

Africa Center for Project Management (ACPM)

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**FINAL EXAMINATION**

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**FINANCIAL MANAGEMENT FINAL EXAMINATION**

**Answer all Questions**

1. Define the followings terms as used in Financial Management
2. **Accounting:**  Accounting is the process of recording financial transactions pertaining to a business. The financial statements used in accounting are a concise summary of financial transactions over an accounting period, summarizing a company's operations, financial position, and cash flows.
3. **Budgeting:** A budget is a formal statement of estimated income and expenses based on future plans and objectives. In other words, a budget is a document that management makes to estimate the revenues and expenses for an upcoming period based on their goals for the business.

Therefore **Budgeting** in brief is the process of preparing detailed projections of future amounts.

1. **Financial reporting standards:** Financial reporting standards provide principles for preparing financial reports and determine the types and amounts of information that must be provided to users of financial statements, including investors and creditors, so that they may make informed decisions.
2. **GAAP:** GAAP (generally accepted accounting principles) is a collection of commonly-followed accounting rules and standards for financial reporting. The acronym is pronounced "gap.” GAAP specifications include definitions of concepts and principles, as well as industry-specific rules. The purpose of GAAP is to ensure that financial reporting is transparent and consistent from one organization to another.

Generally accepted accounting principles (GAAP) refer to a common set of accounting principles, standards, and procedures issued by the Financial Accounting Standards Board (FASB).

b. Giving examples what are the advantages of financial ratios (10 marks)

Financial ratio analysis is a useful tool for users of financial statements because it allows them to compare a company's financial performance and financial position across time and with its competitors.

Therefore the strength of financial ratio analysis lies is its simplicity and comparability which helps us in the following ways:

* Financial ratio analysis simplifies a company's financial statements and allows us to express critical profitability and financial position information in just a few numbers. For example, net profit margin encapsulates the net effect of a company's revenues and all expenses. It enables us to reach a conclusion about a company's profitability without going through the company's income statement.
* It helps in comparing companies of different size with each other. For example, if Company A has a revenue twice the size of Company B, their net profit is not directly comparable unless we standardize it by dividing it by their net revenue. Financial ratio analysis helps with such standardization.
* It helps in trend analysis which involves comparing a single company over a period.
* It highlights important information in simple form quickly. A user can judge a company by just looking at few numbers instead of reading the whole financial statements.

Despite its usefulness, financial ratio analysis suffers from some drawbacks, including:

* Financial ratio analysis is useful only when comparison is made between two companies from the same industries. Many companies have multiple lines of business and their financial statements provide a composite view of the company. Comparing a company with industry average is not very useful because the average also includes companies who have been performing poorly.
* Different companies follow different financial reporting frameworks, which allow different accounting policies for identical transactions. In such a situation, it is important to adjust one company's financial statements. For example, if one company prepares its financial statements under IFRS and another follows US GAAP, we must convert the IFRS financial statements to US GAAP or vice versa.
* Management's ability to change assumptions potentially allows them to manage their ratios by changing accounting assumptions from period to period which could impairs the comparability of financial ratios.
* Ratio analysis explains relationships between past information while users are more concerned about current and future information.
* The calculation methodology of different ratios is not standardized. For example, some analysts calculate return on assets by dividing net income by average assets while others base on operating income and use closing total assets balance in the denominator.

Conclusively, Ratios measure companies' operational efficiency, liquidity, stability and profitability, giving investors more relevant information than raw financial data. Investors and analysts can gain profitable advantages in the stock market by using the widely popular, and arguably indispensable, technique of ratio analysis.

1. a) Outline the features of a sound investment appraisal technique [4 Marks]

**Investment Appraisal Techniques**. **Investment appraisal techniques** are payback period, internal rate of return, net present value, accounting rate of return, and profitability index. They are primarily meant to appraise the performance of a new project.

The features of a sound project appraisal technique are:

* It should consider the time value of money by discounting the cash flows.
* It should give a direct decision criterion on when to accept or reject a project.
* It should rank independent projects in order of their economic viability
* It should distinguish between acceptance and unacceptable projects which are mutually exclusive.
* It should generally be applicable to any conceivable project available.

(b) Clearly distinguish between the following terms as used in a financial system [6 Marks]

**(i) Money Market and Capital Market**: Money markets are used by government and corporate entities to borrow and lend in the short term. Capital markets are used for long-term assets, which are those with maturities of greater than one year.

**(ii) Primary Market and Secondary Market**: In the primary market, the investor can purchase shares directly from the company. In Secondary Market, investors buy and sell the stocks and bonds among themselves. ... In the Primary Market the amount received from the securities are the income of the company, but in the Secondary Market, it is the income of investors.

**(iii) Intermediation and disintermediation:** intermediation. The normal flow of money into financial institutions in the form of deposits, which are then loaned out to earn income. Contrast with disintermediation, which occurs when depositors take their money out of financial institutions because they can earn more money, relatively risk free, in other investments.

**(c) Explain briefly the factors that are considered when establishing a dividend policy for an organization by its directors. [5 Marks]**

Some of the most important determinants of dividend policy are: (i) Type of Industry (ii) Age of Corporation (iii) Extent of share distribution (iv) Need for additional Capital (v) Business Cycles (vi) Changes in Government Policies (vii) Trends of profits (vii) Trends of profits (viii) Taxation policy (ix) Future Requirements and (x) Cash Balance.

The declaration of dividends involves some legal as well as financial considerations. From the point of legal considerations, the basic rule is that dividend can only be paid out profits without the impairment of capital in any way. But the various financial considerations present a difficult situation to the management for coming to a decision regarding dividend distribution.

These considerations are discussed below:

**(i) Type of Industry:** Industries that are characterized by stability of earnings may formulate a more consistent policy as to dividends than those having an uneven flow of income. For example, public utilities concerns are in a much better position to adopt a relatively fixed dividend rate than the industrial concerns.

**(ii) Age of Corporation:** Newly established enterprises require most of their earning for plant improvement and expansion, while old companies which have attained a longer earning experience, can formulate clear cut dividend policies and may even be liberal in the distribution of dividends.

**(iii) Extent of share distribution:** A closely held company is likely to get consent of the shareholders for the suspension of dividends or for following a conservative dividend policy. But a company with a large number of shareholders widely scattered would face a great difficulty in securing such assent. Reduction in dividends can be affected but not without the co-operation of shareholders.

**(iv) Need for additional Capital:** The extent to which the profits are ploughed back into the business has got a considerable influence on the dividend policy. The income may be conserved for meeting the increased requirements of working capital or future expansion.

**(v) Business Cycles:** During the boom, prudent corporate management creates good reserves for facing the crisis which follows the inflationary period. Higher rates of dividend are used as a tool for marketing the securities in an otherwise depressed market.

**(vi) Changes in Government Policies:** Sometimes government limits the rate of dividend declared by companies in a particular industry or in all spheres of business activity. The Government put temporary restrictions on payment of dividends by companies in July 1974 by making amendment in the Indian Companies Act, 1956. The restrictions were removed in 1975.

**(vii) Trends of profits:** The past trend of the company’s profit should be thoroughly examined to find out the average earning position of the company. The average earnings should be subjected to the trends of general economic conditions. If depression is approaching, only a conservative dividend policy can be regarded as prudent.

**(viii) Taxation policy:** Corporate taxes affect dividends directly and indirectly— directly, in as much as they reduce the residual profits after tax available for shareholders and indirectly, as the distribution of dividends beyond a certain limit is itself subject to tax. At present, the amount of dividend declared is tax free in the hands of shareholders.

**(ix) Future Requirements:** Accumulation of profits becomes necessary to provide against contingencies (or hazards) of the business, to finance future- expansion of the business and to modernize or replace equipments of the enterprise. The conflicting claims of dividends and accumulations should be equitably settled by the management.

**(x) Cash Balance:** If the working capital of the company is small liberal policy of cash dividend cannot be adopted. Dividend has to take the form of bonus shares issued to the members in lieu of cash payment.

*Reference taken from 10 Most Important Determinants of Dividend Policy |* [*Financial Management*](https://efinancemanagement.com/financial-management)*. Your Article Library. February 2014.*

1. **a) Discuss the types of foreign exchange risks that a company operating  
   internationally may be exposed to. (10marks)**

**Foreign exchange risk** refers to the losses that an international financial transaction may incur due to currency fluctuations. Three types of foreign exchange risk are transaction, translation, and economic risk as discussed below:-

## Transaction exposure: The transaction exposure component of the foreign exchange rates is also referred to as a short-term economic exposure. This relates to the risk attached to specific contracts in which the company has already entered that result in foreign exchange exposures.

## Economic exposure: Economic exposure is a long-term effect of the transaction exposure. If a firm is continuously affected by an unavoidable exposure to foreign exchange over the long-term, it is said to have an economic exposure.

## Translation Exposure: Translation exposure of foreign exchange is of an accounting nature and is related to a gain or loss arising from the conversion or translation of the financial statements of a subsidiary located in another country. A company such as General Motors may sell cars in about 200 countries and manufacture those cars in as many as 50 different countries.

**b) Explain each of the following currency risk it can be used to mitigate foreign exchange risks.**

1. **Currency forward contracts**: Currency forward contracts are another option to mitigate currency risk. A forward contract is an agreement between two parties to buy or sell a specific asset on a particular future date, at one particular price. These contracts can be used for speculation or hedging.

Forwards are a tool for hedging risks. They are contracts between two parties that define the amount, date and rate for a future currency exchange. The exchange rate of the forward contract is usually calculated based on the current exchange rate and the differential in interest rates between both currencies.

1. **Currency futures contract**: Currency futures: Currency futures are used to hedge exchange rate risk because they trade on an exchange and need only a small amount of upfront margin. ... Currency options give an investor or trader the right to buy or sell a specific currency in a specified amount on or before the expiration date at the strike price.

An FX futures or currency futures contract is a type of foreign exchange derivative, where a buyer agrees to buy one currency in exchange for another currency, at a future date and at a current agreed upon price by both buyer and seller at the moment of creating the contract.

1. **Currency options**: Currency options offer another feasible alternative to hedging exchange rate risk. Currency options give an investor or trader the right to buy or sell a specific currency in a specified amount on or before the expiration date at the strike price.
2. **Currency swaps**: The purpose of a currency swap is to hedge exposure to exchange rate risk or reduces the cost of borrowing a foreign currency. A currency swap is similar to an interest rate swap, except that in a currency swap, there is often an exchange of principal, while in an interest rate swap, the principal does not change hands.

**c) How may global taxation affect the behavior of a transnational company?**

**(6marks)**

**How may global taxation affect the behavior of a transnational company**

Global taxation affect the behavior of transnational company in several ways as stated below:-

**Some problems are shared by domestic corporations**

* Taking advantage of limited liability example Mining companies take out resources, distribute profits, leaving no money to clean up mess
* Use of economic power to get favorable legislation such as Campaign contributions and Distorted information (cigarette companies, oil companies)
* Massive cheating in hard-to-detect ways for example even in U.S.—Exxon in Alaska and Alabama cases required extra-ordinarily sophisticated detection, beyond capability of most developing countries and if this happens in U.S., what must be happening elsewhere?

**Special Problems with multinationals**

* Powers—to get special legislation and treatment that benefits themselves, regulations, short circuiting environmental, health, worker regulations example Economic power often greater than that of country hence Revenues of GM greater than GDP of more than 148 countries
* Sometimes they seek, and get, special tax and tariff treatment; sometimes simply persuading governments not to enforce existing regulations—unlevel playing field, disadvantaging domestic businesses

3. Define and explain the relevance of the following accounting concepts:  
 **a) Accrual concept (3marks):**

**Accrual concept** is the most fundamental **principle** of **accounting** which requires recording revenues when they are earned and not when they are received in cash, and recording expenses when they are incurred and not when they are paid.

**b) Consistency principle (3marks)**

This concept requires that once an organization has decided on one method, it should use the same method for all subsequent transactions and events of the same nature unless it has sound reasons to change methods. If accounting methods are frequently changed, comparison of financial statements for one period with those of another period would be difficult.

The consistency principle states that, once you adopt an accounting principle or method, continue to follow it consistently in future accounting periods. Only change an accounting principle or method if the new version in some way improves reported financial results.

**c) Economic entity assumption (3 marks)**

The entity concept assumes that the financial statements and other accounting information are for the specific business enterprise which is distinct from its owners. Consequently, the analysis of business transactions involving costs and revenue is expressed in terms of the changes in the firm’s financial conditions.

Similarly, the assets and liabilities devoted to business activities are entity assets and liabilities. The transactions of the enterprise are to be reported rather than the transaction of the enterprise’s owners. This concept, therefore, enables the accountant to distinguish between personal and business transactions. The concept applies to sole proprietorship, partnership, companies, and small and large enterprise. It may also apply to a segment of a firm, such as division, or several firms, such as when inter-related firms are consolidated.

**d) Going concern (3marks)**

Going concern is an accounting term for a company that has the resources needed to continue operating indefinitely until it provides evidence to the contrary. If a business is not a going concern, it means it's gone bankrupt and its assets were liquidated.

The going concern concept is a fundamental principle of accounting. It assumes that during and beyond the next fiscal period a company will complete its current plans, use its existing assets and continue to meet its financial obligations.

An entity is assumed to be a going concern in the absence of significant information to the contrary. An example of such contrary information is an entity’s inability to meet its obligations as they come due without substantial asset sales or debt restructurings. If such were not the case, an entity would essentially be acquiring assets with the intention of closing its operations and reselling the assets to another party.