**FINANCIAL MANAGEMENT FINAL EXAMINATION**

1. Define the followings terms as used in Financial Management
2. Accounting:

Accounting is a systematic and comprehensive process of identifying, measuring, processing, classifying and recording of financial transactions pertaining to an economic entity. It refers to summarize, analyze and record such information to be reported to internal users such as management, employees and external users, such as investors, regulators, and the oversight agencies or tax officials.

In another term, Accounting is reporting the financial information using Generally Accepted Accounting Principle (GAAP) and International Financial Reporting Standards (IFRS). The Financial Accounting Standards Board (FASB), the Financial Reporting Council, the Securities and Exchange Commission (SEC), the IRS and other regulatory bodies set accounting standard and requirements for accounting preparation and presentation.

1. Budgeting

Budgeting and financial forecasting are tools that companies use to establish a plan regarding where management ideally wants to take the company (budgeting) and whether it is actually heading in the right direction (financial forecasting). Although budgeting and financial forecasting are often used together, distinct differences exist between the two concepts. Budgeting quantifies the expectation of revenues that a business wants to achieve for a future period, whereas financial forecasting estimates the number of revenues that will be achieved in a future period.

[A budget](https://www.investopedia.com/terms/b/budget.asp) is an outline of expectations for what a company wants to achieve for a particular period, usually one year. Characteristics of budgeting include:

\* Estimates of revenues and expenses

\* Expected cash flows

\* Expected debt reduction

A budget is compared to actual results to calculate the variances between the two figures.

1. Financial reporting standards

Financial reporting is the financial results of an organization that are released to the public. This reporting is a key function of the [controller](https://www.accountingtools.com/articles/2017/5/14/controller-job-description), who may be assisted by the [investor relations officer](https://www.accountingtools.com/articles/2017/5/14/investor-relations-officer-job-description) if an organization is [publicly held](https://www.accountingtools.com/articles/2018/2/16/publicly-held).

Financial reporting typically encompasses the following:

\* [Financial statements](https://www.accountingtools.com/articles/2017/5/10/financial-statements), which include the [income statement](https://www.accountingtools.com/articles/2017/5/17/the-income-statement), [balance sheet](https://www.accountingtools.com/articles/2017/5/17/the-balance-sheet), and [statement of cash flows](https://www.accountingtools.com/articles/2017/5/17/statement-of-cash-flows-overview)

\* Accompanying footnote disclosures, which include more detail on certain topics, as prescribed by the relevant [accounting framework](https://www.accountingtools.com/articles/2017/5/7/accounting-framework)

\* Any financial information that the company chooses to post about itself on its website

\* [Annual reports](https://www.accountingtools.com/articles/2017/5/5/annual-report) issued to shareholders

\* Any [prospectus](https://www.accountingtools.com/articles/2017/5/17/prospectus) issued to potential investors concerning the issuance of securities by the organization

1. GAAP

GAAP (generally accepted accounting principles) is a collection of commonly-followed accounting rules and standards for [financial reporting](https://searcherp.techtarget.com/definition/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](https://whatis.techtarget.com/definition/transparency) and consistent from one organization to another.

There is no universal GAAP standard and the specifics vary from one geographic location or industry to another. In the United States, the Securities and Exchange Commission ([SEC](https://searchfinancialsecurity.techtarget.com/definition/Securities-and-Exchange-Commission)) mandates that financial reports adhere to GAAP requirements. The Financial Accounting Standards Board (FASB) stipulates GAAP overall and the Governmental Accounting Standards Board (GASB) stipulates GAAP for state and local government. Publicly traded companies must comply with both SEC and GAAP requirements.

Many countries around the world have adopted the International Financial Reporting Standards ([IFRS](http://searchsecurity.techtarget.co.uk/definition/IFRS-International-Financial-Reporting-Standards)). IFRS is designed to provide a global framework for how public companies prepare and disclose their financial statements. Adopting a single set of world-wide standards simplifies accounting procedures for international countries and provides investors and auditors with a cohesive view of finances. IFRS provides general guidance for the preparation of financial statements, rather than rules for industry-specific reporting.

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

**\* A Standardized Method of Comparison**

Example:

An old company might boast 50 times the revenue of a new small business, which would make the older company seem stronger at first glance. Analyzing the two companies with ratios such as return on equity (ROE), return on assets (ROA) and net profit margin may reveal that the smaller company operates much more efficiently, generating substantially more profit per dollar of assets employed.

**\* Industry Analysis and Benchmarks**

Example:

Analysis may reveal that the average debt-to-equity ratio in the widget industry is .85; a company with a debt-to-equity ratio of 1.3 would be much more heavily leveraged than other widget manufacturers, even though its total debt may be vastly smaller than larger players' debt.

\* **Stock Valuation for Strength and Weakness**

**Example:**

Help investors and analysts to evaluate and communicate the strengths and weaknesses of individual companies or industries. A careful analysis of a company's ratios can reveal which companies have the fundamental strength to increase their stock value over time and are a potentially profitable opportunity, while pointing out the weaker players in the market as well.

\* **Planning and Performance**

**Example:**

Ratios can provide guidance to entrepreneurs when creating business plans or preparing presentations for lenders and investors. Using industry trends as a baseline, small-business owners can set time-bound performance goals in terms of specific ratios to give investors a glimpse into the potential of the new company. Ratios can also serve as an impetus for strategic change within an organization, providing management with relevant guidance and feedback as ratio valuations shift in response to organizational changes. Ratios keep managers on their toes by revealing financial weaknesses and opportunities.

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

Investment appraisal techniques are [payback period](https://efinancemanagement.com/investment-decisions/payback-period-pbp), [internal rate of return](https://efinancemanagement.com/investment-decisions/internal-rate-of-return-irr), [net present value](https://efinancemanagement.com/investment-decisions/net-present-value-npv), [accounting](https://efinancemanagement.com/financial-accounting/what-is-accounting) rate of return, and [profitability index](https://efinancemanagement.com/investment-decisions/profitability-index-pi-or-benefit-cost-ratio). They are primarily meant to appraise the performance of a new project. The first question that comes to our mind before beginning any new project is “Whether it is viable or profitable? These techniques answer this question very well. Each technique evaluates the project from a different angle and provides a different insight.

**1- Payback period:**

One of the simplest investment appraisal techniques is the payback period. Payback technique states how long does it take for the project to generate sufficient cash-flow to cover the initial cost of the project.

**2- Accounting rate and of return method:**

Accounting rate of return is an accounting technique to measure profit expected from an investment. It expresses the net accounting profit arising from the investment as a percentage of that capital investment. It is also known as [return on investment](https://efinancemanagement.com/financial-analysis/return-on-investment) or return on capital.

**3- Net value present:**

It is the most common method of investment appraisal. Net present value is the sum of discounted future cash inflow & outflow related to the project. Generally, the [weighted average cost of capital (WACC)](https://efinancemanagement.com/investment-decisions/wacc-calculation) is the discounting factor for future cash-flows in net present value method.

In essence, this method sums up the discounted net cash flows from the investment by the minimum required rate of return & deducts initial investment to give the ‘net present value’. The company should accept the project if the NPV is positive.

**4- International rate of return method:**

An internal rate of return is the discounting rate, which brings discounted future cash flow at par with the initial investment. In other words, it is the discounting rate at which the company will neither make loss nor make a profit.

**5- Profitability index**

Profitability index defines how much you will earn per dollar of investment. The present value of an anticipated future cash flow divided by initial outflow gives the profitability index (PI) of the project. It is also one of the easy investment appraisal technique.

**6- Discount payback period method:**

his method is the same as the payback period method. The only difference is, in discounting payback method is that payback period is calculated on the basis of discounted future cash-flows while in payback method it is calculated on basis of future cash-flows.

(b) Clearly distinguish between the following terms as used in a financial system  
  
(i) Money Market and Capital Market

[Money market](https://www.wallstreetmojo.com/money-market/) and Capital market are types of financial market. Money markets are used for [short-term lending or borrowing](https://www.wallstreetmojo.com/external-sources-of-finance/) usually the assets are held for one year or less whereas, Capital Markets are used for long-term securities they have the direct or indirect impact on the capital. Capital markets include equity market and debt market.

**1 – Money Markets:**

Money markets are unorganized markets where banks, financial institutions, money dealers and brokers trade in financial instruments for a short period of time. They trade in short-term debt instruments like trade credit, commercial paper, certificate of deposit, T bills etc. which are highly liquid and can be redeemed in the period less than 1.

**2 – Capital Markets:**

The capital market is a type of financial market where financial products like stocks, bonds, debentures are traded for a long duration of time. The serve the purpose of long-term financing and long-term capital requirement. The Capital market is a dealer and an auction market and consists of two categories:

(ii) Primary Market and Secondary Market

The Capital market is a dealer and an auction market and consists of two categories:

**\* Primary market**: A [primary market](https://www.wallstreetmojo.com/primary-market/) where the fresh issue of securities are offered to the public

**\* Secondary market**: A [secondary market](https://www.wallstreetmojo.com/secondary-market/) where issued securities are traded between the investors.

(iii) Intermediation and disintermediation [6 Marks]

Disintermediation removes the middleman from business transactions and by doing so improves the value of an existing product or service. Disintermediation is often accomplished by changing the perception of delivery. Inversely, intermediation injects a middleman between distribution channels e.g. a customer and businesses that previously sold directly to consumers. Intermediation gains traction when the platform is so large that companies can’t afford not leverage the platform to reach customers.

Disintermediation can take markets by surprise. Banking wasn't prepared, and neither was the music industry. The theme of digital disintermediation is harnessed well in the plight of the music industry with CD's and their struggle to maintain active control over distribution.

**Intermediation** almost more interesting than disintermediation – removing the middleman – is intermediation that adds the middleman back into the mix. Intermediation occurs when digital platforms inject themselves between the customers and a company.  These platforms are so large that businesses can’t afford not to reach customers through these platforms. Intermediation creates a dependency and disintermediation removes the dependency.  
  
(c) Explain briefly the factors that are considered when establishing a dividend policy for an organization by its directors. [5 Marks]

Based on control objective factors the management of a company is completely free to frame the required dividend policy. There are no obligations to be adhered to. So, the company needs to judiciously weight all the above-mentioned factors and formulate a balanced dividend policy. A dividend policy can also be revised in the wake of changes in any of the factors.

Considering the ownership structure factor, The ownership structure of a company also impacts the policy. A company with a higher promoter’ holdings will prefer a low dividend payout as paying out dividends may cause a decline in the value of the stock. Whereas, a high institutional ownership will favor a high dividend payout as it helps them to increase the control over the management.

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

[Foreign exchange](https://www.investopedia.com/terms/f/foreign-exchange.asp) risk refers to the losses that an international financial transaction may incur due to currency fluctuations. Also known as currency risk, FX risk and exchange-rate risk, it describes the possibility that an investment’s value may decrease due to changes in the relative value of the involved currencies.

There are three types of foreign exchange risk:

**1) Transaction risk:** This is the risk that a company faces when it's buying a product from a company located in another country. The price of the product will be denominated in the selling company's currency. If the selling company's currency were to appreciate versus the buying company's currency then the company doing the buying will have to make a larger payment in its base currency to meet the contracted price.

**2) Translation risk:** A parent company owning a subsidiary in another country could face losses when the subsidiary's financial statements, which will be denominated in that country's currency, have to be translated back to the parent company's currency.

**3) Economic risk:** Also called forecast risk, refers to when a company’s [market value](https://www.investopedia.com/terms/m/marketvalue.asp) is continuously impacted by an unavoidable exposure to currency fluctuations.

b) Explain each of the following currency risk it can be used to mitigate  
foreign exchange risks.  
  
 a) Currency forward contracts. (3marks)

[Currency forwards](https://www.investopedia.com/terms/c/currencyforward.asp) can be effectively used to hedge currency risk. While the advantage of forward contracts is that they can be customized to specific amounts and maturities, a major drawback is that they are not readily accessible to individual investors.  
 b) Currency futures contract. (3marks)

[Currency futures](https://www.investopedia.com/terms/c/currencyfuture.asp) are used to hedge exchange rate risk because they trade on an exchange and need only a small amount of upfront [margin](https://www.investopedia.com/terms/m/margin.asp). The disadvantages are that they cannot be customized and are only available for fixed dates.

c) Currency options (3marks)

[Currency options](https://www.investopedia.com/terms/c/currencyoption.asp) offer another feasible alternative to hedging exchange rate risk. Currency options give an investor or [trader](https://www.investopedia.com/terms/t/trader.asp) the right to buy or sell a specific currency in a specified amount on or before the [expiration date](https://www.investopedia.com/terms/e/expiration-date.asp) at the [strike price](https://www.investopedia.com/terms/s/strikeprice.asp).

d) Currency swaps (3marks)

The availability of ETFs that have a specific currency as the [underlying asset](https://www.investopedia.com/terms/u/underlying-asset.asp) means that currency ETFs can be used to hedge exchange rate risk. This is probably not the most effective way to hedge exchange risk for larger amounts. However, for individual investors, their ability to be used for small amounts and the fact that they are margin-eligible and can be traded on the long or short side leads them to provide major benefits.  
  
  
c) How may global taxation affect the behavior of a transnational  
company? (6marks)

Taxation is a vital means by which companies contribute to societies around the world. As business moves beyond borders, governments must ensure that taxation is transparent and non-discriminatory so that the benefits of open trade and investment flow to all.

As a key lever in national governments’ toolkits, taxation can often prove difficult to coordinate between different countries across the globe. International coordination, however, is essential if companies are going to invest internationally and participate in world trade.

Uncoordinated unilateral or bilateral actions by governments can lead to increased risks of double taxation—where companies are taxed more than once on the same earnings—unfair competition and greater uncertainty over the tax consequences of cross-border transactions in a way that impede and distort international trade and investment.

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

Financial statements are prepared under the Accruals Concept of accounting which requires that income and expense must be recognized in the accounting periods to which they relate rather than on cash basis. An exception to this general rule is the cash flow statement whose main purpose is to present the cash flow effects of transaction during an accounting period.

Under Accruals basis of accounting, income must be recorded in the accounting period in which it is earned. Therefore, accrued income must be recognized in the accounting period in which it arises rather than in the subsequent period in which it will be received. Conversely, prepaid income must be not be shown as income in the accounting period in which it is received but instead it must be presented as such in the subsequent accounting periods in which the services or obligations in respect of the prepaid income have been performed.

b) Consistency principle (3marks)

The consistency principle states that, once you adopt an [accounting principle](https://www.accountingtools.com/articles/what-are-accounting-principles.html) or method, continue to follow it consistently in future [accounting periods](https://www.accountingtools.com/articles/what-is-an-accounting-period.html). Only change an accounting principle or method if the new version in some way improves reported financial results. if you make such a change, fully document its effects and include this documentation in the notes accompanying the [financial statements](https://www.accountingtools.com/articles/2017/5/10/financial-statements).

[Auditors](https://www.accountingtools.com/articles/2017/5/5/auditor) are especially concerned that their clients follow the consistency principle, so that the results reported from period to period are comparable. This means that some audit activities will include discussions of consistency issues with the management team. An auditor may refuse to provide an opinion on a client's financial statements if there are clear and unwarranted violations of the principle.

c) Economic entity assumption (3 marks)

The economic entity assumption is an accounting principle that separates the transactions carried out by a business entity and its owner. It could also apply to various divisions within the same company. Each unit must maintain separate accounting records that specifically pertain to its business operations.

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. This term also refers to a company's ability to make enough money to stay afloat or avoid [bankruptcy](https://www.investopedia.com/terms/b/bankruptcy.asp). If a business is not a going concern, it means it's gone bankrupt and its assets were [liquidated](https://www.investopedia.com/terms/l/liquidate.asp).