COURSE CONTENTS

COURSE

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Lecturer Data: Mr Ibrahim Ayomide (B.SC, M.SC)

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Week 1	Dividend Policy and Implications
Week 2	Valuation of Shares
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ACT 418

FINANCIAL MANAGEMENT II

Dividend Policy and Implications

Learning Objectives:

At the end of this class, you should be able to:

1. Define dividend policy.
2. Explain the impact that the issue of dividends may have on a company's share price
3. Explain the theory of dividend irrelevance.
4. Discuss the influence of shareholder expectations on the dividend decision.
5. Discuss the influence of liquidity constraints on the dividend decision.
6. Define and distinguish between bonus issues and scrip dividends.

Main Content

Dividend

The term dividend refers that portion of after-tax profits which is distributed among the shareholders of the company. It is the reward paid to the shareholders for investments made by them in the shares of the company. In short, dividend is the part of profits distributed among the shareholders. Dividend is paid in cash. It is paid out of profit after depreciation and tax.

Types of Dividend

Cash dividend: This is the most popular form of dividend. It is the dividend paid to shareholders in cash. The cash dividend may be of the following two types

(a) Regular or final dividend: lt is the dividend declared and paid at the end of trading period After final accounts have been prepared

(b) Interim dividend: It is the dividend declared before the declaration of the final dividend. This is declared at any time between the two annual general meetings.

2. Stock dividend: Companies not having sufficient cash generally pay dividend in the form of shares by capitalising the past reserves and profits. Such shares are called bonus shares.

3. Scrip dividend: In case a company does not have sufficient funds to pay dividend in cash, it may issue transferable promissory notes for a shorter maturity period for amounts due to shareholders. This is called scrip dividend.

4. Bond dividend: In rare cases, dividends are paid in the form of debentures or bonds or notes for a long-term period bearing interest at fixed rate. A company issues bonds by way of dividend when it does not have enough funds to pay cash dividend.

5. Property dividend: Sometimes dividend is paid in the form of asset instead of paying dividend in cash.

Mechanics and Practices of Dividend Payment Procedure of Dividend Payment)

1. Declaration date: The declaration date indicates when the Board of Directors meets to declare dividend. It should be noted that the words 'regular and interim are used to impart a message to the shareholder. In a legal sense, they have no meaning

2. Amount: The dividend notice also indicates the amount that shall be paid as dividends

3. Holder of record date: The holder of record date indicates the date on which the company opens the Register of Members to determine who will receive dividends. Anyone holding share on the holder of record date receives the dividend declared.

4. Ex-dividend date: The date from which the stock begins to trade without the right to receive the dividend declared is known as "ex-dividend date". The ex-dividend date helps avoid conflict regarding dividend payments to existing shareholders. Usually the right to the dividend remains with the stock until two days before the holder-of-record date. Who buys the stock on or after the ex-dividend date does not get the dividend?

5. Payment date: The dividend cheques or dividend warrants are mailed to shareholders payment date.

Dividend Policy

"Dividend policy means the practice that management follows in making dividend payout decisions, or in other words, the size and pattern of cash distributions over the time to shareholders.". In other words, dividend policy is the firm's plan of action to be followed when dividend decisions are made. It is the decision about how much of earnings to pay out as dividends versus retaining and reinvesting earnings in the firm.

Factors or determinants of dividend policy (Considerations of dividend policy)

A. Internal factors

• stability and size of earnings

The stability and size of a company's earnings are crucial determinants of its dividend policy. Companies with consistent and ample earnings are more likely to pay regular dividends to shareholders.

• Liquidity of funds

The availability of liquid funds influences a company's ability to distribute dividends. Companies need to maintain sufficient liquidity to fund their operations, investments, and future growth initiatives while also meeting dividend obligations.

• Investment opportunities and shareholder’s preference

The availability of liquid funds influences a company's ability to distribute dividends. Companies need to maintain sufficient liquidity to fund their operations, investments, and future growth initiatives while also meeting dividend obligations.

• Attitude of management towards control

Management's attitude towards maintaining control over the company's retained earnings can influence dividend decisions. Some management teams may prefer to retain earnings to fund future growth or acquisitions rather than distributing them as dividends.

• Past dividend rates

Historical dividend payment patterns and rates may influence future dividend policy decisions. Companies often strive to maintain or increase dividend payouts over time to signal financial stability and shareholder value

• Ability to borrow

The company's ability to access external financing through borrowing may affect dividend policy. Companies with limited borrowing capacity may prioritize retaining earnings to finance operations and investments rather than relying solely on debt financing.

B. External factors

• Trade cycle

Economic conditions and fluctuations in the business cycle can impact dividend policy. During economic downturns or recessions, companies may reduce or suspend dividend payments to conserve cash and navigate financial challenges

• Legal requirements

Legal regulations and requirements imposed by regulatory authorities may dictate dividend policy decisions. Companies must comply with laws governing dividend distributions, including restrictions on the use of retained earnings and payment timelines.

• Corporate tax

Tax implications, including corporate tax rates and tax treatment of dividends, influence dividend policy. Companies may adjust dividend payouts based on tax considerations to maximize shareholder value and minimize tax liabilities.

• General state of economy

Overall economic conditions, including inflation rates, interest rates, and market stability, can impact dividend policy. Economic uncertainties may prompt companies to adjust dividend payments in response to changing market conditions and investor expectations.

Types of dividend policy

1. Stable Dividend Policy

Stable dividend means payment of certain minimum amount of dividend regularly. The features are:

(a) Constant dividend per share

(b) Constant percentage of earnings

(c) Constant dividend per share plus extra dividend

Advantages of Stable Dividend Policy

Advantages to shareholders

- It increases the confidence of the shareholders.
- A stable dividend policy meets expectations of investors who are generally income conscious.
- Stable dividend policy attracts investments from institutional investors who wishes always stable rate of dividend.
- It stabilises the market value of shares

Advantages to company

- It increases the goodwill and credit worthiness of the company.
- It helps in preparing financial planning easily
- It is a sign of continued normal operations of the company

Dangers of Stable Dividend

1. Once stable dividend is followed by a company; it is not easy to change it.

2. If the company cannot pay stable dividend in one year, the investors may lose confidence in the company and they may dispose of their holdings.

3. If the company pays stable dividend in spite of its incapacity, it will be suicidal in the long run.

2. Regular and Extra Dividend Policy

Under this policy shareholders are paid a constant rupee dividend as a fixed percentage (called regular dividend) along with extra dividends

3. Regular Stock Dividend Policy

This is the policy of distributing shares (bonus shares) in lieu of (or in addition to cash dividend to the existing shareholders. Such a policy results in increase in the number of outstanding shares of the company.

4. Regular Dividends Plus Stock Dividend Policy This is the policy of giving regular (stable) dividend in cash and extra dividend in stock (shares).

5.Irregular Dividend Policy This policy is adopted by companies having highly unstable earnings. Under this policy, higher rates of dividends shall be paid in the years of higher profits and lower rates of dividends in the years of lesser profits.

Dividend Pay-out Ratio

Dividend pay-out ratio is the percentage or ratio of dividend to the earnings. In other words, it is the percentage share of net earning distributed to the shareholders as dividends. In short, it is the ratio between dividend and earnings. Pay-out ratio and retention ratio are the two terms related to earnings and dividends. These are expressed as follows:

$$\text{Dividend pay-out ratio} = \frac{\text{Dividend Per Share}}{\text{Earnings Per Share}}$$

$$\text{Retention Ratio} = \frac{\text{EPS-DPS}}{\text{EPS}}$$

Alternative to Cash Dividends

1. Scrip dividends

A scrip dividend is a dividend paid by the issue of additional company shares, rather than by cash. When the directors of a company would prefer to retain funds within the business but consider that they must at least a certain amount of dividend, they might offer equity shareholders the choice of a cash dividend or a scrip dividend.

Advantages of scrip dividends

(a) They can preserve a company's cash position if a substantial number of shareholders take up the share option.

(b) Investors may be able to obtain tax advantages if dividends are in the term of shares. (c) Investors looking to expand their holding can do so without incurring the transaction costs of buying more shares

2. Stock split

A stock split occurs where, for example, each ordinary share of N1 each is spilt into two shares of 50K each, thus creating cheaper shares with greater marketability. The difference between a stock split and a scrip issue is that a scrip issue coverts equity reserves into share capital, whereas a stock split leaves reserves unaffected

Theories of Dividend Policy

Traditional Approach

The traditional approach to the dividend policy was given by Mr. B Graham and D.L. Dodd and it lays clear relationship between dividends and the stock market prices. According to this approach, the stock value responds positively to higher dividends and negatively with low dividends.

The Relevance Concept of Dividends: According to this school of thought, dividends are relevant and the amount of dividend affects the value of the firm. Walter, Gordon and others propounded that dividend decisions are relevant in influencing the value of the firm. Walter argues that the choices of dividend policies almost and always affect the value of the enterprise.

The Irrelevance Concept of Dividend: The other school of thought propounded by Modigliani and Miller in 1961. According to MM approach, the dividend policy of a firm is irrelevant and it does not affect the wealth of the shareholders. They argue that the value of the firm depends on the market price of the share; the dividend decision is of no use in determining the value of the firm.

The most important theory explaining this irrelevance concept is Modegliani - Miller Theory. The market value of the shares is not affected by the dividend payment. Hence shareholders would be indifferent between dividend and retention of earnings. As far as shareholders are concerned whether the company pays dividend or retains earnings, it would not affect them. MM dividend irrelevance hypothesis also implies that the shareholders are indifferent between dividends and capital gains. When a shareholder gets dividend, he can either spend for consumption or invest it. On the other hand, if the dividend is not paid, even then the market value of shares will increase. This happens because retained earnings increase and the company does not raise funds either through equity or debt.

Assumptions of MM Theory

1. There are perfect capital markets.

2. Investors behave rationally.

3. There are either no taxes or there are no differences in the tax rates applicable to capital gains and dividend

4. There are no floatation and transaction costs

5. The firm has a fixed investment policy

6. No investor is large enough to affect the market price of shares

Criticisms of the Theory

1. Perfect capital market does not exist in reality

2. While issuing shares the company will have to incur floatation cost.

3. Taxes do exist. Usually capital gains are taxed at a lower rate than dividend income

4. While selling shares investors have to pay brokerage, fees etc. (transaction cost).

5. Most of the shareholders prefer current income rather than future capital gains.

6. Firms need not follow a fixed investment policy

The second theory is the Residual Theory of Dividend. According to this theory, dividend decision has no effect on the wealth of shareholders or the prices of the shares and hence it is irrelevant so far as valuation of firm is concerned. This theory regards dividend decision merely as a part of financing decision because earnings available may be retained in the business for re-investment. But if the funds are not required in the business they may be distributed as dividends. Thus, the decision to pay dividend or retain the earnings may be taken as residual decision. This theory assumes that investors do not differentiate between dividends and retentions by firm. Their basic desire is to earn higher return on their investment. In case the firm has profitable opportunities giving higher rate of return than cost of retained earnings, the investors would be content with the firm retaining the earnings to finance the same. However, if the firm is not in a position to find profitable investment opportunities, the investors would prefer to receive the earnings in the form of dividends. Thus, a firm should retain earnings if it has profitable investment opportunities otherwise it should pay them as dividends.

WALTER'S MODEL:

Walter's model, one of the earlier theoretical models, clearly indicates that the choice of appropriate dividend policy always affects the value of the enterprise. Professor James E. Walter has very scholarly studied the significance of the relationship between the firm's internal rate of return, r, (or actual capitalization rate) and its Cost of Capital, Ke (normal capitalization rate) in determining such dividend policy as will maximize the wealth of the stockholders.

The dividend policy of a firm depends upon the relationship between r and ke. If r> ke (i.e., in case of a growth firm) the firm should have zero pay-out (i.e., no dividend) and reinvest the entire profits to earn more than the investors, If however, r If r = ke (i.e., in case of a normal firm), the shareholders will be indifferent whether the firm pays dividends or retains the profits. In such a case, the return to the firm from reinvesting the retained earnings will be just equal to the earnings available to shareholders on their investment of dividend income.

a) If r> ke the payout ratio should be zero (ie., 100% retention ratio)

b) If r< ke the payout ratio should be 100% (ie zero retention ratio)

c) If r= ke the dividend is Irrelevant and the dividend policy is not expected to affect the market value of the share

Walter's model is based on the following premises:

(1) The firm finance its entire investments by means of retained earnings. New equity stock or debenture is not issued to raise funds.

(2) Internal rate of return (r) and cost of capital (Ke) of the firm remain constant.

(3) The firm's earnings are either distributed as dividends or reinvested internally.

(4) Earnings and dividends of the firm never change.

(5) The firm has long or infinite life

Criticisms of Walter's Model

1. The assumption that investments are financed through retained earnings is not true. External sources are also used.

2.The IRR and cost of capital do not remain constant.

3. We cannot predict that the firm has a very long life.

4. Risk factor is not considered (because it assumes that EPS is constant)

Walter's formula for determining the value of share

$P = D/K + \{r(E-D)/K\}/K$

Where P = Market price per share

D = Dividend per share

r = internal rate of return

E = earnings per share

K = Cost of equity capital

Illustration 4.1

A company has an EPS of Rs. 15. The market rate of discount applicable to the company is 12.5%. Retained earnings can be reinvested at IRR of 10%. The company is paying out Rs.5 as a dividend.

Calculate the market price of the share using Walter's model.

Here, D = 5, E = 15, k = 12.5%, r = 10%

Market price of the share = $P = 5/.125 + \{.10 * (15-5)/.125\} /.125$ =Rs. 104

Gordon's Model

M. Gordon has also given a model on the line of Walter. He suggested that dividends are relevant and it will affect the value of the firm. He argued that the value of a rupee of dividend income is more than the value of a rupec of capital gain. This is on account of uncertainty of future and discounting future dividends by shareholders at a higher rate. According to Gordon the market value of a share is equal to the present value of future infinite stream of dividends. Gordon argues that investors prefer current dividends rather than capital gains, Dividends are more predictable than capital gains. Investors value current dividends more highly than an expected future capital

gain, Gordon's model is also known as bird in hand argument. It is called so because this model is based on the assumption that shareholders prefer to receive current dividend rather than distant capital gain.

Assumptions

1. The firm is an all equity firm.

2. Retained earnings are the only source of financing the investment programme

3. The rate of return on the firm's investment (r) is constant.

4. The growth rate of the firm 'g is the product of its retention ratio b' and its rate of return to i.e., $g = b \times r$

5. Cost of capital is constant and it is more than the growth rate.

6. The firm has long-term life.

7. Corporate taxes do not exist.

Symbolically: -

$$P_o = \frac{E_1 (1-b)}{K-br}$$

Where Po = Market price of equity share

E = Earnings per share of firm.

b = Retention Ratio (1 – payout ratio)

r = Rate of Return on Investment of the firm.

K = Cost of equity share capital

br = g i.e. growth rate of firm.

Exercise 2

Raja company earns a rate of 12% on its total investment of Rs. 6,00,000 in assets. It has 6,00,000 outstanding common shares at Rs. 10 per share. Discount rate of the firm is 10% and it has a policy of retaining 40% of the earnings. Determine the price of its share using Gordon's Model. What shall happen to the price of the share if the company has payout of 60% (or) 20%?

Solution

According to Gordon's Model, the price of a share is

$$P_o = \frac{E_1 (1-b)}{K-br}$$

Given: E= 12% OF Rs. 10= Rs.1.20

r = 12% = 012

K = 10% = 0.10

t= 10%= 0.10

b= 40% =0.40

Put the values in formula:

$$P_o = \frac{1.20\ (1-.40)}{10-(0.40 * 012)}$$

$$= \frac{1.20 * (0.60)}{10-0.048}$$

$$= \frac{0.72}{0.052}$$

=13.85

If the firm follows a policy of 60% payout, then b= 20% =0.20

The Price is $P = \frac{1.20\ (1 * 0.20)}{0.10-(0.2 * 0.12)}$

=0.05

r= 4%, =0.04, D= 25% of 10 = 2.50

$$= \frac{2.50 + \frac{0.04}{0.12}\ (10-2.50)}{0.12}$$

=41.67

ACT 418

VALUATION OF SHARES

Learning Objectives

At the end of this unit, you should be able to:

1. Explain valuation of shares
2. State the various methods of valuing shares

Main Content

Valuation of Share

For anyone involved in the field of corporate finance, understanding the mechanisms of company valuation is an indispensable requisite. In spite of the given quoted prices of a company on the Stock Exchange, there is need to devise techniques for estimating the value of its share. However, a share valuation is also necessary for both listed and unlisted companies because of certain circumstances.

The circumstances are as follows:

(a) For quoted companies, when there is a take-over bid and the offer price is an estimated "fair value" in excess of the current market price of the shares;

(b) For unquoted companies, when;

i) The company wishes to "go public" and must fix an issue price for its share;

ii) There is a scheme of merger, and a value of shares for each company involved in the merger must be assessed;

iii) Shares are sold;

iv) Shares need to be valued for the purpose of taxation;

v) Shares are pledged as collateral as loan

(c) For subsidiary companies, when the group's holding company is negotiating the sale of the subsidiary to a management buy-out team or to an external buyer

In general terms, a valuation may be used for a wide range of purposes:

1. In company buying and selling operations:

For the buyer, the valuation will tell him the highest price he should pay.

i. For the seller, the valuation will tell him the lowest price at which he should be prepared to sell.

2. Valuations of listed companies:

i. The valuation is used to compare the value obtained with the share's price on the stock market and to decide whether to sell, buy or hold the shares.

ii. The valuation of several companies is used to decide the securities that the portfolio should concentrate on: those that seem to it to be undervalued by the market.

iii. The valuation of several companies is also used to make comparisons between companies. For example, if an investor thinks that the future course of ABC's share price will be better than that of XYZ, he may buy ABC shares and short-sell XYZ shares. With this position, he will gain provided that ABC's share price does better (rises more or falls less) than that of XYZ.

3. Public offerings:

i. The valuation is used to justify the price at which the shares are offered to the public

4. Inheritances and wills:

i. The valuation is used to compare the shares' value with that of the other assets

Value and price. What purpose does a valuation serve?

Generally speaking, a company's value is different for different buyers and it may also be different for the buyer and the seller. Value should not be confused with price, which is the quantity agreed between the seller and the buyer in the sale of a company. This difference in a specific company's value may be due to a multitude of reasons. For example, a large and technologically highly advanced foreign company wishes to buy a well-known national company in order to gain entry into the local market, using the reputation of the local brand. In this case, the foreign buyer will only value the brand but not the plant, machinery, etc. as it has more advanced assets of its own. However, the seller will give a very high value to its material resources, as they are able to continue producing.

Methods of Shares Valuation

The most common methods of valuing shares are

1. The earnings method (P/E Ratio)

2. The Accounting Rate of Return (ARR)

3. The net assets

4. CAPM method

5. Super Profit method

6. The Dividend yield

7. DCF-based valuation

8. Share Prices

(a) The Price/Earnings Ratio (Earnings Method)

The P/E ratio method is widely used in practice. This method relies on finding listed companies in similar businesses to the company being valued (the target company), and then looking at the relationship they show between share price and earnings. Using that relationship as a model, the share price of the target company can be estimated. The P/E ratio is the price per share divided by the earnings per share and shows how many years' worth of earnings are paid for in the share price.

P/E Ratio = Market Value /EPS

Where: Market Value= EPS X P/E Ratio

General guidelines for a P/E ratio-based valuation

When a company is thinking of acquiring an unquoted company in a takeover, the final offer price will be agreed by negotiation, but a list of some of the factors affecting the valuer's choice of P/E ratio is given below.

i. General economic and financial conditions

ii. The type of industry and the prospects of that industry

iii. The size of the undertaking and its status within its industry.

iv. The reliability of profit estimates and the past profit record.

v. Asset backing and liquidity

vi. The extent to which the business is dependent on the technical skills of one or more individuals.

Illustration 1:

Ammar Limited wishes to make a take-over bid for the shares of an unquoted company, Yaasir Limited over the past five years have been as follows.

2001- N500,000

2002- N720,000

2003- N680,000

2004- N710,000

2005- N750,000

The average P/E ratio of quoted companies in the industry in which Yaasir Limited operates is 10. Quoted companies which are similar in many respects to Ammar Limited are:

i. Sumayyah Plc., which has a P/E ratio of 15, but is a company with very good growth prospects;

ii. Fidel Plc., had a poor profit record for several years, and has a P/E ratio of 7;

iii. What would be a suitable range of valuations for the shares of Yaasir Limited?

Solution

i. Earnings: Average earnings over the last five years have been N672,000 and over the last four years N715,000. There might appear to be some growth prospects, but estimates of future earnings are uncertain. A low estimate of earnings in 2006 would be, perhaps, N715,000.

ii. A high estimate of earnings might be N750,000 or more. This solution will use the most recent earnings figure of N750,000 as the high estimate.

iii.P/E ratio: A P/E ratio of 15 (Sumayyah Plc.) would be much too high for Yaasir Ltd, because the growth of Yaasir Ltd earnings is not certain and Yaasir Ltd is an unquoted company

On the other hand, Yaasir Ltd's expectations of earnings are probably better than those of Fidel Plc. A suitable P/E ratio might be based on the industry's average, 10; but since Yaasir Ltd is an unquoted company and therefore riskier, a lower P/E ratio might be more appropriate. Perhaps 60% to 70% of 10 which is 6 or 7; or conceivably even as low as 50% of 10, that is 5.

The valuation of Yaasir Ltd's shares might therefore range between;

High P/E ratio and high earnings: 7 X N750,000 = N5,250,000

Low P/E ratio and low earnings: 5 X N715,000 = N3,575,000

(b) The Accounting rate of Return Method

This method considers the ARR which will be required from the company whose shares are to be valued. It is distinct from the P/E ratio method. The ARR method involves using a predetermined notion of the rate of return an investor would expect on a particular type of investment and then having decided on the earnings of the company, to calculate capital sum that would result in such a rate of return.

Formula: Value = Estimated future profits/ Return on capital employed

Illustration 2

Paul Ltd is considering acquiring Peter Ltd. At present, Peter Ltd is earning on average, N48,000,000 after tax. The directors of Paul Ltd feel that after reorganization, this figure could increase to N60,000,000. All the companies in Paul's group are expected to yield a post-tax accounting return of 15% on capital employed. What should Peter Ltd be valued at?

Solution

Valuation = N60,000,000/15% =N400,000,000

(c) **Net Asset Basis**

The method considers all tangible assets less all intangible assets. This means that we should consider only the tangible assets but intangible assets such as goodwill, patents, trademarks,

preliminary expenses should not be assigned with any value. This must be calculated whether requested or not. The difficulty in asset valuation method is not in the arithmetic involved, but in the process of establishing the asset value to use.

The net asset method of valuation should be used:

(a) When the company is on the verge of liquidation

(b) When unquoted shares are offered as collateral for loans.

(c) As a measure of comparison in a scheme of merger.

(d) As a measure of the security in a share value

(d)Dividend Yield Method

This method is suitable for the valuation of small shareholdings in unquoted companies. It is based on the principle that the value of a share is the present value of future dividend payments, discounted at a suitable (marginal) rate of shareholder's time preference. There are two approaches under this technique using net and gross dividends.

(a) Dividend with growth

(b) Dividend with growth

Dividend without growth: Recall that Ke = d/MV

MV = d/Ke (r)

Illustration 3

A company issues 10,000 equity shares of Rs. 100 each at a premium of 10%. The company has been paying 25% dividend to equity shareholders for the past five years and expects to maintain the same in the future also. Compute the cost of equity capital. Will it make any difference if the market price of equity share is Rs. 175?

Solution

Ke= d/MV

=25 * 100

100

=22.72%

If the market price of the share is Rs.175

=25 * 100

175

=14.28%

Net dividend = Dividend (net)/Required rate of return

Gross dividend = Dividend (gross)/Required rate of return

Dividend with growth:

Growth model: MV = d0(1+g)/ r – g

(e) Share Prices

These are prices quoted on the stock Exchange. Users are to use the quoted prices to multiply the number of shares under consideration

ACT 418

ASSET MANAGEMENT

Learning Objectives

At the end of this lesson, the student should be able to:

1. Define asset management
2. State what constitute asset management and what does not
3. Discuss the functions of an asset manager.
4. State the importance of asset management

Main Content

Asset Management

Asset has been defined as "any item of economic value owned by an individual or corporation". And Asset Management is increasingly well understood by the business community as a strategic and business led discipline, where the value of assets is their contribution to achieving explicit business objectives. Asset management typically refers to the process of managing investments on behalf of individuals, corporations, or institutions. This can include a wide range of assets such as stocks, bonds, real estate, and more. The primary goal of asset management is to grow assets over time while minimizing risk according to the client's objectives and risk tolerance.

Asset management can be conducted by individual investors managing their own portfolios, or it can be outsourced to professional asset management firms or financial advisors who manage investments on behalf of clients for a fee. A good 'asset management' decision might be to purchase an expensive, high specification stainless steel piping system within an industrial process. Whilst the initial cost is higher, the maintenance costs may be lower and the expected life 3 times longer, the risk of disruptive failure may be lower and therefore the risk to the organisation from a performance, health & safety and environmental perspective consequently much lower. The total life cycle costs, therefore, may be lower and the total risk to the organisation through purchasing the more expensive piping system therefore represents a good asset management decision.

What Asset Management is and isn't

Asset Management:

i. Is a recognition that assets have a life cycle

ii. Is an approach that looks to get the best out of the assets for the benefit of the organisation and/or its stakeholders

iii. Is about understanding and managing the risk associated with owning assets. One of the challenges with managing an asset is that it is not sentient. It does not keep management edicts. It does not respond to the economy or politics. But it does respond to how it is treated and used.

iv. It involves strategic planning and decision-making regarding the acquisition, utilization, and disposal of assets to maximize their value and contribution to organizational goals.

v. It relies on data and analytics to make informed decisions about asset allocation, maintenance schedules, and investment strategies.

Asset Management:

Simple Maintenance: It's more than just routine maintenance tasks. While maintenance is a crucial aspect, asset management involves strategic planning and decision-making beyond day-to-day upkeep**.**

Just Financial Management: While financial considerations are important, asset management encompasses broader aspects such as operational efficiency, risk management, and strategic alignment.

Static: It's not a one-time activity. Asset management is an ongoing process that requires continuous monitoring, evaluation, and adjustment to adapt to changing conditions and requirements.

Exclusively for Physical Assets: While it often focuses on physical assets like machinery, equipment, and infrastructure, asset management can also include intangible assets like intellectual property, brand reputation, and human capital.

Silos: It's not isolated to a single department or function within an organization. Effective asset management requires collaboration and integration across various departments, including operations, finance, procurement, and IT.

Importance of Asset Management

Asset Management is important because it can help organisations to:

i. Reduce the total costs of operating their assets

ii. Reduce the capital costs of investing in the asset base

iii. Improve the operating performance of their assets (reduce failure rates, increase availability, etc)

iv. Reduce the potential health impacts of operating the assets

v. Reduce the safety risks of operating the assets

vi. Minimise the environmental impact of operating the assets

vii. Asset management plays a crucial role in supporting sustainability initiatives and environmental stewardship efforts

Asset Management is explicitly focused on helping organisations to achieve their defined objectives and to determine the optimal blend of activities based on these objectives.

Functions of Asset Manager

Asset Planning and Strategy: Asset managers develop and implement asset management plans and strategies aligned with the organization's objectives. This involves assessing current asset portfolios, identifying investment opportunities, and defining long-term asset management goals to maximize returns and minimize risks**.**

Asset Acquisition and Disposal: Asset managers are responsible for evaluating potential asset acquisitions and disposals. They conduct feasibility studies, financial analyses, and risk assessments to determine the viability of investment opportunities and ensure alignment with the organization's overall strategy. Asset managers also oversee the negotiation and execution of asset purchase and sale agreements.

Portfolio Optimization: Asset managers actively manage asset portfolios to optimize performance and achieve desired outcomes. This involves asset allocation, diversification, and rebalancing strategies to minimize risks and maximize returns in line with the organization's risk tolerance and investment objectives. Asset managers continuously monitor market conditions and asset performance to make informed decisions about portfolio adjustments.

Risk Management: Asset managers assess and manage risks associated with asset ownership and investment activities. They identify potential risks, such as market volatility, credit risk, liquidity risk, and regulatory compliance risk, and implement risk mitigation strategies to safeguard assets and minimize potential losses. Asset managers also ensure compliance with relevant regulatory requirements and industry standards.

Performance Monitoring and Reporting: Asset managers track and evaluate the performance of assets within their portfolios. They utilize key performance indicators (KPIs), benchmarks, and analytics to measure asset performance, identify trends, and assess the effectiveness of asset management strategies. Asset managers prepare regular performance reports and presentations for stakeholders, providing insights into asset performance and investment outcomes.

Asset Maintenance and Optimization: Asset managers oversee the maintenance, repair, and optimization of physical assets to ensure operational reliability and longevity. They develop maintenance schedules, implement preventive maintenance programs, and coordinate repair activities to minimize downtime and maximize asset availability. Asset managers also explore opportunities for asset upgrades, efficiency improvements, and technology integration to enhance asset performance and value.

Stakeholder Engagement and Communication: Asset managers facilitate communication and collaboration with internal and external stakeholders, including investors, clients, vendors, and regulatory authorities. They provide updates on asset performance, investment strategies, and market trends, addressing stakeholder inquiries and concerns. Asset managers also foster relationships with key stakeholders to support business objectives and promote transparency and trust.

ACT 418

ENTERPRISE MANAGEMENT

Learning Management

At the end of the lesson, the students should be able to:

1. Describe business in contemporary society
2. Describe enterprise management and its importance
3. State the cycle of business
4. State the various forms of business organization

Main Content

Business in contemporary society

Businesses are the engines of economic growth, contributing to prosperity through the production and sale of goods and services. A definition of business activity is any kind of activity that results in the provision of goods and services which satisfy human wants. This includes a variety of actions such as production, sales, marketing, purchasing, financing, investing, and other operations necessary for the business to function and generate revenue.

Goods are tangible while services are intangible. Goods sold to the general public are often referred to as consumer goods. Consumer goods may be classified as durable goods like cars, washing machines, or personal computers; or non-durable goods like sweets, drinks, newspapers. Durable goods can be used regularly over a long period of time while non-durable goods are consumed over a short period, usually soon after they are bought. Examples of services are going to the hairdresser, being served in a restaurant, or visiting a doctor.

In summary, then, business activity involves using resources to produce goods and services which people require in order to satisfy their wants. Business activity can be described as 'wealth-creating'. This is because the term 'wealth' is used to refer to the amount of goods and services, or output available – the more goods and services that exist the greater the amount of wealth. In this sense, then, wealth is not money as such but the total of goods and services which can be given a monetary value.

Enterprise Management

Enterprise management refers to the processes, strategies, and tools involved in overseeing and optimizing the day-to-day operations of an enterprise to ensure its effective functioning and alignment with organizational goals. Enterprise management is the way of conducting and controlling the business, process, information and IT capabilities, system and service offerings, resources and activities of the enterprise. It involves planning, organizing, directing, and controlling all aspects of the business, including its operations, finances, human resources, and technology.

Enterprise management encompasses a wide range of functions, including:

Strategic Planning: Developing long-term goals and objectives for the organization and determining the best course of action to achieve them.

Organizational Structure: Designing the structure of the organization to ensure efficient communication, coordination, and decision-making.

Resource Allocation: Allocating resources such as finances, human resources, and technology to different departments and projects based on their priority and importance to the organization's goals.

Leadership and Direction: Providing leadership and direction to employees to motivate them and ensure they are working towards the organization's goals.

Performance Monitoring: Monitoring and evaluating the performance of the organization, departments, and employees to identify areas for improvement and ensure that goals are being met.

Risk Management: Identifying potential risks and implementing strategies to mitigate them to protect the organization's interests.

Change Management: Managing changes within the organization, whether they are internal changes such as restructuring or external changes such as market shifts, to ensure a smooth transition and minimize disruptions.

Cycle of Business Activity

The cycle of business activity refers to the fluctuations in economic activity that occur over time within a market economy. These fluctuations typically follow a pattern of expansion, peak, contraction, and trough, collectively known as the business cycle. The stages of business activity are:

Expansion (Recovery): The expansion phase marks a period of increasing economic activity characterized by rising production, employment, and consumer spending. Businesses experience growing sales and profits, and confidence in the economy is generally high. During this phase, monetary and fiscal policies may be accommodative to support further growth.

Peak: The peak represents the highest point of the business cycle, where economic activity reaches its maximum level. Production levels are high, and the labor market may be tight, leading to wage pressures. However, as the economy operates at or near full capacity, inflationary pressures may begin to build, prompting policymakers to consider tightening monetary policy to prevent overheating.

Contraction (Recession): The contraction phase, also known as a recession, is characterized by a decline in economic activity. Production slows down, businesses may cut back on hiring, and consumer spending decreases. This phase is typically accompanied by rising unemployment, declining corporate profits, and a decrease in business investment. To counteract the recessionary

pressures, policymakers may implement expansionary monetary and fiscal policies to stimulate economic activity.

Trough: The trough represents the lowest point of the business cycle, where economic activity reaches its lowest level. Unemployment is typically high, and consumer and business confidence may be low. However, the trough also marks the beginning of the recovery phase, as economic indicators start to show signs of improvement. As the economy begins to recover, policymakers may gradually withdraw stimulus measures implemented during the contraction phase.

FORMS OF BUSINESS ORGANIZATION

A business organization refers to the legal structure or entity through which a business operates and conducts its activities. Choosing the right form of business organization is crucial for entrepreneurs as it determines factors such as liability, taxation, ownership structure, and regulatory requirements. The various forms of organization are as follows:

1) Sole proprietorship

2) Partnership

3) Co-operative Society

4. Limited Liability Company

1. Sole-Proprietorship

A sole proprietorship is the simplest form of business organization, where a single individual owns and operates the business. In a sole proprietorship, there is no legal distinction between the business and its owner, meaning the owner assumes full responsibility for all aspects of the business, including its debts, liabilities, and obligations. He has to arrange capital for the business and he alone is responsible for its management. He is therefore, entitled to the profits and has to bear the loss of business, however, he can take the help of his family members and also make use of the services of others such as a manager and other employees.

The features are:

Single Ownership: A sole proprietorship is owned and operated by a single individual, who retains full control and decision-making authority over the business.

Unlimited Liability: The owner of a sole proprietorship is personally liable for all debts, obligations, and legal liabilities of the business. This means that personal assets, including savings, investments, and property, are at risk in the event of business losses or legal disputes.

Sole Profits: The owner retains all profits generated by the business and has the sole right to make decisions regarding their allocation and reinvestment.

Simplicity: Sole proprietorships are easy and inexpensive to set up and operate compared to other forms of business organization. There are minimal legal formalities and regulatory requirements involved in establishing a sole proprietorship.

Advantages of Sole Proprietorship

Direct Control: The owner has complete control over all aspects of the business, including decision-making, operations, and management. This allows for quick and efficient decision-making without the need for consultation or approval from other stakeholders.

Flexibility: Sole proprietorships offer flexibility in terms of business operations, allowing the owner to adapt quickly to changing market conditions, customer preferences, and business opportunities.

Minimal Regulatory Requirements: Sole proprietorships are subject to fewer regulatory requirements and formalities compared to other forms of business organization, reducing administrative burdens and compliance costs.

The disadvantages are:

Unlimited Liability: One of the most significant disadvantages of sole proprietorships is the unlimited liability of the owner. In the event of business losses, debts, or legal liabilities, the owner's personal assets are at risk, which can expose them to financial hardship and personal bankruptcy.

Limited Resources: Sole proprietorships may face limitations in terms of access to capital and resources compared to larger businesses. This can restrict growth opportunities and hinder the ability to invest in expansion, innovation, and long-term sustainability.

Limited Expertise: As the sole decision-maker, the owner may lack expertise in certain areas of business operations, such as finance, marketing, or technology. This can pose challenges in effectively managing and growing the business, especially in competitive or rapidly changing industries.

Limited Growth Potential: Sole proprietorships may have limited scalability and growth potential compared to other forms of business organization. The success of the business is often closely tied to the skills, resources, and efforts of the owner, which can be constrained by time, energy, and capacity.

It can be difficult to raise finance – the sole trader may have to rely on savings or finance from relatives to get started. Banks may provide finance but may charge higher rates of interest if they are willing to lend at all.

The proprietor is solely responsible for all the financial commitments. A sole trader has ‘unlimited liability’, which means that, should the business fail, the owner can be held personally responsible for its debts, even to the extent of having to sell everything they own. This might mean s/he could face bankruptcy if the business fails.

There is no one with whom to share the responsibilities of running the business – many sole traders work long hours with few holidays.

2. Partnership

This is a business which is formed by two or more people on the basis of a partnership agreement. The partners provide the capital to start the business. A partnership is a form of business organization in which two or more individuals (partners) agree to combine their resources, skills, and expertise to carry on a business with the aim of making a profit. Partnerships are governed by a partnership agreement, which outlines the rights, responsibilities, and obligations of the partners, as well as the terms and conditions of the partnership.

Types of Partnership:

General Partnership: In a general partnership, all partners share equally in the management, profits, and liabilities of the business. Each partner has unlimited liability, meaning they are personally responsible for the debts and obligations of the partnership.

Limited Partnership: A limited partnership consists of both general partners and limited partners. General partners have unlimited liability and are actively involved in the management of the business, while limited partners contribute capital but have limited liability and no involvement in management.

Types of Partners:

Active Partner: An active partner, also known as a general partner, is actively involved in the day-to-day operations and management of the business. Active partners have unlimited liability and share equally in the profits and losses of the partnership.

Sleeping Partner: A sleeping partner, also known as a silent partner, is a partner who contributes capital to the partnership but does not participate in the management of the business. Sleeping partners have limited liability and typically receive a share of the profits based on their investment.

Partnership Deed and its Content:

A partnership deed is a legal document that outlines the terms and conditions of the partnership agreement. It typically includes the following content:

Name and Address of the Partnership: The legal name and address of the partnership, as well as any additional business names under which the partnership operates.

Partnership Duration: The duration of the partnership, whether it is for a fixed term or indefinite duration.

Capital Contribution: The amount of capital contributed by each partner to the partnership, as well as the terms and conditions governing additional capital contributions.

Profit and Loss Sharing: The method for sharing profits and losses among the partners, including the percentage or ratio of distribution.

Advantages:

Shared Resources and Expertise: Partnerships allow for the pooling of resources, skills, and expertise of multiple individuals, enabling the business to benefit from diverse perspectives and capabilities.

Shared Risk and Liability: In a partnership, partners share both the risks and rewards of the business. While each partner is personally liable for the debts and obligations of the partnership, this liability is distributed among the partners.

Flexibility: Partnerships offer flexibility in terms of management structure, decision-making processes, and profit-sharing arrangements, allowing partners to adapt quickly to changing market conditions and business opportunities.

Tax Benefits: Partnership income is typically taxed at the individual partner level, avoiding double taxation at both the business and personal level. Partnerships also offer opportunities for tax deductions and credits not available to other forms of business organization.

Disadvantages:

i. All partners except ‘sleeping partners’ have unlimited liability for the debts of the business. Thus some partners may end up paying for mistakes made by other partners.

ii. There may be conflict between partners over matters such as whom to employ or whether to borrow money.

iii. There may be a lack of continuity as partner’s change.

iv. Profits have to be shared.

3. Co-operative Society

A cooperative society is a form of business organization owned and operated by a group of individuals, known as members, who come together voluntarily to meet their common economic, social, and cultural needs and aspirations. Cooperatives are based on the principles of self-help, democratic control, and member participation, with the aim of promoting mutual assistance, economic empowerment, and community development.

Features:

Voluntary Membership: Membership in a cooperative society is voluntary and open to individuals who share a common interest or objective. Anyone who meets the eligibility criteria set by the cooperative can become a member and participate in its activities.

Democratic Control: Cooperatives operate on the principle of democratic control, with each member having equal voting rights regardless of their financial contribution or shareholding. Decisions are made collectively through democratic processes, such as general meetings and elections.

Member Ownership and Control: Cooperatives are owned and controlled by their members, who contribute capital, participate in decision-making, and share in the risks and rewards of the

business. Members have a direct stake in the success of the cooperative and are actively involved in its management and operations.

Limited Return on Capital: Cooperatives aim to provide goods and services to their members at cost or at a minimal profit margin. Any surplus generated by the cooperative is typically reinvested in the business, distributed to members as dividends, or used for community development initiatives.

Social Objectives: In addition to economic objectives, cooperatives often have social objectives aimed at promoting the welfare and well-being of their members and the community. This may include providing affordable goods and services, creating employment opportunities, and supporting local development initiatives.

Advantages:

Member Empowerment: Cooperatives empower members by providing them with a platform to collectively address their economic and social needs, access resources, and participate in decision-making processes.

Economic Benefits: Cooperatives can offer economic benefits to members, such as access to affordable goods and services, higher returns on investments, and opportunities for income generation and employment.

Risk Sharing: Members of cooperatives share the risks and rewards of the business collectively, reducing individual risk exposure and providing a safety net for members in times of economic uncertainty or hardship.

Community Development: Cooperatives contribute to community development by creating local employment opportunities, supporting small-scale producers and businesses, and investing in community infrastructure and services.

Disadvantages:

Democratic Challenges: Democratic decision-making processes in cooperatives can be time-consuming, inefficient, and prone to conflicts and disagreements among members, especially in larger cooperatives with diverse interests and objectives.

Limited Capital: Cooperatives may face challenges in raising capital for investment and expansion, as members' contributions are often limited and external financing may be difficult to obtain.

Limited Expertise: Cooperatives may lack the specialized expertise, skills, and resources needed to compete effectively in certain industries or markets, leading to limitations in innovation, competitiveness, and growth potential.

Dependency on Members: The success of a cooperative depends heavily on the active participation, commitment, and cooperation of its members. If members become disengaged or withdraw their support, it can weaken the cooperative and hinder its ability to achieve its objectives.

4. Limited Liability Company

A Limited Liability Company (LLC) is a flexible form of business organization that combines features of both partnerships and corporations. LLCs offer limited liability protection to their owners (referred to as members), meaning their personal assets are generally protected from business debts and liabilities. LLCs are governed by state laws and regulations, which vary depending on the jurisdiction. There are two types of LLC which are private limited liability and public limited liability company.

Private Limited Liability Company

A private limited liability company (Private Ltd.) is a type of business entity that offers limited liability protection to its owners (shareholders) while restricting ownership and transfer of shares. Private Ltd. companies are commonly used for small to medium-sized businesses and are governed by company law regulations in the jurisdiction where they are registered. The features are:

1. Limited Liability: Shareholders of a private limited liability company have limited liability, meaning their personal assets are generally protected from the debts and liabilities of the company. Their liability is typically limited to the amount they have invested in the company.

2. Ownership Restrictions: Private Ltd. companies have restrictions on the ownership and transfer of shares. Shares are typically held by a small group of founders, investors, or family members, and transfer of shares is subject to approval by existing shareholders or regulatory authorities.

3. Financial Reporting: Private Ltd. companies are required to maintain proper financial records and prepare annual financial statements for regulatory compliance and tax purposes. However, they are not typically required to publicly disclose financial information or file detailed financial reports with regulatory authorities.

4. Management Structure: Private Ltd. companies may have a flexible management structure, with decisions made by directors appointed by the shareholders. The shareholders usually have voting rights proportional to their shareholdings but may also participate in management if they are also directors.

The advantages are:

1. Limited Liability: Limited liability protection shields the personal assets of shareholders from business debts and liabilities, reducing financial risk and exposure.

2. Ownership Control: Shareholders of private Ltd. companies have control over the ownership and management of the company, allowing for strategic decision-making and alignment with the company's objectives and vision.

3. Privacy: Private Ltd. companies are not required to disclose detailed financial information or operational details to the public, providing privacy and confidentiality for the owners and management.

4. Flexibility: Private Ltd. companies offer flexibility in terms of management structure, ownership arrangements, and decision-making processes, allowing for adaptation to changing business needs and market conditions.

The disadvantages are:

1. Capital Constraints: Private Ltd. companies may face challenges in raising capital for expansion or investment, as their ability to attract external investors or access public markets is limited compared to public companies.

2. Ownership Restrictions: Restrictions on the transfer of shares can make it difficult to bring in new investors or shareholders, limiting opportunities for equity financing and growth.

3. Regulatory Compliance: While private Ltd. companies may have fewer regulatory requirements compared to public companies, they are still subject to company law regulations, financial reporting obligations, and tax compliance requirements, which can entail administrative burdens and costs.

4. Limited Access to Resources: Private Ltd. companies may have limited access to resources such as talent, expertise, and networks compared to larger public companies, which can impact their ability to compete and grow in the market.

2. Public Limited Liability Company

A public limited liability company (PLC) is a type of business entity that offers limited liability protection to its shareholders and allows for the public trading of its shares on a stock exchange. PLCs are typically larger and more established than private Ltd. companies and are subject to stricter regulatory requirements and disclosure obligations. The features are:

1. Limited Liability: Shareholders of a public limited liability company have limited liability, meaning their personal assets are protected from the debts and liabilities of the company.

2. Public Trading of Shares: Shares of a public limited liability company are listed and traded on a stock exchange, providing liquidity and marketability for shareholders and allowing for broader ownership and investment.

3. Regulatory Compliance: PLCs are subject to stricter regulatory requirements and disclosure obligations compared to private Ltd. companies. They must comply with company law regulations, financial reporting standards, and disclosure requirements set by regulatory authorities.

4. Corporate Governance: PLCs typically have a formal corporate governance structure with a board of directors, management team, and committees responsible for overseeing the company's operations, strategy, and compliance.

The advantages are:

1. Access to Capital: PLCs have access to a wide pool of capital through the public markets, allowing them to raise funds for expansion, investment, and strategic initiatives through the issuance of equity or debt securities.

2. Enhanced Visibility and Prestige: Publicly traded companies often enjoy greater visibility, credibility, and prestige in the market, which can attract investors, customers, partners, and talent.

3. Market Liquidity: Public trading of shares on a stock exchange provides liquidity and marketability for shareholders, allowing them to buy and sell shares freely and easily.

4. Potential for Growth: PLCs have the potential for rapid growth and scalability, as they can tap into capital markets, attract institutional investors, and pursue strategic acquisitions or partnerships to drive expansion and diversification.

The disadvantages are:

1. Regulatory Burden: PLCs are subject to extensive regulatory requirements, reporting obligations, and compliance standards, which can entail significant administrative burdens, costs, and legal risks.

2. Shareholder Scrutiny: Publicly traded companies are subject to scrutiny and oversight from shareholders, analysts, regulators, and the media, which can increase pressure and expectations for performance, transparency, and accountability.

3. Market Volatility: Publicly traded companies are exposed to market fluctuations, investor sentiment, and macroeconomic factors, which can impact share prices, valuation, and shareholder returns.

4. Loss of Control: Going public may entail a loss of control for existing shareholders and management, as the company becomes subject to the interests and demands of external shareholders, institutional investors, and regulatory authorities.

Reasons for establishing MNCs

i. to increase market share

ii. to secure cheaper premises and labour

iii. to avoid or minimise the amount of tax which has to be paid

iv. Market Expansion: MNCs seek to access new markets and customer segments in different countries to diversify their revenue streams and reduce dependence on any single market. By expanding globally, MNCs can tap into emerging opportunities, reach larger consumer bases, and capitalize on growing demand for their products or services.

v. Resource Access: MNCs establish operations in countries with abundant natural resources, skilled labor, or strategic assets to secure access to inputs and raw materials essential for their production processes. By sourcing locally, MNCs can reduce supply chain risks, lower production costs, and enhance operational efficiency.

vi. Economies of Scale: MNCs leverage economies of scale by consolidating production, distribution, and procurement activities across multiple countries. By standardizing processes, sharing resources, and centralizing operations, MNCs can achieve cost efficiencies, improve productivity, and increase competitiveness in global markets.

Disadvantages of MNCs for the host country

Economic Dependence: Host countries may become overly dependent on MNCs for employment, investment, and revenue generation, leading to vulnerabilities in the event of economic downturns or changes in corporate strategies. This dependence can limit the host country's ability to diversify its economy and pursue sustainable development strategies.

Labor Exploitation: MNCs may exploit cheap labor in host countries by paying low wages, offering poor working conditions, and violating labor rights. This can lead to social inequality, labor abuses, and worker exploitation, undermining human rights and dignity in the host country.

Resource Depletion: MNCs may exploit natural resources in host countries without adequate environmental safeguards, leading to resource depletion, pollution, and ecological damage. This can harm local ecosystems, threaten biodiversity, and jeopardize the long-term sustainability of natural resources essential for local communities' livelihoods.

Monopoly Power: MNCs with dominant market positions may engage in anti-competitive practices, such as price-fixing, predatory pricing, and market manipulation, to stifle competition and maintain their market dominance. This can hinder the growth of local businesses, restrict consumer choice, and distort market dynamics in the host country.

Political Interference: MNCs may exert undue influence on host country governments through lobbying, campaign contributions, and other forms of political interference, shaping policies and regulations in their favor. This can undermine democratic governance, weaken regulatory oversight, and perpetuate corruption and cronyism in the host country.

Technology Dependency: Host countries may become dependent on MNCs for technology, innovation, and know-how, limiting their capacity for indigenous technological development and industrialization. This can hinder the host country's ability to achieve technological self-reliance, innovation-driven growth, and sustainable development.

ACT 418

FINANCIAL MANAGEMENT RISK

Learning Objectives

At the end of the lesson, the student should be able to:

1. Define risk.
2. Define risk management
3. State the process of risk management

Main Content

Risk

Risk is the likelihood of losses resulting from events such as changes in market prices. Events with a low probability of occurring, but that may result in a high loss, are particularly troublesome because they are often not anticipated. Put another way risk is the probable variability of returns. Risk implies the extent to which any chosen action or an inaction that may lead to a loss or some unwanted outcome. The notion implies that a choice may have an influence on the outcome that exists or has existed. Risk is unavoidable and present in every human situation. It is present in daily lives, public and private sector organizations. Depending on the context (insurance, stakeholder, technical causes), there are many accepted definitions of risk in use.

One description of risk is the following: risk refers to the uncertainty that surrounds future events and outcomes. It is the expression of the likelihood and impact of an event with the potential to influence the achievement of an organization's objectives.

Risk Management

As with the definition of risk, there are equally many accepted definitions of risk management in use. Some describe risk management as the decision-making process, excluding the identification and assessment of risk, whereas others describe risk management as the complete process, including risk identification, assessment and decisions around risk issues. One well accepted description of risk management is the following: risk management is a systematic approach to setting the best course of action under uncertainty by identifying, assessing, understanding, acting on and communicating risk issues.

According to the insurance manager, risk management involves the practice of examining the cost-effectiveness of insurance protection. In the perspective of the production manager, risk management may represent a technique for coping with effects of changes. In the case of the cost accountant, risk management may be regarded as a method of arranging self insurance.

Risk management is viewed as a multi-disciplinary function. Hence, it is all embracing in the explicit or implicit actions taken by house wives, farmers, and artisans to the corporate managers. Such actions involve consciously putting a risk management process in place to mitigate disasters such injuries, incapacitation, and even death. In broad based perspective, risk management is said to embrace all the techniques or strategies involved in reducing or minimizing the impact of uncertain loss or events that aggravate risk.

Risk management can be related to a mechanism which embraces planning, organizing, evaluating and controlling resources and operational activities of business for effective reduction or elimination of risk or the adverse effects of risks. Since human beings are mere mortals, risk management can also apply to their lives.

Financial Risk Management

Financial risk management is a process to deal with the uncertainties resulting from financial markets.It involves assessing the financial risks facing an organization and developing management strategies consistent with internal priorities and policies. Addressing financial risks proactively may provide an organization with a competitive advantage. It also ensures that management, operational staff, stakeholders, and the board of directors are in agreement on key issues of risk.

Process of Risk Management

The different tasks of risk management are structured in a process of chronological phases. Although different researchers and authors alike define the phases similarly, the definitions to be found in the literature differ in the way the tasks are ordered into the phases. The process of risk management starts with the identification of risks. This is followed by the analysis and evaluation of risks. After that, in the risk assessment, the best ways to handle the identified risks and how this handling can be included into daily business are evaluated. The final step of the process is the risk

monitoring, which becomes part of the daily business until the process is started again from the beginning.

1. Risk Identification

Williams, Smith and Young (1995) posit that risk identification involves the process by which an organization systematically and continuously identifies risks and uncertainties in its operations. Such identification actions by the organization are focused on generating relevant information on sources of risk, hazards, risk factors, perils and exposure to loss. The aim of this phase to identify all risks, which could interrupt or damage the business development. The risks that should be identified can either have a negative impact on the balance sheet, the financial statement or the cash flow situation of the company and therefore also on its' development. This identification is of great importance as only identified risks can be handled successfully in the next steps of risk management.

2. Risk Evaluation/Measurement

The next consideration in the process of risk management is the evaluation of risk and, by extension, the measurement of its impact on the operations of the firm. According to Kpodo (1989), risk evaluation involves generating very accurate records of past events in order that decisions which will be taken in the future are made on the basis of sound statistics. The separation of the first and the second phase of the risk management process is not clear, as they are directly based upon each other. In defining a process or position as a risk can already be viewed as an analysis or evaluation. However, this does not change the process, where after the identification the risks are categorized and then evaluated.

The aim of the risk evaluation is to determine the degree of the identified risks and quantify their financial impact on the company. It is therefore necessary to analyze in which way the risk could affect the business. In order to get a better overview, the identified risks are first clustered or categorized based on the field of risk, for example whether it is market or financial risks More specifically the source of origin determined by the single risk factors of the risk fields can be used. The clustering allows for a company to later analyse whether some of the risks are related and whether some of them offset each other (e.g. in and outflows in a foreign currency). Furthermore,

the clustering will assist to identify the main risks of business, which is of help for future analysis and focus of risk management.

3. Risk Assessment/Analysis

According to Williams, Smith and Young (1995), this consideration involves engaging in those activities that enable the risk manager to identify, evaluate and measure risk and uncertainty and their potential impact on the organization. Generally, risk assessment is the most basic activity that is being undertaken by the risk manager. The assessment of risk involves actions such as the identification of risks, the analysis of hazards and outcomes, and the measurement of risk. According to the risk willingness, measures to handle the risk will be chosen in the third phase. Those measures range from risk avoidance or prevention, over risk reduction, to transfer of risks and finally acceptance of the risk.

4. Risk Monitoring

At the last phase of the risk management process it should be checked with a risk monitoring whether the risk identification, evaluation and assessment have been successful. This phase is crucial for taking appropriate measures in time in case deviations between the actual and planned risk situation are identified. The monitoring should therefore include developments of the risk positions and measures to control them. Moreover, the overall risk situation of the company should be compared to the plan and the risk strategy and deviations should be documented

ACT 418

METHODS OF AVOIDING FINANCIAL RISKS

Learning Objectives

At the end of the lesson, the students should be able:

1. Define financial risk

2. State the different types of financial risks

3.State the reasons for managing financial risks

4. State the various ways of dealing with financial risks

Main Content

Financial Risk

Financial risks create the possibility of losses arising from the failure to achieve a financial objective. The risk reflects uncertainty about foreign exchange rates, interest rates, commodity prices, equity prices, credit quality, liquidity, and an organization's access to financing. These financial risks are not necessarily independent of each other. For instance, exchange rates and interest rates are often strongly linked, and this interdependence should be recognized when managers are designing risk management systems.

These financial risks relate to the financial operation of a business – in essence, the risk of financial loss (and in some cases, financial gain) – and take many different forms. These include currency risks, interest rate risks, credit risks, liquidity risks, cash flow risk, and financing risks (explanations are given in subsequent sections). The importance of these risks will vary from one organization to another. A firm that operates internationally will be more exposed to currency risks than a firm that operates only domestically; a bank will typically be more exposed to credit risks than most other firms, and so forth.

Financial Risk is the possibility of losing money on an investment or business venture. It is a type of danger that results in the loss of capital to interested parties. It is a danger that translate into the loss of capital. The types of financial risks include:

1. Market Risk:

These are the financial risks that arise because of possible losses due to changes in future market prices or rates. The price changes will often relate to interest or foreign exchange rate movements, but also include the price of basic commodities that are vital to the business. It is also known as Systematic Risk. It arises from the uncertainty inherent in the market and cannot be eliminated through diversification alone. Market risk affects all investments to some extent and is typically associated with fluctuations in asset prices, interest rates, exchange rates, and other macroeconomic variables.

2. Credit Risk

Financial risks associated with the possibility of default by a counter-party. Credit risks typically arise because customers fail to pay for goods supplied on credit. Credit risk exposure increases substantially when a firm depends heavily upon a small number of large customers who have been granted access to a significant amount of credit. The significance of credit risk varies between sectors, and is high in the area of financial services, where short- and long-term lending are fundamental to the business. The risk of losses arising from the failure of a borrower to repay a loan or meet its contractual obligations. It's commonly associated with lending activities, bonds, and other debt instruments. It is one of the most significant risks faced by lenders and investors in debt securities and is influenced by various factors related to the borrower's creditworthiness and the terms of the loan or bond.

3. Financing, Liquidity and Cash Flows Risk

Financing risks affect an organization’s ability to obtain ongoing financing. An obvious example is the dependence of a firm on its access to credit from its bank. Financing risk refers to the potential for adverse financial consequences arising from the way an entity, such as a company or individual, structures its financing activities. It encompasses various aspects related to the procurement and management of funds, including the sources of financing, debt levels, liquidity, and the terms and conditions of financing arrangements.

Liquidity risk refers to uncertainty regarding the ability of a firm to unwind a position at little or no cost, and also relates to the availability of sufficient funds to meet financial commitments when they fall due. The risk of not being able to buy or sell assets quickly enough without significantly

affecting their prices. This risk is more prevalent in assets that are not easily tradable or in markets with low trading volumes.

Cash flow risks relate to the volatility of the firm's day-to-day operating cash flow. Cash flow risk refers to the uncertainty or variability in the timing and amount of cash inflows and outflows within a business or investment. It arises from factors that can disrupt the regularity or predictability of cash flows, potentially leading to liquidity problems, financial instability, or an inability to meet financial obligations.

Why Manage Financial Risks?

Firms can benefit from financial risk management in many different ways, but perhaps the most important benefit is to protect the firm's ability to attend to its core business and achieve its strategic objectives. By making stakeholders more secure, a good risk management policy helps encourage equity investors, creditors, managers, workers, suppliers, and customers to remain loyal to the business.

a. The firm's reputation or 'brand' is enhanced, as the firm is seen as successful and its management is viewed as both competent and credible.

b. Risk management can reduce earnings volatility, which helps to make financial statements and dividend announcements more relevant and reliable.

c. Greater earnings stability also tends to reduce average tax liabilities.

d. Risk management can protect a firm's cash flows.

e. Some commentators suggest that risk management may reduce the cost of capital, therefore raising the potential economic value added for a business.

f. The firm is better placed to exploit opportunities (such as opportunities to invest) through an improved credit rating and more secure access to financing.

g. The firm is in a stronger position to deal with merger and acquisitions issues. It is also in a stronger position to take over other firms and to fight off hostile takeover bids

h. The firm has a better managed supply chain, and a more stable customer base.

i. Preserving Financial Stability: Effective risk management helps safeguard financial stability by identifying, assessing, and mitigating potential threats to financial health. By proactively managing risks, entities can avoid or minimize adverse impacts on their financial resources, operations, and long-term viability.

j. Protecting Investments: Investors face various risks, including market volatility, credit risk, and interest rate fluctuations, which can erode the value of investments and diminish returns. Managing these risks through diversification, hedging, and other risk mitigation strategies can help protect investment portfolios and preserve wealth.

k. Ensuring Business Continuity: Businesses rely on stable cash flows, access to financing, and operational resilience to sustain their operations and pursue growth opportunities. By managing financial risks effectively, companies can mitigate disruptions, ensure continuity of operations, and navigate economic challenges more resiliently.

l. Meeting Financial Obligations: Managing financial risks helps ensure that entities can fulfill their financial obligations, including debt repayments, interest payments, payroll, supplier payments, and other commitments. Maintaining adequate liquidity and cash flow stability is essential for meeting short-term and long-term financial obligations promptly.

m. Enhancing Creditworthiness: Effective risk management practices can enhance an entity's creditworthiness and reputation in financial markets. By demonstrating sound financial management, strong risk controls, and the ability to manage risks prudently, entities may access financing at favorable terms, lower borrowing costs, and attract investment capital.

n. Complying with Regulatory Requirements: Regulatory authorities often require entities to manage financial risks and adhere to specific risk management standards, guidelines, and reporting requirements. Compliance with regulatory obligations helps mitigate legal and regulatory risks, avoid penalties, and maintain good standing with regulatory authorities.

o. Supporting Strategic Decision-Making: Managing financial risks provides decision-makers with better insights into the potential impacts of risk factors on business performance, profitability, and strategic objectives. By understanding and quantifying risks, entities can make informed decisions, allocate resources effectively, and pursue opportunities with greater confidence.

Ways of dealing with financial risk

i. Avoidance: The firm can avoid holding financial assets or liabilities whose values are uncertain.

ii. Loss Control: When risks cannot be avoided, efforts can be made to limit the loss.

iii. Diversification: Instead of concentrating assets in one place, the firm can distribute them across several locations or markets. Spreading investments across different asset classes, sectors, industries, or geographic regions can help reduce the impact of adverse events on a portfolio. Diversification can lower overall risk by mitigating the concentration of risk in any single investment or market.

iv. Transfer: The risk can be eliminated by transferring the asset/liability to another party. Alternatively, the asset/liability can be retained by the company but the risk can be transferred. Or the company may retain the risk but in the event of a loss, a third party assumes the liability. Entities can transfer financial risk to third parties through contractual arrangements such as outsourcing, franchising, licensing, or joint ventures. By sharing risks with partners, suppliers, or contractors, entities can mitigate exposure to certain risks while focusing on core competencies and strategic objectives.

v. Hedging: Hedging involves using financial instruments such as options, futures, forwards, and swaps to offset the risk of adverse price movements in underlying assets. For example, investors can hedge against currency risk, interest rate risk, or commodity price risk by taking offsetting positions in derivative contracts.

vi. Insurance: Purchasing insurance coverage can provide protection against various risks, including property damage, liability, business interruption, and natural disasters. Insurance policies transfer the financial risk to the insurer in exchange for payment of premiums, thereby reducing the potential impact of losses on the insured party.

vii. Risk Mitigation Policies and Procedures: Implementing robust risk management policies, procedures, and controls can help identify, assess, monitor, and mitigate financial risks effectively. This may include establishing risk limits, conducting regular risk assessments, implementing internal controls, and developing contingency plans to address potential threats.

viii. Capital Adequacy: Maintaining sufficient capital reserves and liquidity buffers can enhance an entity's ability to absorb losses, withstand adverse events, and meet financial obligations during periods of stress. Adequate capitalization provides a cushion against unexpected losses and reduces the likelihood of financial distress or insolvency.

ix. Stress Testing and Scenario Analysis: Conducting stress tests and scenario analyses can assess the potential impact of adverse events or market shocks on financial performance, cash flows, and balance sheet resilience. By simulating different scenarios and stress-testing assumptions, entities can identify vulnerabilities, quantify risks, and develop appropriate risk mitigation strategies.

x. Continuous Monitoring and Review: Regularly monitoring and reviewing financial risks, market conditions, and economic trends is essential for maintaining effective risk management practices. Proactive monitoring allows entities to identify emerging risks, adjust risk management strategies, and respond promptly to changing market dynamics.

xi. Compliance and Governance: Ensuring compliance with regulatory requirements, industry standards, and best practices in risk management is critical for mitigating legal, regulatory, and reputational risks. Strong corporate governance practices, risk oversight mechanisms, and transparency promote accountability and reinforce confidence in risk management capabilities.

xii. Staying Informed and Seeking Professional Advice: Keeping abreast of developments in financial markets, economic indicators, and industry trends can help entities make informed decisions and adapt to evolving risk environments. Seeking advice from financial professionals, consultants, or risk management experts can provide valuable insights and expertise in addressing specific financial risks effectively.

ACC 418

NIGERIAN BANKING SYSTEM

At the end of the lesson, the students should be able to:

1. Discuss the Financial System

2. Explain the evolution of the financial system

3. Explain the component of the Nigerian financial system.

4. Discuss the central bank, commercial banks and others

5. State the procedures involved in establishing a bank in Nigeria.

6. Distinguish between central bank and commercial bank.

Main Content

The Financial System

The financial system is the totality of institutions, bodies, rules and regulations governing the flow of financial resources within the economy. The financial system refers to the network of institutions, markets, instruments, and regulations that facilitate the flow of funds between savers, investors, borrowers, and lenders. It plays a crucial role in allocating capital, mobilizing savings, facilitating transactions, managing risk, and supporting economic activities and growth. The financial system plays a vital role in mobilizing savings, allocating capital to productive investments, facilitating economic transactions, and promoting economic growth and development.

The Nigeria financial system is described as the framework of: 1. Laws and regulations 2. Financial institutions 3. Practices which direct the flow of financial resources within the economy

Broadly speaking, "A financial system consists of a network of financial links between economic units – a web of debentures and shares. The financial system is a superstructure created on the basis of the real wealth of the economy" Jack Revel (1975). The financial system itself is an omnibus term which encompasses the generality of financial intermediaries that operate in the

financial sector and the institutional facilities being employed in its operational activities within the economy.

Evolution of the Financial System

The financial system as it is today developed from the effort of individuals who productively engage in trade; exchanging goods for goods in what was primordially denoted as barter. Trade by barter evolve the present financial system. The process succeeds as long as the buyer and seller of equivalent goods exist. However, with ever increasing volume of activities and the need to exchange a variety of commodities (of the seller) for a single product and vice versa, the barter system soon became not only cumbersome but also inadequate on the one hand, surplus units could not preserve their surplus in the most convenient form and on the other hand, deficit units could not obtain resource they require in the most convenient form on the other hand. Over time, the use of standardized commodities, such as grain, livestock, and precious metals, emerged as mediums of exchange, laying the foundation for early forms of money and trade.

The poor performance of the barter system soon paved the way for the usage of gold as a means of exchange. As gold soon became means of exchanging good for good; the higher the quantity of gold you possess, the better your capacity to trade. Gold a commodity in itself soon became what could be exchanged for other forms of goods and services. Several values exist for several forms of gold and with these value equivalent amount of goods and services were exchanged.

The gold system was sustained for a long period of time. In England, precious metals and coins were used almost exclusively as money until the middle of the seventeenth century. However, in 1640, Charles I appropriated £130,000 worth of gold held for merchants in the tower of London. Thereafter, gold and silver bullion plates were kept in the strong rooms of the goldsmiths. Eventually receipts for these deposits were accepted in exchange for goods and so withdrawal of the actual gold and silver became unnecessary. The emergence of bills of exchange, promissory notes, and other negotiable instruments facilitated long-distance trade and international commerce, enabling the efficient transfer of funds and risk management.

This was the origin of the bank note and paper currency which soon began forming an increasing proportion of British money. The paper from which notes are made is comparatively worthless. However people who receive note are confident that other too will accept them. The evolution of

money in its present form was the next stage and with money came the need for financial assets and claims in the form we have them today. The creation of financial assets and claims was facilitated by the emergence of financial intermediaries, which perform the crucial function of matching the needs of surplus units with those of the deficit units. These functions were performed in the form of financial markets-notably the money market and the capital markets

The financial institutions, consisting of the money market and the capital market stand as the major subject of financial system mostly in a developed economy where the governments play only a little role in the financial intermediation. However, in a developing nation like Nigeria, the financial system cannot function without the activities of the government, which makes for a great player in the financial system. Most times in a nation like ours, financial intermediation remains at the subsidiary level because nonfinancial activities are done in Cash rather than through other more articulated means which avoid the risk of Cash and the cumbersomeness of money. The 19th and 20th centuries witnessed the expansion and diversification of financial intermediation, with the establishment of commercial banks, savings banks, insurance companies, and investment banks. The adoption of central banking systems, such as the Federal Reserve System in the United States and the Bank of England, aimed to stabilize monetary systems, regulate banking activities, and manage financial crises. The proliferation of financial innovations, including credit cards, mortgages, mutual funds, pension funds, and derivatives, provided individuals and institutions with new avenues for savings, investment, and risk management.

THE NIGERIAN BANKING SYSTEM

The Central Bank of Nigeria (CBN)

A Central Bank is the apex institution of the monetary and banking system of every country. It is owned by the government but the responsibility of its management is usually rested in the Board of Directors whose members are appointed by the government. It was established by the Central Bank of Nigeria Act of 1958 and commenced operations on 1st July 1959. Among its primary functions, the Bank promotes monetary stability and a sound financial system, and acts as banker and financial adviser to the Federal Government, as well as banker of last resort to the banks. The Bank also encourages the growth and development of financial institutions. Enabling laws made in 1991 gave the Bank more flexibility in regulating and overseeing the banking sector and licensing finance companies, which hitherto operated outside any regulatory framework.

Traditional Functions of the Central Bank

In both developed and developing economies, the following are performed by the Central Bank.

(i) Currency issue and distribution: The Central Bank is the only institution empowered by law to issue currency notes and coins that are used as a medium of exchange in the country. The monopoly power of issuing legal tender currency is important to control the supply of money in order to prevent inflation.

(ii) The bankers' bank: The Central Bank provides facilities for other banks especially commercial banks to keep their cash reserve and clear their balance through the clearing house. It also grants loans to or discount the bills of commercial banks when they are short of fund; hence the Central Bank is referred to as 'lender of last resort'.

(iii) Banker to the government: The Central Bank keeps the accounts of the government and of all its corporations and agencies. It receives all payments due to the government, as well as undertake borrowing on behalf of the government through the issuance of short-term and long-term securities e.g. treasury bills, treasury certificates and long term securities e.g. development stocks. The Central bank is also responsible for the management of domestic and external debts of the government.

(iv) Promotion of monetary stability: The Central Bank controls money supply in the economy to promote price stability. This involves the use of instruments of monetary policy such as open market operations (OMO), reserve requirements, discount rate, etc.

(v) Foreign exchange management: To ensure that foreign exchange disbursement and allocation are consistent with economic priorities, the Central Bank acquires, allocates and monitors the use of scarce foreign exchange resources as well as maintains the country`s foreign exchange reserves.

(vi) Supervision of finance houses: In every modern economy, the Central Bank is backed by law to monitor and supervise the activities and practices of financial houses in order to promote effective execution of monetary policy.

Developmental Functions of The Central Bank

These are activities of the Central Bank to promote growth in various sectors of the economy.

(i) Promotion of the growth of financial markets: The Central Bank usually initiates instruments of mobilizing short-and long-term funds in both the money and capital markets.

(ii) Promotion of development of financial institutions: The Central Bank participates actively (morally and financially) in the establishment of development banks e.g. Bank of Industry (BOI) and Nigeria Agricultural Cooperative and Rural Development Bank (NACRDB) in Nigeria, as well as non bank financial institutions including the Stock Exchange.

(iii) Human capital development: The Central Bank participates directly and indirectly in the training of manpower for the banking industry. For example, in Nigeria, the CBN is involved in the activities of the Chartered Institute of Bankers of Nigeria (CIBN) and the Financial Institution-Training Centre (FITC).

(iv) Establishment of special schemes and funds: The Central Bank promotes special schemes and funds in the areas of agricultural finance, export development and small and medium scale enterprises so as to enhance economic development. Examples in Nigeria include the Agricultural Credit Guarantee Scheme Fund (ACGSF) and Small and Medium Industries Equity Investment Scheme (SMIEIS).

(v) Sources of data for research: Through its regular publications, the Central Bank provides information on financial indices and indicators for use in research and development (R&D) efforts.

Commercial and Merchant Banks

Commercial and Merchant Banks operate under the legal framework of the Banks and other Financial Institutions (BOFI) Act 25 of 1991 (as amended).

Functions of Commercial Banks

The commercial banks offer a range of services which include the following:

(i) Accepting deposits of money: Commercial banks, as savings institutions, provide facilities for the mobilization of savings by accepting deposits from households, firms and government. They use current account, saving account and fixed deposit account to accept demand deposits, saving deposits and time deposits respectively.

(ii) Granting loans and advances: The most profitable function of commercial banks is extending credits to worthy borrowers while charging interest rate higher than the rate they pay on deposits. Short – term credit facilities are extended to customers using special loan account or in the form of overdraft using current account. It may also take the form of loan syndication whereby two or more banks agree to finance a large project.

(iii) Acting as agents of payment: Commercial banks` customers keep current accounts from which they can draw for settlement of debt and for payments for goods and services. They also transfer funds on behalf of their customers through collection of standing orders and direct debiting.

(iv) Creating demand – deposit money: By lending out the money – i.e. deposit that they collected from some customers, commercial banks create additional purchasing power in the economy.

(v) Providing international trade service: Commercial banks are involved in the financial aspects of international trade, especially by discounting bills of exchange for their customers who are exporters and opening letters of credit in favour of their customers who are importers. A letter of credit is an undertaking by the bank accepting to redeem the liability of its customers on an import contract.

(vi) Providing brokerage services: Commercial banks undertake to buy and sell stocks and shares on behalf of their customers.

(vii) Foreign exchange services: Commercial banks act as intermediaries between the Central Bank or authorized foreign exchange dealers and their corporate customers to process foreign exchange allocation. They also provide traveller's cheque to their customers who are travelling out of the country.

(viii) Safekeeping of valuable items: Commercial banks undertake to keep, for their customers, valuable items such as government stock, share certificates, academic certificates, certificate of occupancy, jewelleries, insurance policies, etc.

(ix) Equipment leasing: This is the activity of banks in financing purchases of fixed assets by their customers (mostly business enterprises) and allowing repayment over an agreed period of time. The bank is the lessor, while the beneficiary is the lessee.

Functions of Merchant Banks

The traditional functions of merchant banks include the following:

(i) Acting as issuing houses in the capital market: Merchant banks are engaged in issuing or floating of new securities for private and public companies and for government (state and local) seeking to raise long-term or permanent finance for their projects. For all services involved in the performance of this function, merchant banks receive a commission called brokerage.

(ii) Accepting deposit: Merchant banks accept large deposits from their customers, mostly corporate bodies. Such deposits attract interest and can be withdrawn only with certificate of deposits (CD) and not with cheques as in the commercial banks transactions.

(iii) Providing foreign exchange services: Merchant banks are authorized dealers in the foreign exchange market and as a result they are engaged in the buying and selling of foreign exchange (forex) for commercial and other purposes. They also provide services for both importers and exporters.

(iv) Granting loans and advances: The banks provide medium and long-term loans and advances to manufacturers and big-time traders. They are also engage in loan syndication.

(v) Project Financing: The merchant banks are engaged in the financing of new industrial and agricultural projects on the understanding that the repayment would be made from the revenue stream generated by the project.

(vi) Providing advisory services: Merchant banks offer advice to their clients on project financing, joint ventures, mergers and acquisitions, debt financing, and on the rationalization of the company's capital structure.

(vii) Equipment Leasing: The business of equipment leasing, as described under commercial banking, is more popular with the merchant banks. Equipment leasing can be in the form of finance lease where a bank provides funds to a firm to purchase the equipment, or operation lease where a bank or lessor buys the equipment and rent it out to the firm – i.e (the leasee).

Comparison between Commercial and Merchant Banks

The activities and functions of commercial and merchant banks in a typical developing economy can be compared and contrasted as follow:

i. Commercial banks are retail bankers accepting deposit from individuals, businesses and government, not considering the size. On the other hand, merchant bankers accept deposit not below a specified minimum, mostly from corporate bodies.

ii. Commercial banks grant more of short-term loans and advances to their customers. Merchant banks, on the other hand, grant medium and long-term loans and advances to their customers .

iii. Commercial banks operate with wider branch network, while merchant banks, as wholesale bankers, operate with limited branch network.

iv. Commercial banks offer more of general banking services such as deposit taking and granting of loans and advances. Merchant banks offer mostly specialized banking services such as equipment leasing, debt factoring, project financing, etc.

Community Banks

A community bank in Nigeria is a self-sustaining financial institution owned and managed within a community to provide financial services to that community. The National Board for Community Banks (NBCB) processes applications for the establishment of community banks. The first community bank commenced operation in December 1990. Since then, NBCB has issued provisional licences to 1,366 community banks and are expected to be issued final licences by the CBN after operating for two years.

Differences between Central Bank and Commercial Bank

There are basic differences between the central bank and a commercial bank in terms of their structure and operations in the following ways:

i. The central bank is the apex institution of the monetary and banking structure of the country. The commercial bank is one of the organs of the money market.

ii. The central bank does not operate as a profit-driven institution but only implements the economic policies of the government. But the commercial bank is a profit-making institution.

iii. The central bank is owned by the government, whereas the commercial bank is owned by private individuals as shareholders.

iv. The central bank is a banker to the government and does not engage itself in ordinary banking activities. The commercial bank is a banker to the general public.

v. The central bank has the monopoly of issuing currency of the country as the legal tender but the commercial bank can issue only cheques to its customers; the currency notes and coins issued by a central bank constitute legal tender. But the cheques are mere near-money.

vi. The central bank is the banker to commercial banks. Therefore, it grants window of opportunity for credits to commercial banks in the form of rediscount facilities, keeps their cash reserves, and clears their balances in cheque settlements. On the other contrary, the commercial bank accepts deposits from the general public and grants loans and advances to the customers.

vii. The central bank controls credit in accordance with the needs and policy of the government and the business and economy generally. The commercial bank creates credit to meet the requirements of business

viii. The central bank helps in establishing financial institutions so as to strengthen money and capital markets in a country. On the other hand, the commercial bank helps industries by underwriting shares and debentures, and agriculture by meeting its financial requirements through cooperatives or individually

ix. Every country has only one central bank with its offices at important centres in the country. On the other hand, there are many commercial banks with hundreds of branches within and outside the country.

x. The central bank is the custodian of the foreign currencies of the country while the commercial bank is a dealer in foreign exchange in terms of buying and selling.

PROCEDURES FOR ESTABLISHING A BANK IN NIGERIA

Establishing a bank in Nigeria involves several steps and procedures, as regulated by the Central Bank of Nigeria (CBN) and other relevant regulatory authorities

1. Pre-Incorporation Stage:

a. Feasibility Study: Conduct a thorough feasibility study to assess the viability and market potential for the proposed bank, including market demand, competition, regulatory requirements, and financial projections.

b. Business Plan: Develop a comprehensive business plan outlining the bank's objectives, organizational structure, products and services, target market segments, marketing strategies, operational plans, and financial projections.

c. Capital Requirements: Ensure compliance with the minimum capital requirements stipulated by the CBN for different categories of banks, such as commercial banks, merchant banks, and microfinance banks.

2. Incorporation and Registration:

a. Name Reservation: Apply to the Corporate Affairs Commission (CAC) to reserve the proposed name of the bank, ensuring that it complies with CBN guidelines and is not already in use by another entity.

b. Incorporation: Register the bank as a limited liability company with the CAC, submitting the required incorporation documents, including the memorandum and articles of association, forms CAC 1.1 and CAC 1.2, and other relevant forms and declarations.

c. Obtain Tax Identification Number (TIN): Obtain a Tax Identification Number (TIN) from the Federal Inland Revenue Service (FIRS) for the newly incorporated bank.

3. Application to the Central Bank of Nigeria (CBN):

a. Application Submission: Prepare and submit an application for a banking license to the CBN, accompanied by the required documents and information specified in the CBN Guidelines for the Establishment of Banks and Other Financial Institutions in Nigeria.

b. Due Diligence: Undergo a thorough due diligence process conducted by the CBN to assess the suitability of the proposed bank's promoters, shareholders, directors, and key management personnel.

c. Capital Verification: Ensure that the proposed bank's paid-up capital meets the minimum requirements specified by the CBN, and provide evidence of capital verification by an external auditor.

d. Fit and Proper Test: Demonstrate the fitness, propriety, integrity, and professional competence of the proposed bank's promoters, directors, and key management personnel through the Fit and Proper Test conducted by the CBN.

e. Approval: Await approval from the CBN for the establishment and operation of the bank, subject to compliance with all regulatory requirements and conditions.

4. Post-License Requirements:

a. Operational Setup: Establish the bank's operational infrastructure, including physical premises, technology systems, human resources, and compliance frameworks, in accordance with CBN regulations and industry best practices.

b. Appointment of Key Personnel: Appoint qualified and experienced executives and staff to key positions within the bank, including the board of directors, management team, compliance officers, internal auditors, and other key functions.

c. Compliance and Reporting: Ensure ongoing compliance with CBN regulations, reporting requirements, prudential standards, and supervisory directives, and maintain effective risk management, internal controls, and corporate governance practices.

d. Commencement of Operations: Obtain the necessary approvals and licenses to commence banking operations, including opening branches, offering products and services, and accepting deposits from customers.

ACT 418

MORTGAGE FINANCING

Learning Objectives

At the end of the lesson, the student should be able to:

1. Discuss mortgage finance

2. State the historical background of mortgage finance in Nigeria

3. Discuss the finance options for housing in Nigeria

Main Content

Mortgage Finance

Housing finance constitutes one of the major pillars of housing delivery system. Indeed, without a well-organized and efficient housing finance mechanism, the goal of a housing development policy will be largely unattainable. Housing finance has been recognised as an important, almost indispensable factor in the housing delivery system. This is because only the very few in any nation can afford to pay cash for a house. Most other people must have to finance their house through loans, personal savings, assistance from relatives or friends and gifts. Mortgage finance refers to the provision of loans or financing facilities secured by real estate properties, typically for the purpose of purchasing residential or commercial properties. It enables individuals and businesses to acquire property ownership by borrowing funds from lenders, with the property itself serving as collateral for the loan.

Adequate housing provision has since the early 1970s consequently engaged the attention of most countries, especially the developing nations, Nigeria inclusive, for a number of reasons. First, it is one of the three most important basic needs of mankind- the others being food and clothing. Secondly, housing is a very important durable consumer item, which impacts positively on productivity, as decent housing significantly increases worker's health and wellbeing, and consequently growth. Thirdly, it is one of the indices for measuring the standard of living of people across societies.

An Historical Overview of Mortgage in Nigeria

The history of mortgages in Nigeria can be traced back to the colonial era, with the introduction of formal land tenure systems, property ownership, and mortgage financing mechanisms. Mortgage lending in Nigeria prior to 1976 was largely restricted to a single public-owned housing bank, the Nigerian Building Society (NBS), and supported by some mandatory and state contributions. The NBS was created in 1956 and converted in 1976 into the Federal Mortgage Bank of Nigeria (FMBN). The FMBN mobilized some limited deposits and granted a few mortgage loans mostly to higher-income borrowers. Decree No. 53 of 1989 authorized the licensing of Primary Mortgage Institutions (PMIs) as specialized institutions to collect households' savings and originate mortgage loans. PMIs were based on the British model of building societies and were expected to support the development of a more vibrant and competitive housing finance sector. The Ministry of Works and Housing (MWH) and the FMBN were appointed as regulators and supervisors for PMIs. However, FMBN's regulatory and supervisory responsibilities were transferred to the CBN in 1997.

A National Housing Fund (NHF) was created by Decree No. 3 of 1992 to subsidize “affordable” mortgage loans and catalyze long term funding for PMIs and is managed by the FMBN. Collections began in 1994 and it is funded by mandatory contributions from all employees of 2.5% of basic wages with the employees earning 4% per annum on this money and becoming eligible for NHF financed loans.

By this decree, banks were expected to fund the NHF in amounts equal to 10% of overall loans and advances, to be remunerated at current account interest rate plus 1% (i.e. about 5%). Life and non-life insurance companies were also to invest 20% and 10% of their premiums respectively in the NHF, remunerated at a low fixed rate of 4%. Given inflationary conditions, CBN has never applied this requirement to banks, nor have insurance companies complied with these requirements. Such rules would have contradicted the liberalization of the financial system, undermined the interest rate structure, and put at risk the development of contractual savings.

institutions. However, the enacted decree has not been amended and the resulting ambiguity still affects relations between FMBN (manager of the NHF), banks and insurance companies.

Financing Options for Housing in Nigeria

There are various options of financing options of housing before the evolvement of the modern means of financing housing development in Nigeria. The two major options will be discussed accordingly.

1. Traditional Financing Method:

Traditionally, financing housing in Nigeria has relied on various informal and formal mechanisms, reflecting cultural practices, socio-economic dynamics, and historical factors. Before the advent of modern methods of housing finance, Nigerians had several methods of financing home ownership. Prominent among these were the "Esusu"and "Ajo", which involved group of people contributing money equally for a period of time and handling a lump sum over to one member of the group usually at the end of each month or specified period of time. The "Aro" and "Owe" involved group members contributing by providing labour for each member. Others are loans from traditional moneylenders and social club contributions. These methods of financing may have proved effective for the nature of buildings that were being erected at the time, but with the downward slide in the economy, double-digit inflation and high cost of building materials in recent time, many of these methods have proved ineffective.

2. Modern Financing Method

The following are some of the modern methods of finance available for housing developments and purchase in Nigeria.

(i) The Federal Mortgage Bank of Nigeria (FMBN): The FMBN commenced operation in 1978, following the promulgation of the FBMN Decree No 7 of January 1977 as a direct Federal Government intervention to accelerate its housing delivery programme. The FMBN is expected to expand and coordinate mortgage lending on a nation-wide basis, using resources from deposit mobilized and equity contributions by the Federal Government and CBN at rates of interest below the market rates. By mid-1980s, the FMBN was the only mortgage private institution in Nigeria

(ii) Primary Mortgage Institutions (PMI): The Mortgage Institutions Decree No.53 of 1989 provided the regulatory framework for the establishment and operation of PMIs by private entrepreneurs. The FMBN was empowered to license the PMIs as second tier housing finance institutions. The PMIs were to mobilize savings from the public and grant housing loans to individual, while the FMBN mobilizes capital fund for the PMIs.

(iii) Personal and Family Savings: This constitutes a major source of finance especially for individuals who wish to build their houses themselves. In this case, individuals buy land in area zoned for housing and build their own houses, while government is expected to provide infrastructure to service the houses.

(iv) Corporate organizations: With the promulgation of employee Housing Scheme (Special provision) Decree 54 of 1979, any employer of up to 500 employees is expected to provide minimum of 50 housing units out of which three quarters are to be made available to non-executive staff.

The Mortgage Sector

The Federal Mortgage Bank of Nigeria (FMBN)

The Federal Mortgage Bank of Nigeria (FMBN) is a government-owned financial institution established in 1956 and fully operationalized in 1959. It operates under the Federal Mortgage Bank of Nigeria Act, Cap F16, Laws of the Federation of Nigeria 2004. The primary mandate of the FMBN is to promote homeownership and affordable housing finance in Nigeria by providing mortgage finance, mobilizing funds, and facilitating the delivery of housing solutions to Nigerians. The FMBN took over the assets and liabilities of the Nigerian Building Society. The FMBN provides banking and advisory services, and undertakes research activities pertaining to housing. Following the adoption of the National Housing Policy in 1990, FMBN is empowered to licence and regulate primary mortgage institutions in Nigeria and act as the apex regulatory body for the Mortgage Finance Industry. The financing function of the Federal Mortgage Bank of Nigeria was carved out and transferred to the Federal Mortgage Finance, while the FMBN retains its regulatory role. FMBN is under the control of the Central Bank of Nigeria.

The functions include:

1. Mortgage Finance Provision:

The FMBN provides long-term mortgage finance to individuals, cooperative societies, corporate bodies, and other eligible entities for the construction, acquisition, renovation, or improvement of residential properties. It offers various mortgage products, including home renovation loans, home

completion loans, and home purchase loans, with competitive interest rates and flexible repayment terms.

2. Mobilization of Funds:

The FMBN mobilizes funds from various sources, including the National Housing Fund (NHF), commercial banks, capital markets, international financial institutions, and development partners, to support its housing finance activities. It manages the NHF, which is a statutory savings scheme established to mobilize funds for housing development and mortgage finance through mandatory contributions from employees in the formal sector.

3. Housing Development Financing:

In addition to mortgage finance, the FMBN provides financing support for housing development projects through loans, grants, guarantees, and technical assistance to developers, housing cooperatives, and government agencies involved in housing construction.

It collaborates with state governments, local authorities, housing agencies, and private sector stakeholders to facilitate the delivery of affordable housing projects and infrastructure development initiatives across Nigeria.

4. Mortgage Guarantee and Insurance:

The FMBN offers mortgage guarantee and insurance services to mitigate credit risks and enhance access to mortgage finance for borrowers and lenders. It provides mortgage guarantee cover to participating mortgage institutions (PMIs) to protect against borrower default and loss on mortgage loans, thereby encouraging increased lending to homebuyers.

5. Capacity Building and Housing Sector Development:

The FMBN engages in capacity building, research, advocacy, and policy dialogue activities aimed at promoting housing sector development, enhancing institutional capacity, and fostering best practices in mortgage finance and housing delivery. It supports initiatives to improve housing finance regulations, streamline mortgage processes, and strengthen collaboration among stakeholders in the housing sector.

6. Technology and Innovation:

The FMBN adopts technology-driven solutions and digital platforms to streamline its operations, enhance service delivery, and improve access to housing finance for borrowers and stakeholders. It leverages information and communication technologies (ICT) to automate mortgage processes, facilitate online transactions, and enhance transparency, efficiency, and accountability in its operations.

Primary Mortgage Institutions (PMI):

Primary mortgage institutions operate within the framework of Act No. 53 of 1989. PMIs mobilize savings for the development of the housing sector. Their total assets/liabilities rose to N7248.2 million in 1999. In reaction to distress in the sector, the Federal Mortgage Bank of Nigeria tightened its surveillance of the institutions by issuing "clean bill of health" to 116 mortgage institutions. The share capital requirement for new primary mortgage institutions has been raised to N20 million. PMIs play a crucial role in the housing finance sector by originating, servicing, and administering mortgage loans for individuals, families, cooperatives, and corporate entities seeking to purchase, construct, renovate, or improve residential properties. The functions are:

1. Mortgage Origination:

PMIs originate mortgage loans by providing financing to borrowers for the acquisition, construction, or renovation of residential properties. They assess borrowers' creditworthiness, evaluate property valuations, and structure mortgage loans in accordance with regulatory guidelines and risk management standards.

2. Mortgage Servicing:

PMIs service mortgage loans by collecting monthly mortgage payments from borrowers, maintaining mortgage accounts, and managing escrow funds for property taxes, insurance premiums, and other related expenses. They provide customer service, counseling, and support to borrowers throughout the mortgage lifecycle, including assistance with loan repayment, refinancing, prepayment, and foreclosure prevention.

3. Deposit Mobilization:

PMIs mobilize deposits from savers and investors to fund mortgage lending activities and support housing finance operations. They attract funds through savings accounts, time deposits, certificates of deposit, and other deposit products, offering competitive interest rates and terms to depositors.

4. Intermediation and Risk Management:

PMIs serve as intermediaries between depositors seeking investment opportunities and borrowers in need of housing finance. They manage risks associated with mortgage lending, including credit risk, interest rate risk, liquidity risk, and operational risk, through prudent underwriting, loan portfolio diversification, and risk mitigation strategies. PMIs may also engage in hedging, securitization, and mortgage insurance arrangements to mitigate credit and market risks and enhance the efficiency and liquidity of their mortgage portfolios.

5. Housing Finance Products:

PMIs offer a range of mortgage products and services tailored to meet the diverse needs of borrowers, including home purchase loans, home construction loans, home improvement loans, and refinancing options. They provide flexible terms, competitive interest rates, and personalized financing solutions to accommodate borrowers' financial circumstances, preferences, and housing goals.

6. Compliance and Supervision:

PMIs operate under the regulatory oversight of the Central Bank of Nigeria (CBN) and are subject to compliance with prudential regulations, licensing requirements, and supervisory directives. They adhere to regulatory standards related to capital adequacy, loan underwriting, asset quality, liquidity management, corporate governance, and financial reporting to maintain soundness, stability, and integrity in their operations.

7. Industry Development and Collaboration:

PMIs collaborate with government agencies, housing authorities, real estate developers, mortgage insurers, and other stakeholders to promote housing sector development, facilitate affordable housing finance, and address housing affordability challenges. They support initiatives to enhance

housing finance regulations, streamline mortgage processes, improve access to land and infrastructure, and foster innovation and best practices in mortgage lending and housing delivery.

Concept of Primary Mortgage Market

The Primary Mortgage Market is a market where all the mortgage loans are originated. The market is a place where the mortgage originators and as well as the borrowers come together to set the mortgage deal and negotiate the terms and conditions regarding that deal. The credit unions, mortgage brokers, banks and mortgage bankers etc. all are the part of primary mortgage market. The development of a primary mortgage market depends upon macroeconomic stability of the nation. However, primary mortgage market plays an important role behind the development of a successful secondary mortgage market. The secondary mortgage market on its part, loans and servicing rights are traded between the mortgage securities, mortgage originators and investors. The functions include:

1. Mortgage Origination:

The primary function of the primary mortgage market is to originate mortgage loans by providing financing to borrowers for the purchase, construction, or refinancing of residential properties.

Lenders in the primary mortgage market evaluate borrowers' creditworthiness, assess property valuations, and determine the terms and conditions of mortgage loans based on borrowers' financial profiles, loan-to-value ratios, and other risk factors.

2. Access to Mortgage Finance:

The primary mortgage market provides access to mortgage finance for individuals and families seeking to purchase homes or refinance existing mortgages.

By offering a range of mortgage products, terms, and financing options, the primary market caters to diverse borrower needs, preferences, and financial circumstances, enabling broad-based access to homeownership opportunities.

3. Risk Assessment and Underwriting:

Lenders in the primary mortgage market conduct risk assessment and underwriting to evaluate the creditworthiness of borrowers and assess the risk associated with mortgage loan applications.

This involves verifying borrowers' income, employment history, credit history, assets, liabilities, and property details to determine eligibility for mortgage financing and establish appropriate loan terms and conditions.

4. Loan Pricing and Interest Rates:

The primary mortgage market sets interest rates and loan pricing based on prevailing market conditions, lender risk assessments, borrower credit profiles, and loan characteristics.

Lenders determine the cost of borrowing for borrowers by establishing interest rates, origination fees, discount points, closing costs, and other fees associated with mortgage loans, reflecting the risk and cost of lending.

5. Loan Servicing and Administration:

Lenders in the primary mortgage market service and administer mortgage loans throughout the loan lifecycle, from origination to repayment.

This involves collecting monthly mortgage payments from borrowers, managing escrow accounts for property taxes and insurance premiums, processing loan payments, and providing customer service and support to borrowers.

6. Regulatory Compliance and Consumer Protection:

The primary mortgage market operates under regulatory oversight to ensure compliance with lending standards, consumer protection laws, and regulatory requirements.

Lenders must adhere to regulatory guidelines related to mortgage origination, underwriting standards, disclosure requirements, fair lending practices, and consumer rights to maintain integrity and transparency in mortgage lending operations.

7. Market Liquidity and Secondary Market Transactions:

The primary mortgage market contributes to market liquidity by originating mortgage loans that can be sold or securitized in the secondary market.

Lenders may sell mortgage loans to investors, government-sponsored enterprises (GSEs), or mortgage-backed securities (MBS) issuers to replenish liquidity, manage balance sheet risk, and facilitate additional lending, enhancing the efficiency and availability of mortgage finance

ACT 418

CAPITAL STRUCTURE OF NIGERIAN FIRMS

Learning Objectives

At the end of the lesson, the students should be able to:

1. Define capital structure

2. Discuss the objectives of capital structure.

3. State the forms of capital structure

4. Mention the factors determining capital structure.

5. Explain the different capital structure theories.

Main Content

Capital Structure

Capital structure refers to the kinds of securities and the proportionate amounts that make up capitalization. It is the mix of different sources of long-term sources such as equity shares, preference shares, debentures, long-term loans and retained earnings. Capital structure in simple words refers to debt equity ratio of a company. In other words it refers to the proportion of debt in the investments of the company. It is important for a company to have an appropriate capital structure. The term capital structure refers to the proportion of debt (fixed-interest sources of financing) and equity capital (variable-dividend securities/ source of funds)

The term capital structure refers to the relationship between the various long-term source financing such as equity capital, preference share capital and debt capital. Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm. Capital structure is the permanent financing of the company represented primarily by long-term debt and equity. Capital structure is the permanent financing of the company represented primarily by long-term debt and shareholder's funds but excluding all short-term credit. As such, a company's capital structure is only a part of its financial structure.

According to Gerstenberg, capital structure refers to ‘the makeup of a firm’s capitalisation’. In other words, it represents the mix of different sources of long-term funds (such as equity shares, preference shares, long-term loans, retained earnings) in the total capitalisation of the company. For example, a company has equity shares of ` 1,00,000, debentures 1 1,00,000, preference shares of `100,000 and retained earnings of ` 50,000. The term capitalisation is used for total long-term funds. In this case it is off 3,50,000. The term ‘capital structure is used, for the mix of capitalisation, In this case it will be said that the capital structure of the company consists of `,10,000 in equity shares, `1,00,000 in preference shares, 1,00,000 in debentures and ` 50,000 in retained earnings.

Optimum Capital Structure

Optimum capital structure is the capital structure at which the weighted average cost of capital is minimum and thereby the value of the firm is maximum. Optimum capital structure may be defined as the capital structure or combination of debt and equity that leads to the maximum value of the firm. The financial manager has to establish an optimum capital structure and ensure the maximum rate of return on investment. The ratio between equity and other liabilities carrying fixed charges has to be defined. In the process, he has to consider the operating and financial leverages of his firm

Objectives of Capital Structure

Decision of capital structure aims at the following two important objectives:

1. Maximize the value of the firm.

2. Minimize the overall cost of capital

Forms of Capital Structure

Capital structure pattern varies from company to company and the availability of finance. Normally the following forms of capital structure are popular in practice:

i. Equity shares only.

ii. Equity and preference shares only

iii. Equity and Debentures only.

iv. Equity shares, preference shares and debentures.

Factors Determining Capital Structure

The following factors are considered while deciding the capital structure of the firm:

1. Leverage It is the basic and important factor, which affect the capital structure. It uses the fixed cost financing such as debt, equity and preference share capital. It is closely related to the overall cost of capital.

2. Cost of Capital Cost of capital constitutes the major part for deciding the capital structure of a firm.

3. Trading on Equity A company may raise funds either by issue of shares or by debentures. Debentures carry a fixed rate of interest and this interest has to be paid irrespective of profits. Of course, preference shares are also entitled to a fixed rate of dividend but payment of dividend depends upon the profitability of the company.

4. Retaining Control The capital structure of a company is also affected by the extent to which the promoter/ existing management of the company desire to maintain control over the affairs of the company. The preference shareholders and debentureholders have not much say in the management of the company. It is the equity shareholders who select the team of managerial personnel. It is necessary, therefore, for the promoters to own majority of the equity share capital in order to exercise effective control over the affairs of the company. The promoters or the existing management are not interested in losing their grip over the affairs of the company and at the same time, they need extra funds. They will, therefore, prefer preference shares or debentures over equity shares so long they help them in retaining control over the company

5. Legal Requirements The promoters of the company have also to keep in view the legal requirements while deciding about the capital structure of the company. This is particularly true in case of banking companies which are not allowed to issue any other type of security for raising funds except equity share capital on account of the Banking Regulation Act

6. Purpose of Financing The purpose of financing also to some extent affects the capital structure of the company. In case funds are required for some directly productive purposes, for example, purchase of new machinery, the company can afford to raise the funds by issue of debentures. This is because the company will have the capacity to pay interest on debentures out of the profits so

earned. On the other hand, if the funds are required for non-productive purposes, providing more welfare facilities to the employees such as construction of school or hospital building for company's employees, the company should raise the funds by issue of equity shares.

7. Period of Finance The period for which finance is required also affects the determination of capital structure of companies. In case, funds are required, say for 3 to 10 years, it will be appropriate to raise them by issue of debentures rather than by issue of shares. This is because in case the funds are raised by issue of shares, their repayment after 8 to 10 years (when they are not required) will be subject to legal complications. Even if such funds are raised by issue of redeemable preference shares, their redemption is also subject to certain legal restrictions. However, if the funds are required more or less permanently, it will be appropriate to raise them by issue of equity shares.

8. Market Sentiments The market sentiments also decide the capital structure of the company. There are periods when people want to have absolute safety. In such cases, it will be appropriate to raise funds by issue of debentures. At other periods, people may be interested in earning high speculative incomes; at such times, it will be appropriate to raise funds, by issue of equity shares. Thus, if a company wants to raise sufficient funds, it must take into account market sentiments, otherwise its issue may not be successful

9. Requirement of Investors Different types of securities are to be issued for different classes of investors. Equity shares are best suited for bold or venturesome investors. Debentures are suited for investors who are very cautious while preference shares are suitable for investors who are not very cautious. In order to collect funds from different categories of investors, it will be appropriate for the companies to issue different categories of securities. This is particularly true when a company needs heavy funds.

10 Size of the Company Companies which are of small size have to rely considerably upon the owners funds for financing. Such companies find it difficult to obtain long-term debt. Large companies are generally considered to be less risky by the investors and, therefore, they can issue different types of securities and collect their funds from different sources. They are in a better bargaining position and can get funds from the sources of their choice.

Features of Capital Structure

Financial manager should develop an appropriate capital structure, which is helpful to maximize shareholders wealth. This can be possible when all factors which are relevant to the company's capital structure and properly analyzed, balanced and considered.

1. Profitability: The company should make maximum use of leverage at a minimum cost. In other words, it should generate maximum returns to owners without adding additional cost.

2. Flexibility: Flexible capital structure means it should allow the existing capital structure to change according to the changing conditions without increasing cost. It should be possible for the company to provide funds whenever needed to finance its possible activities. The company should be able to raise funds whenever the need arises and also retire debts whenever it becomes too costly to continue with particular source.

3. Solvency: The use of excessive debt threatens the solvency of the company. Debt should be used till the point where debt does not add significant risk, otherwise use of debt should be avoided.

4. Control: The capital structure should involve minimum dilution of the control of the company. A company that issues more and more equity dilutes the power of existing shareholders as number of shareholders increases. Also raising of additional funds through public issue may lead to dilution of control.

5. Cost of Capital: If the cost of any component of capital structure of the company like interest payment on debts is very high then it can increase the overall cost of the capital of the company. In such case the company should minimize the use of that component of capital structure in its total capital structure in its total capital structure.

CAPITAL STRUCTURE THEORIES

Capital structure is the major part of the firm's financial decision which affects the value of the firm and it leads to change EBIT and market value of the shares. There is a relationship among the capital structure, cost of capital and value of the firm. The aim of effective capital structure is to maximize the value of the firm and to reduce the cost of capital. There are two major theories explaining the relationship between capital structure, cost of capital and value of the firm.

Capital Structure Theories

1. Modern Approach

2. Traditional Approach

3. Net Income Approach

4. Net Operating Income Approach

5. Modigliani-Miller Approach

(a) **Traditional Approach**

It is the mix of Net Income approach and Net Operating Income approach. Hence, it is also called as intermediate approach. According to the traditional approach, mix of debt and equity capital can increase the value of the firm by reducing overall cost of capital up to certain level of debt. Traditional approach states that the Ko decreases only within the responsible limit of financial leverage and when reaching the minimum level, it starts increasing with financial leverage.

Assumptions

Capital structure theories are based on certain assumption to analysis in a single and convenient manner: • There are only two sources of funds used by a firm; debt and shares.

• The firm pays 100% of its earning as dividend.

• The total assets are given and do not change.

• The total finance remains constant.

• The operating profits (EBIT) are not expected to grow.

• The business risk remains constant.

• The firm has a perpetual life.

• The investors behave rationally

Illustration 1

ABC Ltd., needs N30,000,000 for the installation of a new factory. The new factory expects to yield annual earnings before interest and tax (EBIT) of N5,000,000. In choosing a financial plan, ABC Ltd., has an objective of maximizing earnings per share (EPS). The company proposes to issuing ordinary shares and raising debit of N3,000,000 and N10,000,000 of N 15,000,000. The

current market price per share is N250 and is expected to drop to N200 if the funds are borrowed in excess of N12,000,000. Funds can be raised at the following rates:

i. up to N3,000,000 at 8%

ii. over N3,000,000 to N 15,000,000 at 10%

iii. over N15,000,000 at 15%

Assuming a tax rate of 50% advise the company

Solution

Earnings Before Interest and Tax (BIT) less Interest Earnings Before Tax less: Tax@50%.

Alternatives		
I (N3,000,000 debt)	II (N10,000,000 debt)	III (N15,000,000 debt)
5,000,000 24,000	5,000,000 1,000,000	5,000,000 2,250,000
4,760,000 2,380,000	4,000,000 2,000,000	2,750,000 1,370,500
2,380,000 27,000,000	2,000,000 20,000,000	1,370,500 15,000,000
250 10,800 2,3800,000	250 8,000 2,000,000	200 7,500 1,370,500
No. of shares 10,800 Earnings per share 22.03	8,000 25	7,500 18.33

The secure alternative which gives the highest earnings per share is the best. Therefore the company is advised to revise N10,000,000 through debt amount N20,000,000 through ordinary shares

2. **Net Income (NI) Approach**

Net income approach suggested by the Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm. In other words, a change in the capital structure leads to a corresponding change in the overall cost of capital as well as the total value of the firm. According to this approach, use more debt finance to reduce the overall cost of capital and increase the value of firm. This theory gives the idea for increasing market value of firm and decreasing overall cost of capital. A firm can choose a degree of capital structure in which debt is more than equity share capital. It will be helpful to increase the market value of firm and decrease the value of overall cost of capital. Debt is cheap source of finance because its interest is deductible from net profit before taxes. After deduction of interest company has to pay less tax and thus, it will decrease the weighted average cost of capital

Net income approach is based on the following three important assumptions:

1. There are no corporate taxes.

2. The cost debt is less than the cost of equity.

3. The use of debt does not change the risk perception of the investor.

$V = S+B$

V = Value of firm

S = Market value of equity

B = Market value of debt

Market value of the equity can be ascertained by the following formula:

$S=NI/K_e$

where

NI = Earnings available to equity shareholder

Ke = Cost of equity/equity capitalization rate

(c) Net Operating Income (NOI) Approach

Another modern theory of capital structure, suggested by Durand. This is just the opposite of the Net Income approach. According to this approach, Capital Structure decision is irrelevant to the valuation of the firm. The market value of the firm is not at all affected by the capital structure

changes. According to this approach, the change in capital structure will not lead to any change in the total value of the firm and market price of shares as well as the overall cost of capital. Net operating income theory or approach does not accept the idea of increasing the financial leverage under NI approach. It means to change the capital structure does not affect overall cost of capital and market value of firm. At each and every level of capital structure, market value of firm will be same.

NI approach is based on the following important assumptions;

I. The overall cost of capital remains constant;

II. There are no corporate taxes;

III. The market capitalizes the value of the firm as a whole;

$V=EBIT/K_e$

Where,

V = Value of the firm

EBIT = Earnings before interest and tax

K_o = Overall cost of capital

XYZ expects a net operating income of Rs. 2,000,000. It has 8,000,000, 6% debentures. The overall capitalization rate is 10%. Calculate the value of the firm and the equity capitalization rate (Cost of Equity) according to the net operating income approach. If the debentures debt is increased to Rs. 10,00,000. What will be the effect on volume of the firm and the equity capitalization rate?

Solution

Net operating income = Rs. 2,000,000

Overall cost of capital = 10%

Market value of the firm (V)

$= EBIT/K_O$

=2,000,000 * 100/10

=RS 20,000,000

Market value of the Firm=	Rs 20,000,000
Less market value of debentures=	Rs 8,000,000
	12,000,000

Equity capitalization rate (or) cost of equity (K_{O})

$$=\frac{EBIT-1}{V-D}$$

Where V= Value of the Firm

D= value of the debt capital

$$=\frac{2,000,000-48,000}{20,000,000-8,000,000}$$

=12.7%

If the debentures debt is increased to Rs. 10,00,000, the value of the firm shall remain changed to Rs. 20,00,000. The equity capitalization rate will increase as follows:

$$=\frac{EBIT-1}{V-D}$$

$$\frac{2,000,000-60,000}{20,000,000-10,000,000} \quad *100$$

-14%

(d) Modigliani and Miller Approach

Modigliani and Miller approach states that the financing decision of a firm does not affect the market value of a firm in a perfect capital market. In other words MM approach maintains that the average cost of capital does not change with change in the debt weighted equity mix or capital structures of the firm.

MM theory or approach is fully opposite of traditional approach. This approach says that there is not any relationship between capital structure and cost of capital. There will not effect of increasing debt on cost of capital. Value of firm and cost of capital is fully affected from investor's expectations. Investors' expectations may be further affected by large numbers of other factors which have been ignored by traditional theorem of capital structure.

Modigliani and Miller approach is based on the following important assumptions:

i. There is a perfect capital market.

ii. There are no retained earnings.

iii. There are no corporate taxes.

iv. The investors act rationally.

v. The dividend payout ratio is 100%.

vi. The business consists of the same level of business risk

Value of the firm can be calculated with the help of the following formula:

$=EBIT/K_O (1-t)$

Where EBIT = Earnings before interest and tax

Ko = Overall cost of capital

t = Tax rate

There are two firms 'A' and 'B' which are exactly identical except that A does not use any debt in its financing, while B has Rs. 2,50,000 , 6% Debentures in its financing. Both the firms have earnings before interest and tax of Rs. 75,000 and the equity capitalization rate is 10%. Assuming the corporation tax is 50%, calculate the value of the firm

$Vu=EBIT/K_e$

$=\frac{75,000}{10/100}$ $=75,000 *100/10$

=Rs750,000

The market value of firm B which uses debt financing of Rs 250,000

Vr= Vu +t

Vu= 750,000, t=50% of Rs 250,000

=750,000 +125,000

=Rs 875,000