.
4. **Debt repudiation**-disputing the validity of contract and refusing to honor its term.
5. **Debt rescheduling**-restructuring the forms of the existing loan or bond in order to extend the payment period.

## SOURCES OF FINANCE FOR BUSINESS ORGANIZATION.

These are the various categories of capital that are available to the firm ie the sources from which business entity may obtain finances for its operation. The source may be classified as follows:

**(a).according to duration.**

- Permanent-these funds are not refundable as long as the company is a going concern e.g. ordinary share capital.
- Long-term-these are refundable after a long period of time.
- Medium term-these are medium such as lease.
- Short term-these are refundable within a short period of time eg bank overdraft.

(**b) According to origin**

- Internal
- External

**(C) According to relationship with the firm.**

- Equity capital-provided by the owners of the company.
- Debt-provided by the 3rd party.

**(d) According to nature of return.**

- Fixed return
- Variable return

**Long term sources of capital**

**1. Equity finance**

For small companies, this is personal saving (contributions from the owners of the company). For large companies equity finance is made of ordinary share capital and reserves.

**(a) Ordinary share capital**-this is raised from the public from the sale of ordinary shares.

**Features of ordinary share capital**.

a. It is permanent source of capital.
b. It has a variable income in form of dividends.
c. The company is under no obligation to pay dividends.
d. Dividend is disallowable for tax purposes.
e. Ordinary share holder has a residue claim on company's assets.
f. Providers of the capital get ownership and right to vote.
g. It involves heavy floatation cost.
h. It is not secured.
i. It is provided without conditions.
j. It reduces the company gearing level.

**Reasons why the share capital is attractive despite being risky.**

- Shares are used as security for loan.
- Its value grows.
- They are transferrable.
- They influence the company's decision.
- Carry variable returns-is good under high profits.
- Perpetual investment.

**Disadvantages of ordinary share capital**

1. It involves high floatation costs.
2. Dividends are not allowable for tax purposes.
3. Only available to limited companies.
4. It leads to dilution of earnings.
5. It involves a lot of formalities.

**Methods of issuing share capital**

1. Right issue.
2. Bonus/script issue.
3. Private placement
4. Offer through prospectus (IPO)
5. Tender for shares.

**PREFERENCE SHARE CAPITAL. (QUASI EQUITY)**

**Classification.**

1**. Redeemable preference share**

They are preference shares which are brought back by issuing company after a given duration of time.

**2. Irredeemable preference share**

Are perpetual preference share as they will not be redeemed back ie it has no maturity period.

**3. Convertible preference share.**

**4. Non- convertible preference shares.**

**3. DEBT FINANCE**

This is capital provided by creditors or debt holders. Debt finance is a fixed return finance as the cost (interest) is fixed on the par value (face value ) of the debt.

**Feature of debt finance**

- It is issued for a specified period of time.
- Providers of the debt have no voting right.
- Interest on debt is allowable for tax.
- It is provided with conditions.
- It is usually secured.
- Interest is payable in priority to dividend.
- It has prior claim on assets in case of liquidation.
- It involves lower floatation cost.
- It increases the gearing level of the company.
- Has less formalities compared to equity share capital..

**Disadvantage of debt capital.**

- ➢ It is a conditional finance.
- ➢ If used excessively, it may interrupt the company decision making process.
- ➢ It is dangerous to use in a recession as such conditions may force the company into receivership through lack of fund to service the loan.
- ➢ The use of the debt finance may lower the value of the share if used excessively.

**Differences between debt finance and ordinary share capital.**

| Ordinary share capital | Debt |
|---|---|
| Its permanent finance. | It is refundable (redeemable) |
| Returns are paid when available. | It is fixed return capital. |
| Dividends are not tax allowable. | Interests on debt are tax allowable. |
| Unsecured finance. | Secured finance. |
| Carry voting right. | No voting right. |
| Reduces gearing level. | Increase gearing level. |
| No legal obligation to pay | Has a legal obligation to pay. |
| Has a residual claim | Carries a superior claim |
| Owners money | Creditors money |

**Similarities between preference and equity finance.**

1. Both may be permanent if preference share capital is irredeemable (convertible)
2. Both are naked or unsecured finance.
3. Both are traded at the stock exchange.
4. Both are raised by public companies only.

5. Both carry residue claim after debt.
6. Both dividends are not a legal obligation for the company to pay.

**Differences between preference and equity finance.**

| Ordinary share capital | Preference share capital |
|---|---|
| Has a residual claim both on asset and profit. | Has a superior claim |
| Carries voting right | No voting right |
| Reduces the gearing ration | Increases the gearing ratio |
| Variable dividends hence grow over time | Fixed dividend and has no growth |
| Permanent finance | Usually redeemable |
| Easily transferable | Not easily transferable |

**Similarities between preference share capital and debt**

1. Both have a fixed return.
2. Both will increase the company's gearing level
3. Both are usually redeemable
4. Both do not have voting right.
5. Both may force the company into receivership.
6. Both are external finances.

**Differences between preference share capital and debt.**

| Debt | Preference |
|---|---|
| Interest is tax allowable | Dividend are not tax allowable |
| Interest is a legal obligation | Dividend are not a legal obligation |
| Debt finance is always secured | Preference is not a secured finance |
| Debt finance is pre-conditional | It is not conditional |
| Has a superior claim | Has a residual claim after debt |



**Why it may be difficult for small SME's (JUAKALI) to raise debt finance in Kenya.**

1. Lack of security.
2. Ignorance of finances available.
3. Most of them are risky businesses.
4. Cost of finance may be too high.
5. Lack of business principles that are sound and difficult to evaluate te performance.

## OTHER SOURCES OF FINANCE.

### 1. Venture capital

Venture capital is a form of investment in new small risky enterprises required to get them started by specialist called ***venture capitalists.*** Venture capitalists are therefore investment specialists who raise pools of capital to fund new ventures which are likely to become public corporations in return for an ownership interest. They buy part of the company stock at a lower price in anticipation that when the company goes public, they would sell the shares at a higher price and hence make a profit.

**Attributes of venture capitalist.**

- Equity participation.

- Long term investment.
- Participation in management.

***Role of venture capital in economic development.***

1. Business start-up.
2. Business development.
3. Management buy-out.

**Constraints of venture capital in Kenya.**

- ✓ Lack of rich investors in Kenya hence inadequate equity capital.
- ✓ Inefficiencies in stock market.
- ✓ Infrastructure problems.
- ✓ Lack of managerial skill on part of venture capitalists and owners of the firm.
- ✓ Focus on low risk ventures.
- ✓ Conservative approach by venture capitalist.
- ✓ Lack of government support.
- ✓ Dilute control of a firm.

**2. Business Angels**

Business angels are wealthy, entrepreneurial individuals who provide capital in return for a proportion of the company equity. They take high personal risk in the expectation of owning part of a growing and successful business.

**Advantages of business angel financing**

- ➢ They are free to make investment decisions quickly.
- ➢ No need for collateral ie personal asset.
- ➢ Access to your investor's sector knowledge
- ➢ Better discipline due to outside scrutiny.
- ➢ Access to BA mentoring or management skills.
- ➢ No payment of interest.



## FINANCIAL MARKETS

**FINANCIAL MARKET**-this is a mechanism that allows people to buy and sell financial securities such as bonds and stocks.

**Types of financial markets.**

The global financial system fulfills its various role mainly through markets where financial claims and financial services are traded.

The financial markets can be divided into different sub-markets as follows.

1. **<u>Primary versus secondary market.</u>**
   ***Primary market*** are those financial markets in which financial instruments are issued for the first time in the market e.g. a company being listed in the stock for the first time.
   **Advantages of primary market.**
   - Firms can raise capital in the primary market.
   - Helps in mobilizing savings.
   - It is a vehicle for direct foreign investment.

- The government can raise fund through sale of treasury bonds in primary market

***Secondary financial market*** is a market for subsequent selling and purchase of the financial securities.

***Advantages /role of secondary markets.***

- It gives investors a chance to buy or dispose their shares.
- It increases the divestments of investments.
- It improves corporate governance through separation of ownership and management.
- It provides investment opportunities for companies and small investors.

2. **Organized exchange versus over the counter market (OTC)**

   **Organized exchange** is where trading of securities is done by brokers and the buyers and sellers need not to be present. Trading is done electronically or via internet.

   **Over the counter** is where trading is usually organized by dealers or stock brokers themselves who buys the securities themselves and then sell them.

   ***Features of the OTC markets.***

   - Prices are relatively low.
   - It usually deals with new securities of the firm.
   - It is composed of small and closely held firms.

3. **Open versus negotiated market**

   ***An open financial market*** is where the instruments are sold to the highest bidder openly in the market.

   ***Negotiated market*** is where securities are sold to one entity or a few entities under private contract i.e. private placement.

4. **Money and capital market.**

   ***Money market*** is a market concerned with short-term financial securities. Financial instrument in money market includes commercial papers, treasury bills, and bill of exchange.

   **Functions of money market.**

   - It provides finance to solve the liquidity problems of the company.
   - It offers advice to the concerned parties.
   - It acts as a channel through which short term investment are offered to the general public
   - It acts as a source of finance to small businesses which are unable to raise funds in the capital market.

   ***The capital market***-is a market for long term sources of finance which are used to acquire fixed assets for company's development purposes.

***Factors contributing to the slow growth of capital market in emerging markets***.

1. Limited number of securities available for investing.
2. Lack of knowledge or lack of interest by ordinary citizen.
3. Low automation-market operation should be highly computerized and online.
4. High taxes on investment income earned in the capital market discourages investor
5. High growth of informal financial schemes as alternative investment avenues.
6. Inadequate legal framework.

7. Lack of transparency in stock exchange.
8. Low numbers of quoted companies due to stringent listing requirement.

## QUOTATION/LISTING OF COMPANIES.

This involves the company going public. When the companies goes public to issue security to the general public through the stock exchange.

**Advantages of quotation/going public.**

1. Risk diversification.
2. The quoted company will be able to raise funds from the public.
3. A company that is quoted is able to obtain underwriting facilities.
4. A listed company is able to raise permanent capital.
5. A listed company obtains some privileges from the government such as tax allowances.
6. A listed company will be able to compare its performance with similar companies.
7. Public company is perceived credit worthy.

**Disadvantages of being listed**

1. It leads to loss of confidential information to the public.
2. There are certain regulations and rules which govern the quotation of company.
3. Quotation involves several formalities such as getting permission fro CMA.
4. The existing shareholders may lose control as a result of quotation.
5. In-case the profits decreases and are not promising, it may be de-registered.

**FUNCTION OF A NATIONAL SECURITY EXCHANGE e.g. NSE.**

1. To aid in the mobilization of savings for investment.
2. To check against capital flight
3. To assist in separation of management from ownership thereby improving corporate governance.
4. To facilitate equity financing as opposed to debt financing
5. To enhance easier access to finance by new and smaller companies.
6. To encourage the quotation of private companies.

**ROLE OF THE SECURITY EXCHANGE IN ECONOMIC DEVELOPMENT**

1. Raising capital for business.
2. Mobilizing savings for investments.
3. Redistribution of wealth.
4. Improving corporate governance.
5. Creates investment opportunities.
6. Government source of capital.
7. Barometer of the economy.

**Factors to consider when buying shares of a company.**

- Integrity of the company's management.
- Economic conditions of the country to inflation.
- Nature of the product dealt with.
- Variety of companies operations.

- Company’s trading partners.
- Level of competition.
- Prospects of growth.

**THE STOCK MARKET INDEX.**

An index is a numerical figure which measures the relative change in variables between two periods. A stock index is therefore, measure of relative changes in price or values of shares.in order to construct the index, it is necessary to establish the base year. The NSE20 share index has 1996 as the base year. This index tracks performance of 20 key companies listed on the NSE. this include:mumias sugar, express Kenya, sasini tea, Kenya airways, KCB, kengen, centum, KPLC, EABL, bamburi cement, backlays Kenya, safaricom, national media group.

**Factors to consider when constructing an index.**

1. Need to choose a base year on which the base price changes.
2. The selection of the companies to be used in constructing the index.
3. Use of suitable weights to be attached to the security.

**Limitations/drawbacks of the NSE index.**

1. The 20 companies representing the index cannot be a true reflection of all the companies in Kenya.
2. The base year of 1996 is too far in the past.
3. Dormant firms-some of the companies forming the index are dormant with very little price changes.

**Rules governing floatation of new shares in the NSE.**

- The company must have an issued capital of at least sh 20m.
- The company must have made profits during the last 3 years.
- At least 20% of the issued capital should be offered to the public.
- The company should be registered under the companies Act CAP 486.
- The firm must issue the prospectus.

**THE CENTRAL DEPOSITORY SYSTEM (CDS)**

This is a computerized system established by the NSE that enables transfer of securities without the need for the physical movement of the securities. In this case the ownership is through the book entry instead of physical exchange.

**Advantages of CDS**

1. Reduced registration process in the stock exchange.
2. It improves the liquidity of the stock exchange leading to increase in turnover of equity.
3. It leads to efficient and transparent security market.
4. It improves communication between the company and the investors.
5. It reduces the clearing and settlement costs ie no need for preparing certificates.
6. It is faster and less risky which makes the market more attractive.
7. It reduces the chances of errors and fraud occurring.

**Disadvantages.**

1. Computer literacy is required in-order to operate CDS account.

2. There is ignorance on the art of investors on the availability of the CDS account.
3. Lack of active government participation in investment opportunities.

**Parties involved In CDS.**

- Government.
- Capital market authority (CMA)
- NSE
- Investors
- Brokers

**Central Depository Settlement Corporation (CDSR)**

This is the company in charge of the CDS operation in Kenya. It is owned by the brokers, the NSE and the CMA among others.

**Central Depository Agent**

These are agents authorized by the CDS to open accounts on behalf of the investors and clients.

**Immobilization.**

This involves the storage of security certificates in a vault to eliminate their physical use and movement. This is the first step in implementing the CDS system



## CROSS BOARDER LISTING.

This refers to the listing of securities issued by a foreign issuer on a domestic security exchange.

**Reasons for cross boarder quotation by a company**.

1. To boost its status as a truly global player.
2. To raise capital through debt or equity.
3. To increase trading volume.
4. To improve shareholders relation.
5. To improve the company's goodwill.
6. Acquisition of overseas investors and customers.
7. Mobilization of savings across region.
8. Risk diversification.

**Disadvantages**

1. Greater costs are involved in cross-listing.
2. Cultural and language difference.
3. Exchange rate differences.
4. Vast requirements.

## INTEREST RATE.

**Function of interest rate in the economy**

1. Interest rate determines the propensity of people to either save or consume.

2. Determines the velocity of money-how many times that the money supply turns over during the year.
3. Also determines which investment should or should not be made. This is according to the investor's expected rate of return.
4. Determines the discount rate that the government charges commercial banks.

**Determinants of interest rates.**

1. Economic condition
   Interest rate have a tendency to move up or down with changes in the volume of business activities.
2. Monetary policy
   Monetary policy refers to the policy adopted by the central bank of the country such as changes in rate of interest and the credit availability.
3. Bank rate
4. Expected rate of inflation
5. Government deficit.
6. International capital flow.

**THEORIES OF INTEREST RATES.**

1. **Classical theory.**
   Classical theory of interest rate compares the supply of savings with the demand for borrowing.
   It is determined by market forces for demand for borrowing and supply of savings.
2. **Liquidity preference theory**.
   Interest rate here is determined by motives for money. There are 3 major motives for money:
   - Transactional motive.
   - Precautionary motive
   - Speculative motive
3. **Loanable fund theory.**
   The loanable fund market is a hypothetical market that brings savers and borrowers together. Here the interest rate is determined by the real purchasing power.
4. **Market segmentation theory**
   The interest rate here is determined based on maturity time i.e. the shorter the period the lower the interest and vice versa.
5. **Rational expectation theory.**

**Theories of the term structure of interest rate.**

1. **The pure expectation theory.**
   This theory states that the shape of the yield curve depends on the market expectation about the future interest rate**.**
2. **The pure liquidation theory.**
   This theory states that investors prefers to have cash rather than investing even in low risk investment opportunities.
3. **The market segmentation theory.**

This states that the market is segmented into 2 categories i.e. market for short-term funds and market for long-term funds.

## INTERNATIONAL CAPITAL MARKET.

These are integrated capital market that deals with the international stock bonds and foreign currencies which are part of their transactions. Therefore these markets assist larger companies to raise fund to finance long-term projects. They include:

(a) **Euro bond**-they are bonds that are dominated in a currency, different from that of the country in which they are issued.
(b) **Foreign bonds**-they are bonds that are dominated in the currency of the country in which a foreign entity issues the bond.
(c) **Euro equity**-they issues securities which are exchanged in the listed companies across the world.

**Primary drivers of the international capital market.**

1. **Advancement of technology**-the use of internet and computer to facilitate the growth of the capital market
2. **Deregulation**-deregulation of the market by allowing not only domestic investors to investing the foreign market has facilitated the growth of the capital market.
3. **Development of financial institutions**-new financial institutions like the forward market and future market has contributed to the growth of the capital market.

**Motives for investing in the international capital market**

1. To take advantage of favorable economic conditions.
2. To take advantages of appreciation of the foreign currency against the domestic currency.
3. To benefit from international diversification.
4. Access to foreign commodities or product.

**Aims of regulating financial market.**

1. To prevent cases of market manipulation such as insider trading.
2. To ensure competence of the providence of financial services.
3. To protect clients interest and investigate their complaints.
4. To maintain confidence in the financial system.
5. To reduce violation of the financial laws.

**Benefits accruing from international trade and cross boarder investment**

1. Financial integration.
2. Benefits for competition in the international market.
3. Aid in the benefits of economies of scale.
4. Benefit for the consumers-consumer has a wide access to variety of products.

**Benefits of mobile money transfer.**

1. Security.
2. Convenience.
3. Reduced cash in the economy.
4. Low cost

5. Financial inclusion.
6. Mobility.

**MARKET SEGMENTATION.**

It is a financial market imperfection caused mainly by government constraint institutional practices and investors' perceptions. Therefore, they are event which make the market to be inefficient.

**Causes of capital market segmentation.**

1. Lack of transparency.
2. High securities transaction costs.
3. Foreign exchange risks.
4. Political risks
5. Corporate governance differences.
6. Regulation barriers
7. Asymmetrical information between the domestic and foreign based investors.

## INTERNATIONAL MONETARY FUND (IMF)

**Benefits of IMF**

1. To promote international monetary cooperation.
2. Assisting in stabilizing the currencies.
3. To facilitate the expansion and balanced growth of the international trade.
4. To promote the exchange rate stability.
5. To shorten the duration in the international balance of payment of the members.
6. To make resources available to its member who are experiencing BOP difficulties.

**Activities of IMF/Functions**

1. *Financial assistance*-this includes the credit and loan extended to the IMF member countries.
2. *Technical assistance*-this consists of the expertise and procedure which are extended to the members in handling the accounting transaction.
3. *Training official in financial matters for member countries*.

## WORLD BANK

It was established as a multi-lateral lending agencies focusing on the projects with long-term implications.

The objective was to promote economic and social progress in developing nations by helping to raise the productivity so that their people can live better lives. The sources of finance for the bank include:

1. Equity-this was capital contributed by member countries when joining the association.
2. Bonds-this was the amount raised from the world financial markets.
3. Private markets-these were finances from investment banks and commercial banks who were lending money to the institution.

**Reasons for the success in raising borrowed funds in the institution.**

1. Supportive conservative lending policies.
2. Strong financial backing by its members.
3. Prudent financial management.

**Types of projects assisted by the bank.**

- Health care. .education
- Family planning assistance .housing
- Nutrition .infrastructure

## THE CENTRAL BANK.

The central bank is an organ of the government that is responsible for supplying and regulation of money in circulation within an economy.

**Functions of the central bank.**

1. Is the regulator of the currency.
2. It is a banker/fiscal agent of the government.
3. Is the financial advisor of the government.
4. The custodian of cash reserve of the commercial banks.
5. The controller of the commercial banks.
6. Is the lender of the last resort.
7. The management and custody of the foreign exchange reserve.
8. Is the controller of credit.

**COMMERCIAL BANKS.**

These are established with the main goals of profit creation. The main source of earnings of these banks is the interest charged on loans advanced by the banks.

**Functions of the commercial banks.**

1. The issue of money inform of bank notes.
2. Settlement of payment.
3. The credit intermediation-they borrow and then lend.
4. Credit creation.

**MICRO FINANCE INSTITUTIONS (MFIs).**

MFI is an organization that provides financial services to the poor.

**Objectives of MFIs**

a. To improve the quality of life of the poor by providing access to financial and support services.
b. To be a viable financial institution developing sustainable communities.
c. To mobilize resources in order to provide financial and support services to the poor particularly women.
d. To create opportunity for self-employment for the under privileged.

e. To train the rural poor in simple skills and enable them utilize the available resources and contribute to employment in rural area.

**Challenges facing MFIs in developing countries.**

1. Perceived high risk of micro entrepreneurship and small entrepreneur usually has no collateral to offer to MFI for loans.
2. The high cost involved in small transactions.
3. Lack of debt and equity funds for the MFIs to pass on the poor capital availability.
4. Difficult in measuring the social performance of the MFIs.
5. Lack of customized solutions for the poor.
6. Lack of micro-finance training for human resource in MFI businesses.
7. Poor distribution system of MFIs and lack of information about the micro finance investment opportunities.
8. Mixing charity with business-this makes MFIs fall to protect loan repayment.

**Role of the government in supporting MFIs**

1. Setting dome macro-economic policies that provides sustainability and low inflation.
2. Avoiding interest rate ceiling.
3. Adjusting bank regulations to facilitate deposit taking by MFI.

## FINANCIAL INNOVATION.

This can be defined as an act of creating and then popularizing new financial instrument as well as new financial technologies.

**Factors that have led to financial innovation/engineering**

1. Increased interest rate fluctuations.
2. Frequency of tax and regulation changes.
3. Deregulation of financial service industry.
4. Increased competition within the investment banking.
5. Technological advancement.
6. Accounting benefits.
7. Changes in prices.
8. Opportunities to increase the asset liquidity.
9. Opportunity to reduce risk
10. Transaction cost

**Types of financial innovation.**

1. Security innovation.
2. Financial process innovation.
3. Creative solutions to the corporate finance problems.

**1. SECURITY INNOVATIONS.**

It is the development of the innovation financial instrument for consumer type applications and the corporate finance application. Examples include.

- New bank accounts for customer's e.g. personal loan, credit cards, savings account.

- Swaps using caps and floors.

2. **FINANCIAL PROCESS INNOVATION**
   This aims at to reflect the effort in reducing the transaction costs and the steps taken to reduce the idle cash balance and the availability of inexpensive computer technology to facilitate transaction.
   **Examples of process innovation include.**
   - Online banking.
   - Use of ATM's
3. **CREATIVE SOLUTIONS TO CORPORATE FINANCE PROBLEMS.**
   This involves corporate restructuring, which aim at managing the financial issues.it involves tax effect cash management strategies. Examples include.
   - Leases.
   - Project finance.
   - Corporate restructuring.

## FINANCIAL ENGINEERING.

It is defined as application of technical methods especially from mathematical finance.

**FINANCIAL LIBERIZATION**-this is where the market is influenced and controlled by the market forces ie demand and supply

**FINANCIAL REPRECISION**-is where the government gives policies which govern the financial markets.

## FINANCIAL INTERMEDIERIES.

These are institutions which acts as mediators between two parties in a financial transaction.it normally occur between borrowers and lenders. Examples of financial intermediaries will include:

- Banks
- Insurance companies
- Pension funds
- Mutual funds
- Government saving department

**Functions of financial intermediaries.**

1. Information
2. Regulation
3. Convenience-they are convenient.
4. Maturity transformation.
5. Risk reduction.

**Benefits of financial intermediaries in the economy.**

1. Facilitation of flow of funds.
2. Efficient allocation of funds.
3. Assistance in price discovery.
4. Money creation.

5. Enhanced liquidity for lenders.
6. Improve diversification for lenders.
7. Economies of scale.
8. Payment system.
9. Risk alleviation.
10. Money policy function.

## THE FINANCIAL SYSTEM.

This is a system that allows the exchange of funds between lenders, borrowers and investors.

**FUNCTIONS OF THE FINANCIAL SYSTEM**.

1. Saving function.
2. Wealth function-money and capital market provides an excellent way to store wealth until fund are needed for spending.
3. Liquidity function.
4. Credit function-the financial system provides a credit supply to support both consumption and investment spending in the economy.
5. Risk function.
6. Payment function-provides a mechanism for making payment for goods and services e.g. debit and credit card.
7. Policy function.

## ISLAMIC FINANCE

Islamic finance is the system of finance that follows the principles of sharia (Islamic law). It is influence by:

a. The Quran and its practices. Quran is the holy book of Muslims.
b. The Sunnah-this is the way of life prescribed as normative in Islam. It's based upon the teachings and practices of Prophet Mohammed.
c. The consensus of the Jurist and Inter prefers of Islamic laws.

**Principles of Islamic finance.**

1. No investment must be made in contradiction to the Sharia rules.
2. The investments must not deal items that are deemed undesirable and prohibited under sharia ie alcohol, gambling, drugs etc.
3. Risk relating to any transaction must be shared between at least two parties.
4. The following are prohibited:
    - Riba-taking or receiving interest.
    - Masir-speculation or gambling.
    - Gharar-uncertainity regarding the subject matter or the terms of the contract.

**Differences between Islamic finance and other convectional finance.**

| ISLAMIC FINANCE | CONVECTIONAL FINANCE |
|---|---|
| Adherence to Islamic principles. | Do not follow rules of any religion. |
| Islamic laws denounce recipient and payment | Receipt and payment of interest is allowed. |

| | |
|---|---|
| of interest. | |
| Prohibition on speculations ie risk contract not allowed. | No prohibition on speculations. |
| Goods forbidden under Islam are invalid. | No prohibition on goods |
| Trading on non-existent goods is void | Trading on non-existent goods with mutual consent of buyer or seller |
| Transaction before ownership of the subject of trade is void. | Ownership of subject of trade is not necessary. |
| Seller must have possession of subject of sale. | No restriction on possession of subject at sale |
| Sale must be instant and absolute | Sale can be made on future date |
| Sale must be unconditional | Sales can be conditional |

**INTEREST (RIBA)**

Riba means excess increase or additional under Islamic laws. It refers to any excess compensation without due consideration and is prohibited. Islam prohibits the supplier of funds from receiving only interest in return of prohibiting loan.

**INVESTMENT VEHICLES UNDER ISLAMIC FINANCE.**

1. **Equities**-investment in common shares is permitted if:
    - Entity's business is legal.
    - Is in compliance with sharia
    - Instead of directly buying shares of a company, an investor can also invest in Islamic mutual fund.
2. **Fixed income fund**-an Islamic investor can obtain fixed income by investing in real estate.
3. **Islamic financial securities**-they include:
   **(a).Trade credit (Murabaha).**
   Murabaha is the sale of an asset for a deferred price ie the whole price of the asset is not paid when the asset is purchased it is conducted because transactions that create debt are invalid under Islamic finance. It involves three parties:
    - The client
    - The seller
    - The financer of the asset

**Steps involved in Murabaha.**

i. The client and the financier sign an agreement.
ii. When the client requires a particular asset, the financier appoints the client as their agent to purchase on their behalf.
iii. The client buys the desired asset and takes its possession as an agent of the financier.

iv. The client informs the financier that it has purchased the asset on behalf of the financier and makes an offer to purchase the asset.
v. The financier accepts the clients offer and sells the asset to the client.

**Features of Murabaha.**

- It is form of cost-plus sale.
- Usually banks act as financier.
- In case of default, the buyer is liable for contracted sale price.
- It’s not a loan agreement.
- It’s a way of providing finance to a business to acquire assets.
- The installment to be paid by the buyer to the financier is determined before the asset is purchased.

**(b) Lease finance (IJARA)**

Ijara is a leasing contract. It allows one party to lease an asset for a specific time and cost.

**There are two types of lease.**

i. **Al-ijarah**-its where asset is leased for a very short period of time.
ii. **Al-ijarah wal iqtina (lease to purchase)**-there is an obligation to the lease to purchase the asset at the end of the lease period.

**Features of IJARA agreements.**

1. The lessor and the lessee agree in advance about the duration and rental fees of the lease.
2. The lessor cannot give the asset on lease until it has possession and legal ownership of the asset.
3. The leased item if transferred to lessee on completion of the lease on competition of the lease agreement must be fit to perform the required tasks.
4. Late payment of rental entities the lessor to terminate the Ijara immediately.
5. The lessor has a right to claim compensation for any damage caused to the leased assets due to the negligence of the lessee.

**(c) Equity finance (mudaraba).**

It is an agreement in which one entity provides the capital (financier) and another party entity provides expertise and management. The profits from the business are shared in predetermined ratios whereas the losses are borne by the financier (capital provider).

Mudaraba is commonly used for investment funds.

**(d) Debt finance (Sukuk)**

Sukuk are certificates that represent ownership of:

Debts, assets, projects, businesses, investments etc.

The Sukuk provide returns to their holders by:

- Giving them ownership of an asset.
- Giving them share of the rental income.
- Accumulating returns from various Sukuk.

**Features of Sukuk.**

1. No interest is paid on Sukuk.
2. They are asset-backed securities.
3. They have an active secondary market.
4. They represent proportional beneficial ownership In the asset.
5. Their holders are entitled to share in the proceeds at the realization at the Sukuk assets.

**(e) Venture capital (musharaka)**

Musharaka is a business relationship established under a contract with mutual consent of all the parties involved that sharing of profit and losses will take place in a specified joint business venture.

**Features.**

- All the partners/shareholders contribute funds to the business.
- All the partners have a right to participate in the business.
- The profit is shared in the agreed ratio.
- The losses are shared in the ration of capital invested by the partners.
- The capital contribution can be monetary or non-monetary.

## MAIN CONTRACTS IN ISLAMIC FINANCE

1. **Profit and loss sharing (Mudaraba)-**is a financial contract between two parties one being the provider of the capital and the other to provide labor.
2. **Joint venture (Musharaka)-**is a financial contract between two or more parties to establish a commercial enterprise based on capital and labor. The profit and loss are shared at an agreed proportion according to the amount of contribution.
3. **Cost plus (Murabaha)** - refers to the sale of a good or property with an agreed profit against a deferred payment or lump sum payment.
4. **Leasing (Ijarah)-**in which the two parties are involved ie the lessee and lessor.
5. **Salam**-is another contract where full payment for good is paid in advance but the delivery of the good is made at an agreed future date.

## SALAM AND ISTISNA CONTRACTS.

**SALAM CONTRACT**-is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at spot. Salam contract creates a moral obligation on the Salam seller to deliver the goods.

**ISTISNA CONTRACT**-in Islamic finance, ISTISNA is a contract to manufacture goods, assemble or process them and the payment is made when the good or property is finished

**Difference between SALAM and ISTISNA contract under Islamic finance (May 2017 q4c)**

1. The subject of istisna is always a thing which needs manufacturing, while Salam can be effected on anything, no matter it needs manufacturing or not.
2. It is necessary for Salam that the price is paid in full in advance, while it is not necessary in istisna.
3. The contract of Salam, once effected cannot be cancelled unilaterally, while the contract of istisna can be cancelled before the manufacturer starts the work.
4. The time of delivery is an essential part of the sale in salam while it is not necessary in istisna that the time of delivery is fixed.

**JUNE 2005 Q1B (Valuation of security.)**

Akili ltd has issued a debenture whose par value is sh 1000. The debenture can be redeemed at par after four years or converted to ordinary shares at a conversion rate of sh 100 per share. The projected market price of the share after the four year period could be either sh 90 or sh 120 based on the company's performance.

The investors required rate of return is 10%.

**Required:**

The value of the debenture based on each of the expected share price (8 mks)

**CONCEPT OF TIME VALUE OF MONEY.**

**QUESTION 1**

**Present value of single cash flows.**

Consider the following project which is expected to generate the following cash-flow.

| Year | 1 | 2 | 3 | 4 |
|---|---|---|---|---|
| Cash-flows | 120,000 | 80,000 | 70,000 | 60,000 |

If the discounting rate is 12%, determine the present value of the cash-flows.

**QUESTION 2**

**Present value of an annuity.**

Consider an investor who expects to receive sh 100,000 at the end of each year for the next 5 years. If the discounting rate is 10%, determine the present value of this cashflows.

**QUESTION 3**

**Present value of annuity in perpetuity**.

An investor expects to receive dividend income of sh 100,000 per annum to infinity. If the discounting rate is 10%, determine the present value of this dividend.

**QUESTION 4**

**Present value of differential annuities.**

Consider the following project which is expected to generate the following cashflows.

| Year | 1-4 | 5-9 | 10-α |
|---|---|---|---|
| cashflows | 50,000 | 90,000 | 40,000 |

If the cost of capital is 10%, determine the total present value.

**QUESTION 5**

**PAYBACK PERIOD**

Consider a 5 year project whose initial investment is sh. 100,000 and the project is expected to generate the following cashflows.

| Period | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Cash inflows | 35,000 | 30,000 | 35,000 | 25,000 | 20,000 |

Required:

a) Calculate the payback period of the project.
b) Calculate the payback period assuming the initial capital was 115,000

**QUESTION 6**

**IRR**

Consider the following projects with the following features.

| **project** | **Initial capital** | **Annual cashflows** | **Project life** |
|---|---|---|---|
| A | 15,000,000 | 3,286,800 | 7 years |
| B | 30,000,000 | 8,141,760 | 6 years |
| C | 10,000,000 | 5,000,000 | 3 years |

Determine the IRR of each project.