Final Examination

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Course: Diploma in Financial Management for NGO’S.

Final Examination

1. **Define the followings terms as used in Financial Management**
2. **Accounting** - It is a systematic process of identifying, recording, measuring, classifying, verifying, summarizing, interpreting and communicating financial information. It reveals profit or loss for a given period, and the value and nature of a firm's assets, liabilities and owners' equity.
3. **Budgeting:** Budget is an estimate or plan of expenditure in relation to Income, or periodic estimate of an organization’s revenue and expenditure. Most of the literature define a Budget as a quantitative expression of a proposed plan of action by management for a specified period, budget is a financial map or plan, written in terms of money or numbers. A budget is financial plan that quantifies future expectations and actions relative to acquiring and using resources, budgets don, t guarantee success, but they certainly help to avoided failure.
4. **Financial reporting standards**—It’s the process that The Organization should maintain and report financial data using any accepted accounting standards e.g. the Generally Accepted Accounting Principles (GAAP) Basis, International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) etc
5. GAAP.. Generally Accepted Accounting Principles (GAAP) is promulgated by IFAC - International Financial Accounting Standards Committee.

The financial statements of the Organization shall be prepared in accordance with International Financial Reporting Standards and in compliance with the National Laws & Acts.

***In order to comply with GAAP, the following concepts must be reflected:***

**Accruals concept:** accruals basis records expenditure and revenue when they become due (i.e. in many cases before the associated cash flows take place). Before it records assets and liabilities and therefore involves with provision of depreciation on assets with finite lives and production of balance sheets.

**Matching Concept:** is based on the assumption that period costs are expensed as incurred and matched against related revenue in the appropriate period.

**Recognition Concept:** is based on the assumption that revenue is recognized when the earnings process is virtually complete and an exchange transaction has occurred.

**Historical Cost Concept:** is based on the assumption that GAAP normally requires assets and liabilities to be accounted for and reported on the basis of acquisition price.

**Stable Money Concept:** is based on the assumption that the monetary unit is relevant, simple, universally available, understandable, and useful.

**Going Concern Concept:** is based on the assumption that the business enterprise should have a long life.

**Materiality Concept:** is based on the assumption that an item is material if its inclusion or omission would influence or change the judgment of a reasonable person in his/her review of financial statements.

**Cost/Benefit Concept:** is based on the assumption that the costs of providing information must be weighed against the benefits that can be derived from using that information.

**Flexibility:** the accounting policies and procedures must undergo regular review and revision when changes in corporate policy or governing accounting principles deem it appropriate.

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

Financial ratios can help to make sense of the overwhelming amount of information that can be found in a company's financial statements.

Knowing how to pick out small bits of important information, combine them with other small

bits of information and interpret the resulting number is more of an art than a science. But it's

undoubtedly one of the most important arts that an investor should practice.

To start your journey into ratio analysis, you'll need a company's consolidated financial

statements, found in a company's website. The three most important financial statements are the income statement, balance sheet and cash flow statement. Track these down before proceeding further. While there are quite a few financial ratios, investors use a handful of them over and over again. These 15 ratios are indispensable tools that should be a part of every investor's research process. Price Ratios Price ratios are used to get an idea of whether a stock's price is reasonable or not. They are easy

to use and generally pretty intuitive, but do not forget this major caveat: Price ratios are

"relative" metrics, meaning they are useful only when comparing one company's ratio to another company's ratio, a company's ratio to itself over time, or a company's ratio to a benchmark.

**1) Price-to-Earnings Ratio (P/E)**

What you need: Income Statement, Most Recent Stock Price

The formula: P/E Ratio = Price per Share / Earnings Per Share

What it means: Think of the price-to-earnings ratio as the price you'll pay for $1 of earnings. A very, very general rule of thumb is that shares trading at a "low" P/E are a value, though the definition of "low" varies from industry to industry.

**2) PEG Ratio**

What you need: Income Statement, Most Recent Stock Price

The formula: PEG Ratio = (P/E Ratio) / Projected Annual Growth in Earnings per Share

What it means: The PEG ratio uses the basic format of the P/E ratio for a numerator and then divides by the potential growth for EPS, which you'll have to estimate. The two ratios may seem to be very similar but the PEG ratio is able to take into account future earnings growth. A very generally rule of thumb is that any PEG ratio below 1.0 is considered to be a good value.

**3) Price-to-Sales Ratio**

What you need: Income Statement, Most Recent Stock Price

The formula: Price-to-Sales Ratio = Price per Share / Annual Sales Per Share

What it means: Much like P/E or P/B, think of P/S as the price you'll pay for $1 of sales. If

you are comparing two different firms and you see that one firm's P/S ratio is 2x and the other is 4x, it makes sense to figure out why investors are willing to pay more for the company with a P/S of 4x. The P/S ratio is a great tool because sales figures are considered to be relatively

reliable while other income statement items, like earnings, can be easily manipulated by using

different accounting rules.

**4) Price-to-Book Ratio (P/B)**

What you need: Balance Sheet, Most Recent Stock Price

The formula: P/B Ratio = Price per Share / Book Value per Share

What it means: Book value (BV) is already listed on the balance sheet, it's just under a

different name: shareholder equity. Equity is the portion of the company that owners (i.e.

shareholders) own free and clear. Dividing book value by the number of shares outstanding gives you book value per share.

Like P/E, the P/B ratio is essentially the number of dollars you'll have to pay for $1 of equity.

And like P/E, there are different criteria for what makes a P/B ratio "high" or "low."

**5) Dividend Yield**

What you need: Income Statement, Most Recent Stock Price

The formula: Dividend Yield = Dividend per Share / Price per Share

What it means: Dividends are the main way companies return money to their shareholders. If a firm pays a dividend, it will be listed on the balance sheet, right above the bottom line.

Dividend yield is used to compare different dividend-paying stocks. Some people prefer to invest in companies with a steady dividend, even if the dividend yield is low, while others prefer to invest in stocks with a high dividend yield.

**6) Dividend Payout Ratio**

What you need: Income Statement

The formula: Dividend Payout Ratio = Dividend / Net Income

What it means: The percentage of profits distributed as a dividend is called the dividend

payout ratio. Some companies maintain a steady payout ratio, while other try to maintain a

steady number of dollars paid out each year (which means the payout ratio will fluctuate). Each

company sets its own dividend policy according to what it thinks is in the best interest of its

shareholders. Income investors should keep an especially close eye on changes in dividend

policy.

Profitability Ratios Profitability ratios tell you how good a company is at converting business operations into profits. Profit is a key driver of stock price, and it is undoubtedly one of the most closely followed metrics in business, finance and investing.

**7) Return on Assets (ROA)**

What you need: Income Statement, Balance Sheet

The formula: Return on Assets = Net Income / Average Total Assets

What it means: A company buys assets (factories, equipment, etc.) in order to conduct its

business. ROA tells you how good the company is at using its assets to make money. For

example, if Company A reported $10,000 of net income and owns $100,000 in assets, its ROA is 10%. Forever $1 of assets it owns, it can generate $0.10 in profits each year. With ROA, higher is better.

**8) Return on Equity (ROE)**

What you need: Income Statement, Balance Sheet

The formula: Return on Equity = Net Income / Average Stockholder Equity

What it means: Equity is another word for ownership. ROE tells you how good a company is at

rewarding its shareholders for their investment. For example, if Company B reported $10,000 of

net income and its shareholders have $200,000 in equity, its ROE is 5%. For every $1 of equity

shareholders own, the company generates $0.05 in profits each year. As with ROA, higher is

better.

**9) -Profit Margin**

What you need: Income Statement

The formula: Profit Margin = Net Income / Sales

What it means: Profit margin calculates how much of a company's total sales flow through to the

bottom line. As you can probably tell, higher profits are better for shareholders, as is a high

(and/or increasing) profit margin.

Liquidity Ratios

Liquidity ratios indicate how capable a business is of meeting its short-term obligations.

Liquidity is important to a company because when times are tough, a company without enough

liquidity to pay its short-term debts could be forced to make unfavorable decisions in order to

raise money (sell assets at a low price, borrow at high interest rates, sell part of the company to a

vulture investor, etc.).

**10) Current Ratio**

What you need: Balance Sheet

The formula: Current Ratio = Current Assets / Current Liabilities

What it means: The current ratio measures a company's ability to pay its short-term liabilities

with its short-term assets. If the ratio is over 1.0, the firm has more short-term assets than short

term debts. But if the current ratio is less than 1.0, the opposite is true and the company could be

vulnerable to unexpected bumps in the economy or business climate.

**11) Quick Ratio**

What you need: Balance Sheet

The formula: Quick Ratio = (Current Assets - Inventory) / Current Liabilities

What it means: The quick ratio (also known as the acid-test ratio) is similar to the quick ratio in

that it's a measure of how well a company can meet its short-term financial liabilities. However,

it takes the concept one step further. The quick ratio backs out inventory because it assumes that

selling inventory would take several weeks or months. The quick ratio only takes into account

those assets that could be used to pay short-term debts today.

Debt Ratios

These ratios concentrate on the long-term health of a business, particularly the effect of the

capital and finance structure on the business:

**12) Debt to Equity Ratio**

What you need: Balance Sheet

The formula: Debt-to-Equity Ratio = Total Liabilities / Total Shareholder Equity

What it means: Total liabilities and total shareholder equity are both found on the balance sheet.

The debt-to-equity ratio measures the relationship between the amount of capital that has been

borrowed (i.e. debt) and the amount of capital contributed by shareholders (i.e. equity).

Generally speaking, as a firm's debt-to-equity ratio increases, it becomes more risky because if it

becomes unable to meet its debt obligations, it will be forced into bankruptcy.

**13) Interest Coverage Ratio**

What you need: Income Statement

The formula: Interest Coverage Ratio = EBIT / Interest Expense

What it means: Both EBIT (aka, operating income) and interest expense are found on the income statement. The interest coverage ratio, also known as times interest earned (TIE), is a measure of how well a company can meet its interest payment obligations. If a company can't make enough to make interest payments, it will be forced into bankruptcy. Anything lower than 1.0 is usually a sign of trouble. Efficiency Ratios

These ratios give investors insight into how efficiently a business is employing resources

invested in fixed assets and working capital. It's can also be a reflection of how effective a

company's management is.

**14) Asset Turnover Ratio**

What you need: Income Statement, Balance Sheet

The formula: Asset Turnover Ratio = Sales / Average Total Assets

What it means: Like return on assets (ROA), the asset turnover ratio tells you how good the

company is at using its assets to make products to sell. For example, if Company A reported

$100,000 of sales and owns $50,000 in assets, its asset turnover ratio is 2x. Forever $1 of assets

it owns, it can generate $2 in sales each year.

**15) Inventory Turnover Ratio**

What you need: Income Statement, Balance Sheet

The formula: Inventory Turnover Ratio = Costs of Goods Sold / Average Inventory

What it means: If the company you're analyzing holds has inventory, you want that company to be selling it as fast as possible, not stockpiling it. The inventory turnover ratio measures this efficiency in cycling inventory. By dividing costs of goods sold (COGS) by the average amount of inventory the company held during the period, you can discern how fast the company has to replenish its shelves. Generally, a high inventory turnover ratio indicates that the firm is selling inventory (thereby having to spend money to make new inventory) relatively quickly

1. **A) Outline the features of a sound investment appraisal technique**

**[4 Marks]**The features of a sound investment appraisal technique are: It should consider the time value of money by discounting the cash flows. – here are some highlight

**Characteristics**

* Reliability and Validity: ...
* An Atmosphere of Confidence and Trust: ...
* Immediate Superior as Appraiser: ...
* Less Time Consuming and Economical: ...
* Open Communication: ...
* Post Appraisal Interview: ...
* Job Relatedness:  
  **(b) Clearly distinguish between the following terms as used in a financial system**:  
  (i**) Money Market and Capital Market**: Money market and Capital market are types of financial market. Money markets are used for short-term lending or borrowing 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.  
  (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, security can be sold only once, whereas in the secondary market it can be done an infinite number of times.  
  **(iii) Intermediation and disintermediation:** 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. [6 Marks]  
    
  **(c) Explain briefly the factors that are considered when establishing a dividend policy for an organization by its directors. [5 Marks**

The following are the various factors that have a bearing on the dividend policy:

**Factor # 1. Nature of Earnings:**

The nature of business has an important bearing on the dividend policy. The industrial units that are having stability of earnings may formulate (adopt) stable or a more consistent dividend policy than other that are having variations in earnings, because they can predict easily their earnings.

Firms that are involved in necessities suffer less from stable incomes than the firms that are involved in luxury goods. The industries/firms that are having stable earnings can adopt stable or high dividend policy, while the other firms that are having variations in earnings should follow a variable or low dividend policy.

**Factor # 2. Age of Company:**

The age of company has more impact on distribution of profits as dividends. A newly started and growing company may require much of its earnings for financing expansion programms or growth requirements and it may follow rigid dividend policy, wherein most of the earnings are retained.

On the other hand, an old company with good track record and good name in the public can formulate a clear cut and more consistent dividend policy. This type of companies may even pay 100 per cent dividend payout ratio and the required amount for growth can be raised from public.

**Factor # 3. Liquidity Position of Company:**

Generally, dividends are paid in the form of cash, hence it entails cash. Although, a firm may have sufficient profits to declare dividends, it may not have sufficient cash to pay dividends. Thus, availability of cash and sound financial position of the firm are an important factor in taking dividend decision.

The liquidity of a company depends very much on the investment and financial decisions of a firm, while in turn determining the rate of expansion and the manner of financing. If cash position of a firm is weak, stock dividend will be better and if cash position is good it can go for payment of dividend by cash.

**Factor # 4. Equity Shareholders Preference for Current Income:**

Legally, the Board of Directors has discretion to decide the distribution of the earnings of a firm. The shareholders who are legal owners of the firm appoint the (BODs). Hence, directors have to take into consideration owners’ preferences, while deciding dividend payment. Shareholders’ preference for current dividends or capital gains depends on their economic status and the effect of tax differential on dividends and capital gains.

When shareholders have more preference in current dividend than capital gains, the firm may require to follow liberal dividend policy. On the other hand, if shareholders prefer capital gains (it may be due to tax or economically sound) than the current dividend then the firm may require to retain more earnings.

**Factor # 5. Requirements of Institutional Investors**:

Institutional investors like LICs, GICs and Mutual funds (UTI), have an investment policy, which says that these type of institutes have to invest only in companies that have a continuous dividend payment record with stability. They purchase large blocks of shares relatively retail investors to hold or retain for a long period of time. Hence, they represent a significant force in the financial markets, and their demand for company’s securities may increase share price and thereby owners’ wealth.

To attract institutional investors firms may require to follow a stable dividend policy. Apart from theoretical postulates for the desirability of stable dividends, there are also many empirical studies, classic among them being that of Limner, to support the viewpoint that companies pursue a stable dividend policy. Most firms are in favour of stable dividend per share but they are very careful not to raise dividends per share to a level that can safely be sustained in the future.

This cautious creep up of dividends per share results in stable dividend per share pattern during fluctuating earnings per share periods, and a rising step function pattern of dividends per share during increasing earnings per share periods.

**Factor # 6. Legal Rules:**

Legal rules are significant as they provide framework within which dividend policy is formulated. In other words, dividend policy of a firm has to be evolved within the legal framework and rules and regulations. The legal rules have to do with capital impairment rule, net profits and insolvency rule.

**i. Capital Impairment Rule**:

First these provisions require that the dividend can be paid from earnings either from current year earnings or from past years’ earnings and reflected in the earned surplus. If firm pays dividend out of capital that adversely affects the security of its lenders. The purpose of this rule is to protect creditors (preference shareholders and auditors of the firm) by providing sufficient equity base because they have originally relied on that base. Therefore, the financial manager should keep in mind the legal rules while declaring dividends.

**ii. Net Profits:**

This rule is essentially a result of the earlier rule. A firm can pay cash dividends within the limits of current profits plus accumulated balance of retained earnings. According to Sec. 205 of the Companies Act, 1956 provides that dividends shall be declared or paid only from current profits or past profits after recovery of depreciation.

But Central Govt, is empowered to allow (only in public interest) any company to pay dividends for any financial year out of profits of the company without providing depreciation. A firm can take profits of past years if the current year’s profits are not sufficient to maintain stable dividend policy.

If there are any losses that are carried forward, they should be set off from the current year’s earnings before declaration of dividends. So financial manager within the boundaries, at the same time, he has to consider many financial variables and constraints in deciding the amount that is paid as dividends.

**iii. Insolvency Rule:**

A firm is said to be insolvent in two cases. One, in a legal sense, the recorded value of liabilities exceeding the recorded value of assets, or second, as in a technical sense, as the firm’s inability to pay its creditors as obligations come due. If the firm is insolvent in either sense, it is prohibited from the payment of dividends. The rationale of this rule is to protect the creditors.

**Factor # 7. Contractual Requirements:**

Generally, lenders may put conditions in a bond indenture or loan agreement which often includes a restriction on the payment of dividend. This is done to protect their interests when the firm is experiencing low liquidity or profitability.

The restrictions may be in three forms:

Firstly, firms may be prohibited from paying dividends in excess of a certain percentage say 10 per cent.

Secondly, a ceiling in terms of net profits that may be used for dividend payment may be laid down. Say only 50 per cent of net profits or a given absolute amount of net profits can be paid as dividends.

Finally, dividends may be restricted by insisting upon a minimum of earnings to be retained. Re-investment reduces debt-equity ratio, which enhances the margin of pillow for the lenders. Therefore, keeping in mind all the restrictions of lenders dividend declaration should be done.

**Factor # 8. Financial Needs of the Company:**

This is one of the key factors, which influence the dividend policy of a firm. Financial needs means funds required for foreseeable future investment. The required funds may be determined with the help of long-term financial forecasts. A firm that has sufficient profitable investment opportunities, it should follow low dividend payout ratio.

On the other hand, a firm that has no profitable investment opportunity or few investment opportunities adopts high dividend payout ratio (that low retention) because owners’ can reinvest dividends elsewhere at higher rate of return than the firm can do and nominal retention of profit is required to replace and modernise firm’s assets.

**Factor # 9. Access to the Capital Market (External Sources):**

Access to the capital market means the firm’s ability to raise funds from the capital market. A company, which has easy access to the capital market, provides flexibility in deciding dividend policy.

Easy access to capital market is possible only when companies are well-established and hence, have a profit track record. Generally, dividend policy and investment decisions are interrelated, but in this situation they are independent. The management may tempt to declare a high rate of dividend that attracts investors and maintain existing shareholders.

On the other hand, a firm that has difficulty in accessing capital market to raise required funds, will not be able to pay more dividends. It has to depend on internal funds, so management should follow a conservative dividend policy by maintaining a low rate of dividend and plough back a sizeable portion of profits to face any contingency.

Likewise, the term lending financial institutions advance loans on stiffer terms, it may be desirable to rely on internal sources of financing and accordingly conservative dividend policy should be pursued.

**Factor # 10. Control Objective**:

Control on the company is also an important factor, which influences dividend policy. When a firm distributes more earnings as dividends in the form of cash it reduces its cash position. As a result, the firm will have to issue shares to the public to raise funds required to finance investment opportunities that leads to loss of control, since, the existing shareholders will have to share control with new owners.

Financing investment projects by way of internal source avoids loss of control. Hence, if the shareholders and management of the firms are reluctant to dilution of control, thus the firm should retain more earnings for investment programmes, by following a conservative dividend policy.

**Factor # 11. Inflation:**

Inflation is the state of economy in which the prices of products or goods have been increasing. Inflation is a factor that influences dividend policy indirectly. Indian accounting system is based on historical costs.

The funds accumulated from depreciation may not be sufficient to replace the outdated asset or equipment, since depreciation is provided based on historical costs. Consequently, to replace assets and equipment, firm has to depend upon retained earnings, this leads to the payment of low dividend, during inflation period.

**Factor # 12. Dividend Policy of Competitors:**

Keeping one eye on the competitors’ dividend policy is very important. If the firm wants to retain the existing shareholders or it wants to maintain share price in the market, and if it is planning to raise funds from the public for expansion programms, it has to pay dividends on par with competitors. Hence, it is one of the factors that influence dividend policy of a firm.

**Factor # 13. Past Dividend Rates of the Company:**

This is the factor that influences the dividend policy of an existing company (that has already paid dividends). Owners and prospective investors prefer stability in dividends. Generally, firms’ tries to maintain stability in dividends that is based on past dividend rates of the company. Hence, directors will have to keep in mind the past dividend rates while declaring dividends.

**Factor # 14. Others: Apart from the above there are some other factors,** which influence dividend policy of a firm, such as trade cycles, corporate taxation policy, and attitude of investors group and repayment of loan.]

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

Companies are exposed to three types of risk caused by currency volatility:

1. Transaction exposure. This arises from the effect that exchange rate fluctuations have on a company's obligations to make or receive payments denominated in foreign currency. ... the transaction exposure (or translation exposure) is the level of uncertainty businesses involved in international trade face. Specifically, it is the risk that currency exchange rates will fluctuate after a firm has already undertaken a financial obligation.
2. Translation exposure. ... Translation exposure (also known as translation risk) is the risk that a company's equities, assets, liabilities or income will change in value as a result of exchange rate changes. This occurs when a firm denominates a portion of its equities, assets, liabilities or income in a foreign currency.
3. Economic (or operating) exposure. Economic exposure, also known as operating exposure refers to an effect caused on a company's cash flows due to unexpected currency rate fluctuations. Economic exposures are long-term in nature and have a substantial impact on a company's market value.   
     
   **b) Explain each of the following currency risk it can be used to mitigate  
   foreign exchange risks.**  
     
    **a) Currency forward contracts. (3marks)**  A currency forward is a binding contract in the foreign exchange market that locks in the exchange rate for the purchase or sale of a currency on a future date. ... Currency forwards are OTC contracts traded in forex markets that lock in an exchange rate for a currency pair.  
    b) Currency futures contract. (3marks) A currency future, also known as an FX future or a foreign exchange future, is a futures contract to exchange one currency for another at a specified date in the future at a price (exchange rate) that is fixed on the purchase date; see Foreign exchange derivative. Typically, one of the currencies is the US dollar.  
    **c) Currency options (3marks)** A currency option (also known as a forex option) is a contract that gives the buyer the right, but not the obligation, to buy or sell a certain currency at a specified exchange rate on or before a specified date. For this right, a premium is paid to the seller.  
    **d) Currency swaps (3marks)** A currency swap is an agreement in which two parties exchange the principal amount of a loan and the interest in one currency for the principal and interest in another currency. At the inception of the swap, the equivalent principal amounts are exchanged at the spot rate.  
   c**) How may global taxation affect the behavior of a transnational  
   company? (6marks)** through which international tax rules affect the costs of international business activities ... reform. The Context: Multinational Firms, FDI, and International Tax Rules ... Feldstein's paper makes clear that domestic policymakers might consider the .... tems behave as though they face additional costs when taking advantage of.

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

Accrual Concept. 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)**

Consistency Concept. The concept of consistency means that accounting methods once adopted must be applied consistently in future. ... If for any valid reasons the accounting policy is changed, a business must disclose the nature of change, the reasons for the change and its effects on the items of financial statements

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

In accounting, an economic entity is one of the assumptions made in generally accepted accounting principles. ... The "Economic entity assumption" states that the activities of the entity are to be kept separate from the activities of its owner and all other economic entities.  
 **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.

**Thanks you.**

**Mr. John Gatwich Kuol.**

**Final Examination.**