FM.

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Introduction to FM

- Finance is a branch of economics which deals with generation & allocation of the company's scarce resources to the projects available. (to the competing needs of the company).
- Allocation of the co.s resources is affected by the market forces of dd & ss.

The scope of a finance manager is described by the functions of a finance manager.

Function of a finance Manager

There are in 2 categories

i) Managerial functions ii) Routine Functions.

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i) Managerial functions N.B These are technical finance ma...

a) Invest / Capital Budgeting decisions
This involves commitment of ē co.s resources amongst the competing needs of ē co. or in ē long term projects in ē co.
It is therefore the responsibility of the finance manager to identify ē projects in w/c the co. should invest in.

b) Working Capital Management (CA - CL)
Working capital (w.c) is the current assets less current liabilities.
2:1 CA/CL - It is a role of the FMr to maintain ē w.c at the required level inorder to improve the profitability & liquidity of ē co.

c) Financing Decisions
This involves raising funds from various sources (loans, shares) of finance with an aim of minimizing the cost of raising the finances.

d) Dividend Policy Decisions.
Dividends are part of the earnings which are distributed to the ordinary shareholder for their investment in the co.
It is ē role of ē FMr to determine ē amnt of divident to be paid, to ē ordinary s/hs.

ii) Routine Functions.
They do not require technical expertise & knowledge of a FMr.
They are supportive to the managerial functions and can be delegated to the junior staff in the finance dept.
They include:
1. Implementing the internal controls in the finance dept.
2. Receipt & Payment of cash
3. Issue of cash
4. Safeguarding important financial documents etc

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1. wc mgt
2. Investment decisions
3. Dividend policy
4. Financing decisions

Goals of a Firm.

They are categorised into 2 as follows
i) Financial Goals   ii) Non-financial goals.

i) Financial Goals

They include:
- Profit maximization Goal
- Wealth Maximization Goal
- Leverage/Gearing Goal

Profit Maximization Goal May 2017 Q.5a.

Profit is the difference btn the sales & the purchases.
This operate under the objective assumption that the co. operates in full capacity.
In order for a co. to maximize profit it will do the following 2 ways:

1. Increase the selling price while holding the expenses constant.
2. Holding the sales constant while reducing the expenses.

Advantages of Profit Maximization Goal.

1. All bss are set up to make primarily profit.
2. Profitability is a barometer to measure the efficiency & economic prosperity of a business.
3. Profitability is the main source of finance for the growth of a business.
4. Profitability is essential in fulfilling the social responsibility goals.

Disadvantages of Profit Maximization Goal.

1. It is a short term objective which is inconsistent with going concern concept.
2. It is ambiguous/fake. It is not precise on what profit is being maximized e.g GP, PBT, NP

3. It ignores the concept of time value of money.
4. It ignores other stakeholders who are interested in the company.
5. It is associated with the sole proprietorship bs & therefore it may not be applicable in the partnership bs.

Wealth Maximization Goal

These are benefits received by the shareholders. The benefits includes: The dividends received each end of year end & the capital gains.

When these two benefits are added together & expressing to the present value terms they can be used to determine the value of the company.

Advantages of Wealth Maximization Goal

1. It is a long term objective which is consistent with the going concern concept.
2. It takes into account, the concept of time value of money by computing the present value of all its expected future benefits.
3. It is applicable in the modern cooperate setup of joint ownership.
4. It considers the risks associated with a given cash flow by computing the present value of the cashflow.

Disadvantages of Wealth Maximization

1. It ignores the welfare of other interested parties in the bs.
2. It is subjective since it uses the future cash flows which are highly risk.
3. It assumes that the cost of capital does not stand.

May 2017 5c.

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June 2008 Q1a
Sept 2015 Q2a - Pilot Paper

Target Gearing/Leverage Goal

- Gearing/Leverage refers to the extend to which the company has borrowed the external capital in order to finance its activities
- The capital structure w/c is attractive to all investors & which will increase the value of co. is known as the optimal capital structure
- The capital structure refers to the long term sources of finance employed by the company.
- The long term sources of finance include; equity, preference shares and debentures.
- The financial structure of a company refers to both the longterm and short term sources of finance employed by the company.
- Therefore, the capital structure is part of the financial structure.
- The short term sources of finance include; creditors, accruals and bank overdraft etc.

ii) Non - Financial Goals.

These are the social responsibilities of the company. They include.

1. Welfare to the employees/workers.

They expect fair renumeration, fair promotion policies, good working conditions, training and refreshment programs, good retirement benefits e.t.c.

2. Welfare to the gov't.

Gov't expects prompt payment of taxes, compiling with the rule & regulations of the business, dealing with legal business activities e.t.c.

3. Welfare to the community.

Community expects the organization to employ the community members, participate in the community development programs e.t.c.

Agency Theory Concept

The concept explains the r/ship that exist ~~b/w~~ when one party known as the principal appoints another party known as the agent to act on his behalf.

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They are various categories of agency r/ship w/c includes:

i) Shareholders Vs Management
ii) Creditors Vs Shareholders
iii) Gov't Vs shareholders.
iv) Shareholders Vs Auditors.

Shareholders Vs Management

Whenever there is separation of ownership from control, they may arise a conflict of interest between the shareholders and the managers which include: (causes of conflict of interest)

i) Incentive problems

Managers normally earn a fixed salary and they may not be motivated to work hard because irrespective of the profit that they make, their salaries remain constant.

ii) Differences in the risk profile.

Managers normally prefer investing in low risky investment w/c have low returns however, the s/h prefer high risk high return investment.

iii) Evaluation Horizon

Managers normally prefer undertaking projects w/c are profitable in the short run in order to take credit on their work. However, s/hs prefer undertaking projects w/c are profitable in the long run since it is consistent with the going concern accounting concept.

iv) Creative Accounting

This involves manipulation of the accounting policies to report high profits through the changes in stock valuation methods & recognizing profit immediately in the long term project.

v) Persuing power & Self-esteem goals

Managers prefer to manage big organization. They facilitate the growth or expansion of the organization w/c is achieved through merger & acquition. Therefore, it will affect the ownership & control on the side of the s/hs.

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Solutions to the Agency Problems (Shareholders Vs Management)

1. Threat of firing the managers; Shareholders normally appoint the managers during the AGM and therefore can threaten to fire them especially where they are not meeting the target.
2. Threat of hostile takeover; If the managers are not performing as expected, the s/hs can threaten to sale the co. to ē competitors.
3. Performance based compensation; In this case, managers will be compensated based on their performance.
4. Incurring agency cost; These are costs that will be incurred as a result of the agency r/ship problems. They include monitoring costs, cost incurred to prevent undesirable behaviour on the side of the mgt. Inspection cost → This cost may include external audit fee, internal control system e.t.c.
5. Direct intervention by the shareholders; This whereby the s/hs will directly intervene & show the mgt how they want the company to be run

Creditors Vs Shareholders.

- In this case the creditors are the principal while the s/hs are the agents.

The s/hs may affect the gain of the creditors hence causing conflict of interest in the following ways:

i) By investing the borrowed capital on high risk high return investment than the expected projects.

ii) By selling the ~~security~~ asset that was offered as a security (collateral) to obtain ē loan capital

iii) By borrowing additional debt capital. This will take priority in repayment.

iv) By paying high dividends so that there is no retained earnings for the payment of the loan capital.

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Solutions to Agency Problems (Creditors Vs Shareholders)

1. By setting restrictive convenants i.e. these are terms and conditions set by creditors eg. no additional borrowing.
2. By having a representative in the company's Board of Directors to represent the interest of ē creditors.
3. Demanding for the security before giving the credit
4. Recalling the amnt advanced as creditor if ē s/hs are not compling with the terms of the loan agreement.
5. Collaborability - They come together to do the business as one.
6. Convertability - This is where the debt holders can convert their debt into ordinary shareholders.

Dec 2013 Q1a.
Causes of conflict btn s/hs & Debt ~~holders~~ creditors.

Government Vs Shareholders.

In this case, the Gov't is the principal while the s/hs are the agent.

The s/hs can affect the pstn of the Gov't hence as causing conflict of interest in the following ways.

i) Engaging in illegal business activities
ii) Avoiding investment in some businesses or areas considered to be risky.
iii) Avoiding payment of taxes.
iv) Not taking part in corporate social responsibilities.

Solutions to Agency Problems (Gov't Vs Shareholders)

1. The Gov't should offer incentives to encourage investments in some areas.
2. The Gov't should incur monitoring cost such VAT inspection fee e.t.c.
3. The Gov't should appoint one of its own in the Board of ē co. to represent its interest.
4. Legistlations - The Gov't can put in place legal framework to control or to cover the operations of the business.

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Shareholders vs Auditors

In this case, the s/h is the principal while the auditors are the agent. The s/hs normally appoints auditor to monitor the performance of the management. however, the auditor may affect the position of the s/hs causing conflicts in the following ways:

i) Colliding with the management in their performance of the audit duties whereby their independence may be compromised
ii) By demanding high audit fee which reduces the profits of the company.
iii) By issuing reports w/c are misleading to the shareholders & the general public.
iv) Failure to apply profession care and due deligence in the performance of their audit work.

Solutions to Agency Problems (Shareholders V. Auditors)

1. Taking legal actions; The s/hs can institute legal proceedings against the auditors who issue misleading reports for damages.
2. Firing auditors; Auditors may be removed from the offices by the s/hs during the AGM.
3. Disciplinary actions by the professional bodies i.e ICPAK; This will lead to the withdrawal of their practising certificate.
4. Audit committee and Audit reviews.

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