

BUA305

FINANCIAL MANAGEMENT



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Series 1: Foundations and Scope of Financial Management

Series outline

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Introduction

In every organisation, decisions about money are central to survival and growth. Whether it is choosing how to raise funds, deciding where to invest, or determining how much profit to distribute, financial management provides the framework for making these choices wisely. Without a clear understanding of its foundations and scope, managers may struggle to align financial decisions with long-term corporate objectives. This Series therefore sets the stage for



the rest of the course by introducing you to the essential principles that underpin financial management.

The aim of this Series is to equip you with a solid grasp of the nature, scope, and purpose of financial management, while also highlighting the role of financial managers in guiding organisations towards value creation and sustainability.

We shall commence this Series by examining the nature and purpose of financial management, establishing its definition and objectives. Next, we will explore the scope of financial management, focusing on investment, financing, and dividend decisions. Following that, we will consider the evolution of financial management, contrasting traditional and modern approaches. Moving on, we will study the functions of the financial manager, including planning, appraisal, and risk control. Finally, we will wrap up by discussing the importance of financial management in corporate success, linking it to governance, sustainability, and growth.

Series Learning Outcomes

Upon completing this Series, you should be able to:

- **1.1** define the nature and purpose of financial management,
- **1.2** explain the scope of financial management in terms of investment, financing, and dividend decisions,
- **1.3** analyse the evolution of financial management by distinguishing between traditional and modern approaches,
- **1.4** demonstrate the key functions of a financial manager, including planning, appraisal, and risk control,
- **1.5** evaluate the importance of financial management in achieving corporate success, governance, and sustainability.

1.1 Nature and Purpose of Financial Management

1.1.1 Definition of financial management

Financial management refers to the planning, organising, directing, and controlling of financial activities such as the procurement and utilisation of funds. It involves applying general management principles to financial resources to ensure that an organisation achieves its objectives. In simple terms, financial management is about making sound decisions regarding money, both in raising it and in using it effectively.

Fill in the blank: Financial management involves the _____, organising, directing, and controlling of financial activities.



FIGURE 1.1 CYCLE OF FINANCIAL MANAGEMENT



PLANNING → ORGANISING → DIRECTING → CONTROLLING
FINANCIAL MANAGEMENT

1.1.2 Objectives of financial management

The primary objective of financial management is to maximise the value of the firm for its shareholders. This is achieved by ensuring profitability, maintaining liquidity, and safeguarding solvency. Profitability ensures that the organisation generates sufficient returns, liquidity ensures that the firm can meet short-term obligations, and solvency ensures long-term stability.

Profitability means the ability of a firm to generate earnings greater than its costs. **Liquidity** refers to the ease with which a firm can meet its short-term obligations. **Solvency** is the capacity of a firm to meet its long-term commitments.



Fill in the blank: The three core objectives of financial management are profitability, _____, and solvency.

Box 1.1 Objectives of financial management

- **Profitability:** Ensuring adequate returns
- **Liquididy:** Meeting short-term obligations
- **Solveny:** Sustaning are-lorgm comtitments

1.1.3 Role of financial management in organisations

Financial management plays a crucial role in guiding organisations towards growth and sustainability. It ensures that funds are raised from appropriate sources, allocated to profitable ventures, and monitored for efficiency. The role extends to balancing risk and return, maintaining investor confidence, and supporting strategic decision-making.

Risk is the possibility of an outcome being different from what is expected, often involving potential loss. **Return** refers to the gain or profit derived from an investment.



Fill in the blank: Financial management balances the relationship between _____ and return to achieve corporate success.



Plate 1.1 Role of financial management in organisations

Pilot questions 1.1

1. Which of the following best defines financial management? a. The study of accounting records b. The planning, organising, directing, and controlling of financial activities c. The distribution of dividends only d. The preparation of tax returns
2. Which of the following is not an objective of financial management? a. Profitability b. Liquidity c. Solvency d. Advertising
3. Financial management balances which two key elements? a. Assets and liabilities b. Risk and return c. Profit and loss d. Income and expenditure



4. Which of the following ensures long-term stability of a firm? a. Liquidity b. Profitability c. Solvency d. Efficiency
5. The role of financial management includes: a. Raising funds from appropriate sources b. Allocating funds to profitable ventures c. Monitoring efficiency d. All of the above

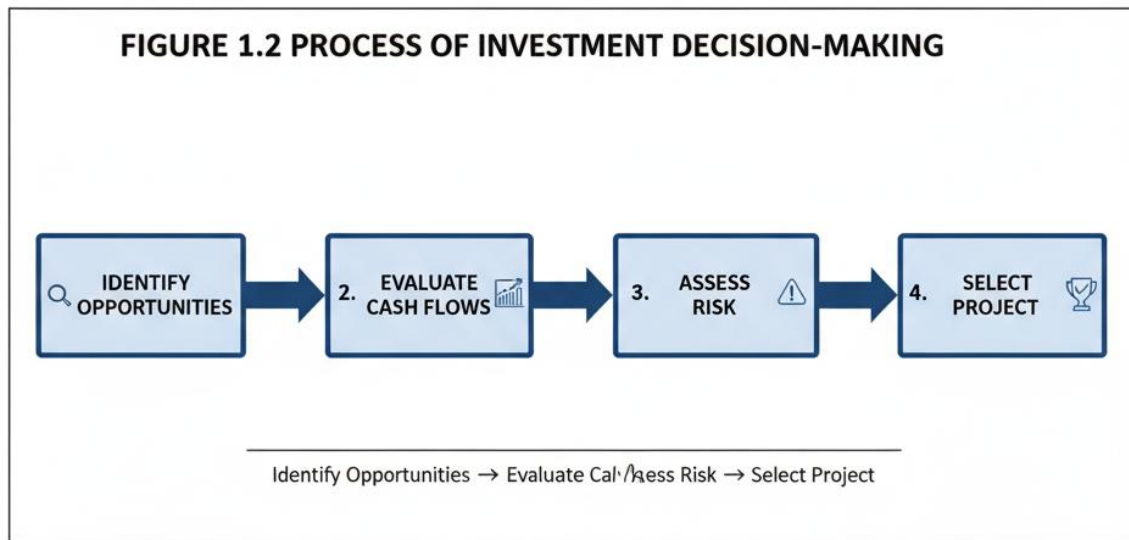
1.2 Scope of Financial Management

1.2.1 Investment decisions

Investment decisions refer to choices made by managers about where to allocate funds in order to generate returns. These decisions often involve evaluating projects, assets, or ventures to determine their potential profitability and risk. Investment decisions are sometimes called capital budgeting decisions because they require careful analysis of expected cash flows, costs, and benefits.

Fill in the blank: Investment decisions are also known as _____ budgeting decisions.





1.2.2 Financing decisions

Financing decisions involve determining the best sources of funds to support investments and operations. Managers must decide between equity financing, debt financing, or a mix of both. Equity financing means raising funds by issuing shares, while debt financing involves borrowing from banks or issuing bonds. The choice depends on cost, risk, and the impact on ownership and control.

Fill in the blank: Financing decisions require managers to choose between equity financing and _____ financing.



Table 1.1 Comparison of equity and debt financing

Aspect	Equity financing	Debt financing
Source of funds	Issuing shares	Borrowing (loans, bonds)
Cost	Dividend payments	Interest payments
Ownership impact	Dilutes ownership	No dilution of ownership
Risk	Lower financial risk	Higher financial risk

1.2.3 Dividend decisions

Dividend decisions concern how much profit should be distributed to shareholders and how much should be retained for reinvestment. A dividend is a portion of earnings paid to shareholders, usually in cash or shares. Managers must balance shareholder expectations with the need to finance future growth. Factors influencing dividend decisions include profitability, liquidity, taxation, and market trends.

Fill in the blank: A dividend is a portion of _____ paid to shareholders.



Box 1.2 Factors influencing dividend decisions

- **Profitability:** Higher profits allow larger dividends
- **Liquidity:** Adequate cash is required to pay dividends
- **Taxation:** Tax rules may affect dividend policies
- **Market trends:** Investor expectations influence dividend levels

Pilot questions 1.2

1. Investment decisions are primarily concerned with: a. Raising funds b. Allocating funds to projects c. Distributing profits d. Preparing tax returns
2. Financing decisions involve choosing between: a. Equity and debt financing b. Profit and loss c. Assets and liabilities d. Cash and credit
3. Which of the following is not a source of equity financing? a. Issuing shares b. Borrowing from banks c. Retained earnings d. Venture capital
4. Dividend decisions determine: a. How much profit is distributed to shareholders b. How much tax is paid c. How much debt is repaid d. How much inventory is purchased



5. Which factor does not influence dividend decisions? a. Profitability b. Liquidity c. Taxation d. Colour of company logo

1.3 Evolution and Approaches to Financial Management

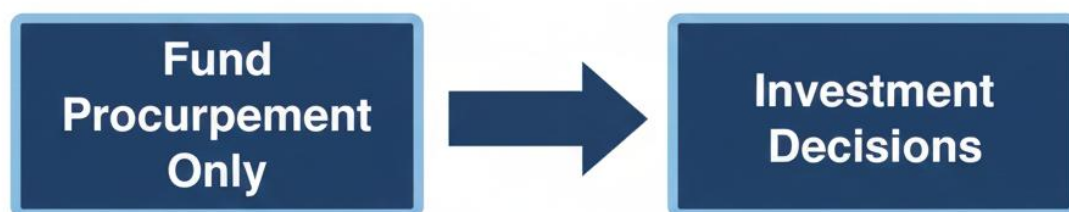
1.3.1 Traditional approach

The **traditional approach** to financial management focused mainly on the procurement of funds. It was concerned with how organisations raised money from external sources such as banks, investors, or issuing shares. This approach was narrow because it emphasised financing activities without giving equal attention to how funds were utilised.

Fill in the blank: The traditional approach to financial management concentrated mainly on the _____ of funds.



FIGURE 1.3 Traditional approach to financial management



Fund Procurement Only → Investment Decisions

1.3.2 Modern approach

The **modern approach** broadened the scope of financial management to include both procurement and effective utilisation of funds. It emphasises decision-making in three key areas: investment, financing, and dividend policy. This approach recognises that financial management is not just about raising money but also about ensuring that funds are allocated efficiently to maximise shareholder value.

Fill in the blank: The modern approach to financial management includes procurement and _____ of funds.



Box 1.3 Key features of the modern approach

- Focus on both raising and using funds
- Emphasis on investment, financing, and dividend decisions
- Goal of maximising shareholder value

1.3.3 Strategic perspective

The **strategic perspective** of financial management integrates financial decisions with overall corporate strategy. It considers long-term goals such as growth, sustainability, and competitiveness. Financial managers under this perspective act as strategic partners, ensuring that financial decisions support broader organisational objectives. This approach highlights the importance of aligning financial management with corporate governance and market dynamics.

Fill in the blank: The strategic perspective of financial management integrates financial decisions with overall _____ strategy.





Plate 1.2 Strategic perspective of financial management

Pilot questions 1.3

1. The traditional approach to financial management focused mainly on: a. Procurement of funds b. Utilisation of funds c. Dividend distribution d. Risk management
2. The modern approach to financial management includes: a. Only raising funds b. Raising and utilising funds c. Preparing tax returns d. Advertising strategies
3. Which of the following is a key feature of the modern approach? a. Ignoring dividend decisions b. Emphasis on investment, financing, and dividend policy c. Concentrating only on short-term liquidity d. Avoiding shareholder value
4. The strategic perspective of financial management integrates financial decisions with: a. Marketing strategy b. Overall corporate strategy c. Human resource planning d. Production scheduling



5. Financial managers under the strategic perspective act as: a. Tax consultants b. Strategic partners c. Auditors only d. Shareholders

1.4 Functions of the Financial Manager

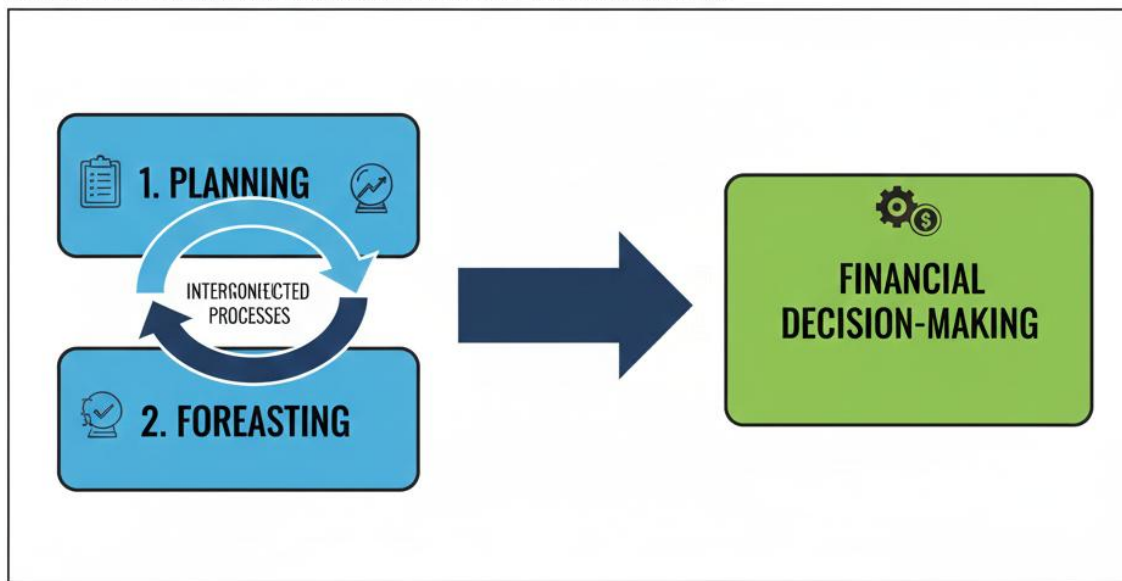
1.4.1 Planning and forecasting

Planning in financial management refers to setting financial goals and determining the strategies to achieve them. **Forecasting** is the process of estimating future financial outcomes based on past and present data. Together, planning and forecasting help managers anticipate challenges and allocate resources effectively.

Fill in the blank: Planning sets financial goals, while _____ estimates future outcomes based on data.



FIGURE 1.4 PLANNING AND FORECASTING IN FINANCIAL MANAGEMENT



Planning ⇒ Forecasting → Financial Decision-Making

1.4.2 Investment appraisal

Investment appraisal is the evaluation of potential projects or investments to determine their profitability and risk. Techniques such as Net Present Value (NPV), Internal Rate of Return (IRR), and Payback Period are commonly used. These methods help managers decide whether to accept or reject investment opportunities.

Fill in the blank: Investment appraisal techniques include NPV, IRR, and _____ period.



Table 1.2 Common investment appraisal techniques

Technique	Description	Decision basis
Net Present Value	Present value of cash inflows minus outflows	Accept if NPV > 0
Internal Rate of Return	Discount rate making NPV = 0	Accept if IRR > cost of capital
Payback Period	Time taken to recover initial investment	Accept if within acceptable timeframe

1.4.3 Risk assessment and control

Risk assessment involves identifying potential uncertainties that may affect financial outcomes. **Risk control** refers to strategies used to minimise or manage these risks, such as diversification, insurance, or hedging. Effective risk management ensures stability and protects the organisation from unexpected losses.

Fill in the blank: Risk assessment identifies uncertainties, while risk _____ minimises or manages them.



Box 1.4 Risk management strategies

- **Diversification:** Spreading investments across assets
- **Insurance:** Protecting against specific losses
- **Hedding:** Using financial instruments of offret risks

1.4.4 Communication with stakeholders

Stakeholders are individuals or groups with an interest in the organisation, such as shareholders, employees, creditors, and regulators. Effective communication ensures transparency and builds trust. Financial managers must present accurate reports, explain financial decisions, and engage stakeholders in discussions about performance and strategy.

Fill in the blank: Shareholders, employees, creditors, and regulators are examples of _____ in an organisation.





Plate 1.3 Communication with stakeholders

Pilot questions 1.4

1. Planning and forecasting in financial management help managers to: a. Set goals and estimate future outcomes b. Prepare tax returns c. Advertise products d. Hire employees
2. Which of the following is not an investment appraisal technique? a. Net Present Value b. Internal Rate of Return c. Payback Period d. Market segmentation
3. Risk assessment involves: a. Identifying uncertainties b. Minimising risks c. Preparing budgets d. Recruiting staff
4. Which strategy is used to offset risks in financial management? a. Diversification b. Insurance c. Hedging d. All of the above
5. Stakeholders in an organisation include: a. Shareholders b. Employees c. Creditors d. All of the above



1.5 Importance of Financial Management in Corporate Success

1.5.1 Contribution to value creation

Value creation refers to the process of increasing the worth of a company for its shareholders and stakeholders. Financial management contributes to value creation by ensuring that resources are allocated to profitable ventures, risks are managed effectively, and returns are maximised. When financial decisions are aligned with organisational goals, the company is more likely to achieve sustainable growth.

Fill in the blank: Financial management contributes to _____ creation by allocating resources to profitable ventures.



FIGURE 1.5
VALUE CREATION THROUGH FINANCIAL MANAGEMENT



1.5.2 Link with corporate governance

Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled. Financial management supports corporate governance by promoting transparency, accountability, and fairness in financial decisions. Strong governance ensures that managers act in the best interests of shareholders and other stakeholders, thereby enhancing trust and credibility.

Fill in the blank: Corporate governance promotes transparency, accountability, and _____ in financial decisions.



Box 1.5

Principles of corporate governance supported by financial management

- **Transparency:** Clear and open reporting of financial information
- **Accountability:** Managers held responsible for financial decisions
- **Fairness:** Equal treatment of shareholders and stakeholders

1.5.3 Impact on sustainability and growth

Sustainability in financial management means ensuring that the organisation can continue to operate and grow without exhausting its resources or harming its environment. Financial management supports sustainability by balancing short-term profitability with long-term stability. Growth is achieved when financial strategies encourage innovation, expansion, and reinvestment. Together, sustainability and growth ensure that the organisation remains competitive in the market.

Fill in the blank: Financial management balances short-term profitability with long-term _____ to achieve sustainability.





Plate 1.4

Financial management supporting sustainability and growth

Pilot questions 1.5

1. Value creation in financial management refers to: a. Increasing the worth of a company for shareholders b. Reducing costs only c. Preparing tax returns d. Advertising products
2. Corporate governance ensures: a. Transparency, accountability, and fairness in financial decisions b. Profit maximisation only c. Tax avoidance d. Employee recruitment
3. Which principle is not part of corporate governance? a. Transparency b. Accountability c. Fairness d. Profitability
4. Sustainability in financial management means: a. Balancing short-term profitability with long-term stability b. Focusing only on immediate profits c. Ignoring environmental concerns d. Reducing shareholder value



5. Financial management supports growth by: a. Encouraging innovation and reinvestment
b. Avoiding expansion c. Limiting shareholder returns d. Reducing transparency

Series summary

This Series introduced you to the foundations and scope of financial management, highlighting its importance as the backbone of sound organisational decision-making. We began by defining financial management and examining its objectives, before moving on to explore its scope through investment, financing, and dividend decisions. We then traced the evolution of financial management from the traditional approach to the modern and strategic perspectives, followed by a detailed look at the functions of the financial manager such as planning, appraisal, risk control, and communication. Finally, we considered how financial management contributes to corporate success through value creation, corporate governance, and sustainability.

By completing this Series, you should now be able to define the nature and purpose of financial management, explain its scope, analyse its evolution, demonstrate the functions of financial managers, and evaluate its importance in achieving corporate success. These abilities directly reflect the Series Learning Outcomes (SLOs) and provide you with a strong foundation for the subsequent Series in this course.

Series Glossary

- **Accountability:** The responsibility of managers to justify and take ownership of their financial decisions.
- **Corporate governance:** The system of rules, practices, and processes by which a company is directed and controlled.
- **Dividend:** A portion of a company's earnings distributed to shareholders, usually in cash or shares.
- **Equity financing:** Raising funds by issuing shares, which may dilute ownership but avoids debt obligations.
- **Financial management:** The planning, organising, directing, and controlling of financial activities to achieve organisational goals.
- **Forecasting:** Estimating future financial outcomes based on past and present data.
- **Investment appraisal:** The evaluation of projects or investments to determine profitability and risk, using techniques such as NPV, IRR, and Payback Period.
- **Liquidity:** The ability of a firm to meet its short-term obligations easily.
- **Profitability:** The capacity of a firm to generate earnings greater than its costs.
- **Risk:** The possibility of outcomes differing from expectations, often involving potential loss.
- **Risk control:** Strategies used to minimise or manage risks, such as diversification, insurance, or hedging.
- **Risk assessment:** Identifying potential uncertainties that may affect financial outcomes.



- **Shareholders:** Individuals or entities that own shares in a company and expect returns in the form of dividends or capital gains.
- **Solvency:** The ability of a firm to meet its long-term commitments and remain stable.
- **Stakeholders:** Individuals or groups with an interest in the organisation, including shareholders, employees, creditors, and regulators.
- **Value creation:** The process of increasing the worth of a company for its shareholders and stakeholders.

Concept Check Questions [Series 1]

Objective questions

1. Financial management is best defined as: a. The preparation of tax returns b. The planning, organising, directing, and controlling of financial activities c. The distribution of dividends only d. The study of marketing strategies (Linked to SLO 1.1)
2. Which of the following is not part of the scope of financial management? a. Investment decisions b. Financing decisions c. Dividend decisions d. Recruitment decisions (Linked to SLO 1.2)
3. The modern approach to financial management emphasises: a. Procurement of funds only b. Raising and utilising funds effectively c. Dividend distribution only d. Tax avoidance (Linked to SLO 1.3)
4. Which of the following is a function of the financial manager? a. Planning and forecasting b. Investment appraisal c. Risk assessment and control d. All of the above (Linked to SLO 1.4)
5. Corporate governance in financial management promotes: a. Transparency, accountability, and fairness b. Profit maximisation only c. Tax evasion d. Employee recruitment (Linked to SLO 1.5)

Short-answer questions

6. Define financial management in one sentence. (Linked to SLO 1.1)
7. Explain the difference between equity financing and debt financing. (Linked to SLO 1.2)
8. Distinguish between the traditional and modern approaches to financial management. (Linked to SLO 1.3)
9. Identify two techniques used in investment appraisal. (Linked to SLO 1.4)
10. State one way financial management contributes to sustainability. (Linked to SLO 1.5)

Long-answer questions

11. Analyse the scope of financial management by discussing investment, financing, and dividend decisions. (Linked to SLO 1.2)
12. Evaluate the importance of financial management in corporate success, focusing on value creation, corporate governance, and sustainability. (Linked to SLO 1.5)



Answers to Concept Check Questions [Series 1]

Objective questions

1. b
2. d
3. b
4. d
5. a

Short-answer questions

6. Financial management is the planning, organising, directing, and controlling of financial activities to achieve organisational goals.
7. Equity financing raises funds by issuing shares, which dilutes ownership, while debt financing involves borrowing, which requires repayment with interest but does not dilute ownership.
8. The traditional approach focused only on procuring funds, while the modern approach includes both raising and utilising funds effectively.
9. Net Present Value (NPV) and Internal Rate of Return (IRR).
10. By balancing short-term profitability with long-term stability.

Long-answer questions

11. **Basic response:** Investment decisions allocate funds to profitable projects, financing decisions determine sources of funds, and dividend decisions balance profit distribution with reinvestment. **Value-added response:** Beyond these, managers must consider risk, cost of capital, and shareholder expectations, integrating decisions to maximise value and ensure long-term sustainability.
12. **Basic response:** Financial management supports corporate success by creating value, promoting governance, and ensuring sustainability. **Value-added response:** Outstanding learners may add that financial management also enhances competitiveness, builds investor confidence, and aligns financial strategies with broader corporate objectives such as innovation and market leadership.

Answers to Pilot Questions [Series 1]

Part 1.1



1. b
2. d
3. b
4. c
5. d

Part 1.2

1. b
2. a
3. b
4. a
5. d

Part 1.3

1. a
2. b
3. b
4. b
5. b

Part 1.4

1. a
2. d
3. a
4. d
5. d

Part 1.5

1. a
2. a
3. d
4. a
5. a

Series 2: Sources of Finance and Capital Budgeting

Series outline

2.1 Sources of short-term finance



- 2.1.1 Trade credit
- 2.1.2 Bank overdrafts
- 2.1.3 Commercial papers

2.2 Sources of medium-term finance

- 2.2.1 Term loans
- 2.2.2 Leasing and hire purchase
- 2.2.3 Venture capital

2.3 Sources of long-term finance

- 2.3.1 Equity shares
- 2.3.2 Preference shares
- 2.3.3 Debentures and bonds

2.4 Cost of finance and selection criteria

- 2.4.1 Concept of cost of capital
- 2.4.2 Factors influencing choice of finance
- 2.4.3 Balancing risk and return

2.5 Capital budgeting techniques

- 2.5.1 Payback period
- 2.5.2 Net Present Value (NPV)
- 2.5.3 Internal Rate of Return (IRR)
- 2.5.4 Profitability Index

Introduction

Finance is the lifeblood of any organisation, and the ability to source funds wisely and invest them effectively determines whether a business thrives or struggles. Managers must not only identify suitable sources of finance but also evaluate how those funds are used to generate returns. This Series builds on the foundations of financial management by focusing on where money comes from and how it is allocated through capital budgeting decisions.

The aim of this Series is to familiarise you with the different sources of finance available to organisations, and to equip you with the skills to apply capital budgeting techniques in evaluating investment opportunities.

We shall commence this Series by examining sources of short-term finance such as trade credit, bank overdrafts, and commercial papers. Next, we will explore medium-term finance options including term loans, leasing, and venture capital. Following that, we will consider long-term



finance sources such as equity shares, preference shares, and debentures. Moving on, we will discuss the cost of finance and the criteria used in selecting appropriate sources. Finally, we will conclude with capital budgeting techniques, including payback period, Net Present Value, Internal Rate of Return, and the profitability index, which provide managers with tools to make sound investment decisions.

Series Learning Outcomes

Upon completing this Series, you should be able to:

- **2.1** describe the main sources of short-term finance such as trade credit, bank overdrafts, and commercial papers,
- **2.2** explain the sources of medium-term finance including term loans, leasing, and venture capital,
- **2.3** analyse the sources of long-term finance such as equity shares, preference shares, and debentures,
- **2.4** evaluate the cost of finance and apply criteria for selecting appropriate sources,
- **2.5** demonstrate the use of capital budgeting techniques including payback period, Net Present Value, Internal Rate of Return, and profitability index.

2.1 Sources of Short-Term Finance

2.1.1 Trade credit

Trade credit is an arrangement where suppliers allow businesses to purchase goods or services and pay for them at a later date. It is one of the most common forms of short-term finance, especially for small and medium enterprises. Trade credit helps businesses manage cash flow by delaying payments while still maintaining operations.

Fill in the blank: Trade credit allows businesses to purchase goods and pay at a _____ date.



FIGURE 2.1 Flow of trade credit



Supplier → Goods Delivered → Delayed Payment

Trade Credit Flow

2.1.2 Bank overdrafts

A **bank overdraft** is a facility that allows businesses to withdraw more money than they have in their account, up to an agreed limit. It provides flexibility in managing short-term cash shortages. However, overdrafts often come with interest charges and fees, making them relatively expensive compared to other sources of short-term finance.

Fill in the blank: A bank overdraft allows businesses to withdraw more money than they have in their _____.



Box 2.1 Features of bank overdrafts

- Flexible borrowing facility
- Interest charged on overdrawn amount
- Useful for temporary cash shortages

2.1.3 Commercial papers

Commercial papers are unsecured, short-term promissory notes issued by large corporations to raise funds quickly. They are usually issued at a discount and redeemed at face value, making them attractive to investors. Commercial papers are suitable for companies with high credit ratings, as they rely on investor confidence.

Fill in the blank: Commercial papers are unsecured short-term _____ notes issued by large corporations.



Table 2.1 Characteristics of commercial papers		
Aspect		Description
Nature	Unsecured promissory notes	
Duration	Short-term, less of year	Short-term, usually year
Issuers	Large corporations with strong credit Institutions and wealthy individuals	

Pilot questions 2.1

1. Trade credit allows businesses to: a. Pay suppliers immediately b. Delay payments for goods and services c. Borrow from banks d. Issue shares
2. A bank overdraft is: a. A long-term loan b. A facility to withdraw more than account balance c. A dividend payment d. A type of equity financing
3. Which of the following is not a feature of bank overdrafts? a. Flexibility b. Interest charges c. Long-term repayment schedule d. Temporary cash support
4. Commercial papers are issued by: a. Small businesses b. Large corporations with strong credit ratings c. Government agencies d. Banks only
5. Commercial papers are usually: a. Secured by assets b. Issued at a discount and redeemed at face value c. Paid as dividends d. Used for long-term financing



2.2 Sources of Medium-Term Finance

2.2.1 Term loans

Term loans are loans provided by banks or financial institutions for a fixed period, usually ranging from one to five years. They are commonly used to finance equipment purchases, business expansion, or other medium-term needs. Repayment is typically made in instalments, with interest charged on the outstanding balance.

Fill in the blank: Term loans are usually provided for a fixed period ranging from one to _____ years.



Table 2.2 Features of term loans

Aspect	Description
Duration	One to five years
Purpose	Equipment, expansion, medium-term needs
Repayment	Instalstments with interest
Source	Banks and financial institutions

2.2.2 Leasing and hire purchase

Leasing is a contractual arrangement where a business uses an asset owned by another party (the lessor) in exchange for regular payments. **Hire purchase** is similar, but ownership of the asset transfers to the business after all payments are completed. These methods allow businesses to access assets without making large upfront payments.

Fill in the blank: In hire purchase, ownership of the asset transfers to the business after all _____ are completed.



Box 2.2 Differences between leasing and hire purchase

- **Leasing:** Asset remains the property of the lessor
- **Hire purchase:** Ownership transfers after full payment
- **Both:** Provide access of assets without large upfront costs

2.2.3 Venture capital

Venture capital is funding provided by investors to start-ups and small businesses with high growth potential. Venture capitalists provide not only money but also expertise and guidance. In return, they usually acquire equity in the business, sharing both risks and rewards. Venture capital is particularly important for innovative businesses that may not qualify for traditional loans.

Fill in the blank: Venture capitalists usually acquire _____ in the business in exchange for funding.





Plate 2.1 Venture capital funding in practice

Pilot questions 2.2

1. Term loans are typically provided for: a. Less than one year b. One to five years c. More than ten years d. Indefinite periods
2. Which of the following is true about leasing? a. Ownership transfers immediately b. Asset remains the property of the lessor c. Payments are not required d. It is a form of equity financing
3. In hire purchase, ownership of the asset transfers: a. At the beginning of the contract b. After all payments are completed c. Immediately after first payment d. Never
4. Venture capital is most suitable for: a. Large established corporations b. Start-ups with high growth potential c. Government agencies d. Non-profit organisations



5. Venture capitalists usually provide: a. Only money b. Money and expertise c. Only loans d. Only dividends

2.3 Sources of Long-Term Finance

2.3.1 Equity shares

Equity shares represent ownership in a company. Shareholders who purchase equity shares become part-owners and have voting rights in major decisions. They also receive dividends when profits are distributed, although dividends are not guaranteed. Equity financing is a permanent source of capital and does not require repayment, but it dilutes ownership among shareholders.

Fill in the blank: Equity shares represent _____ in a company and provide voting rights to shareholders.



Table 2.3 Features of equity shares

Aspect	Description	Permanence
Ownership	Represents ownsship in the company	
Voting rights	Shareshoders can vote on decisions	
Dividend	Paid when profits are distributed, not guarnted	
Permanence	not guaranteed, guranteed	
Permanence	Permanent source of capital	Permanent source of capital

2.3.2 Preference shares

Preference shares are shares that provide shareholders with preferential rights over equity shareholders. Holders of preference shares receive dividends before equity shareholders and have priority in repayment if the company is liquidated. However, they usually do not carry voting rights. Preference shares combine features of both equity and debt, offering fixed returns with lower risk.

Fill in the blank: Preference shareholders receive dividends before _____ shareholders.



Box 2.3 Characteristics of preference shares

- Priority in dividend payments
- Priority in repayment during liquidation
- Usually no voting rights
- Fixed rate of return

2.3.3 Debentures and bonds

Debentures and **bonds** are long-term debt instruments issued by companies to raise funds. Investors who purchase them become creditors, not owners. Debentures are typically unsecured, while bonds may be secured by specific assets. Both pay interest at fixed intervals and must be repaid at maturity. They are attractive to investors seeking steady income with relatively lower risk compared to equity.

Fill in the blank: Debentures and bonds are long-term _____ instruments issued by companies to raise funds.



FIGURE 2.2 DEBENTURES AND BONDS AS SOURCES OF LONG-TERM FINANCE

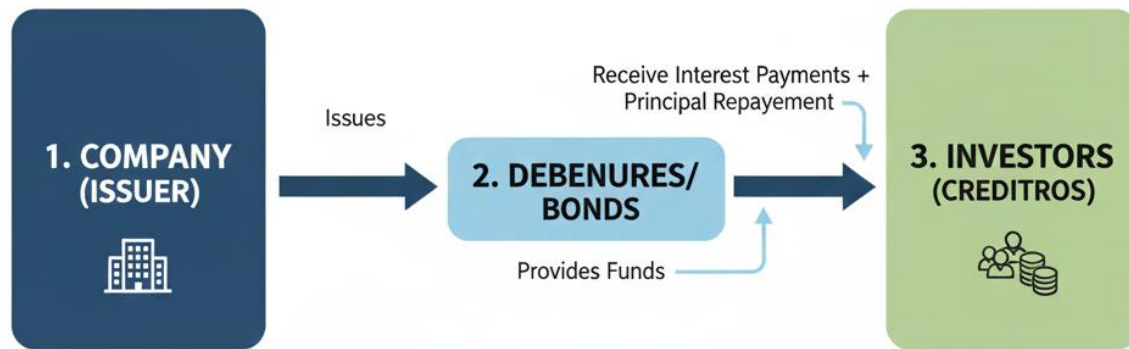


Diagram showing company issuing debentures/bonds to investors who provide funds receive regular interest payments, along principal repayment at maturity.

Pilot questions 2.3

- Equity shares represent: a. Ownership in a company b. Debt owed by a company c. Preference in repayment d. Government securities
- Which of the following is true about preference shares? a. They guarantee voting rights b. They receive dividends before equity shareholders c. They are unsecured debt instruments d. They dilute ownership
- Debentures and bonds are: a. Equity instruments b. Long-term debt instruments c. Short-term promissory notes d. Dividend payments
- Which of the following is not a feature of equity shares? a. Voting rights b. Permanent capital c. Guaranteed dividends d. Ownership in the company



5. Preference shares combine features of: a. Equity and debt b. Equity and trade credit c. Debt and overdrafts d. Bonds and debentures

2.4 Cost of Finance and Selection Criteria

2.4.1 Concept of cost of capital

Cost of capital is the minimum rate of return a company must earn on its investments to satisfy its investors or creditors. It represents the opportunity cost of using funds in a particular project instead of elsewhere. The cost of capital serves as a benchmark for evaluating investment decisions, ensuring that projects undertaken generate sufficient returns.

Fill in the blank: The cost of capital is the minimum _____ of return a company must earn to satisfy investors.



FIGURE 2.3 COST OF CAPITAL AS A BENCHMARK

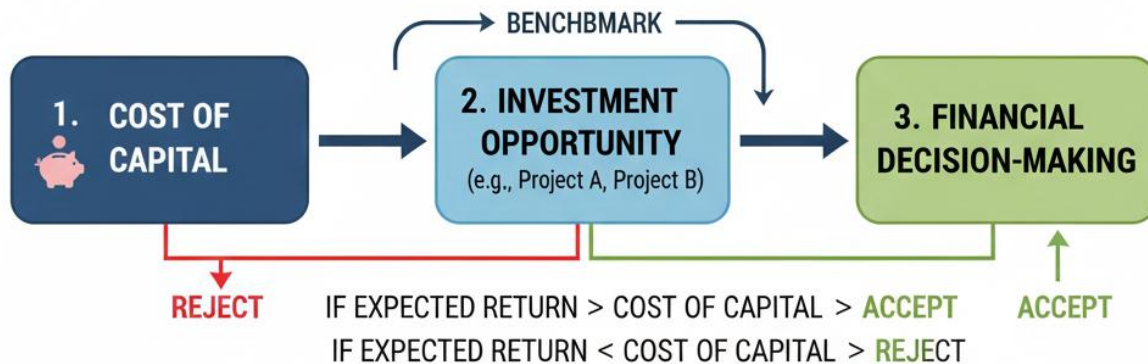


Diagram showing the cost of capital as benchmark for evaluating investment opportunities.

2.4.2 Factors influencing choice of finance

The choice of finance depends on several factors, including cost, risk, control, and availability.

- **Cost** refers to the interest or dividend payments associated with the source of finance.
- **Risk** involves the uncertainty of meeting repayment obligations.
- **Control** relates to whether ownership is diluted or retained.
- **Availability** considers whether the source of finance is accessible to the organisation.

Fill in the blank: The choice of finance depends on cost, risk, control, and _____.



Box 2.4 Factors influencing choice of finance

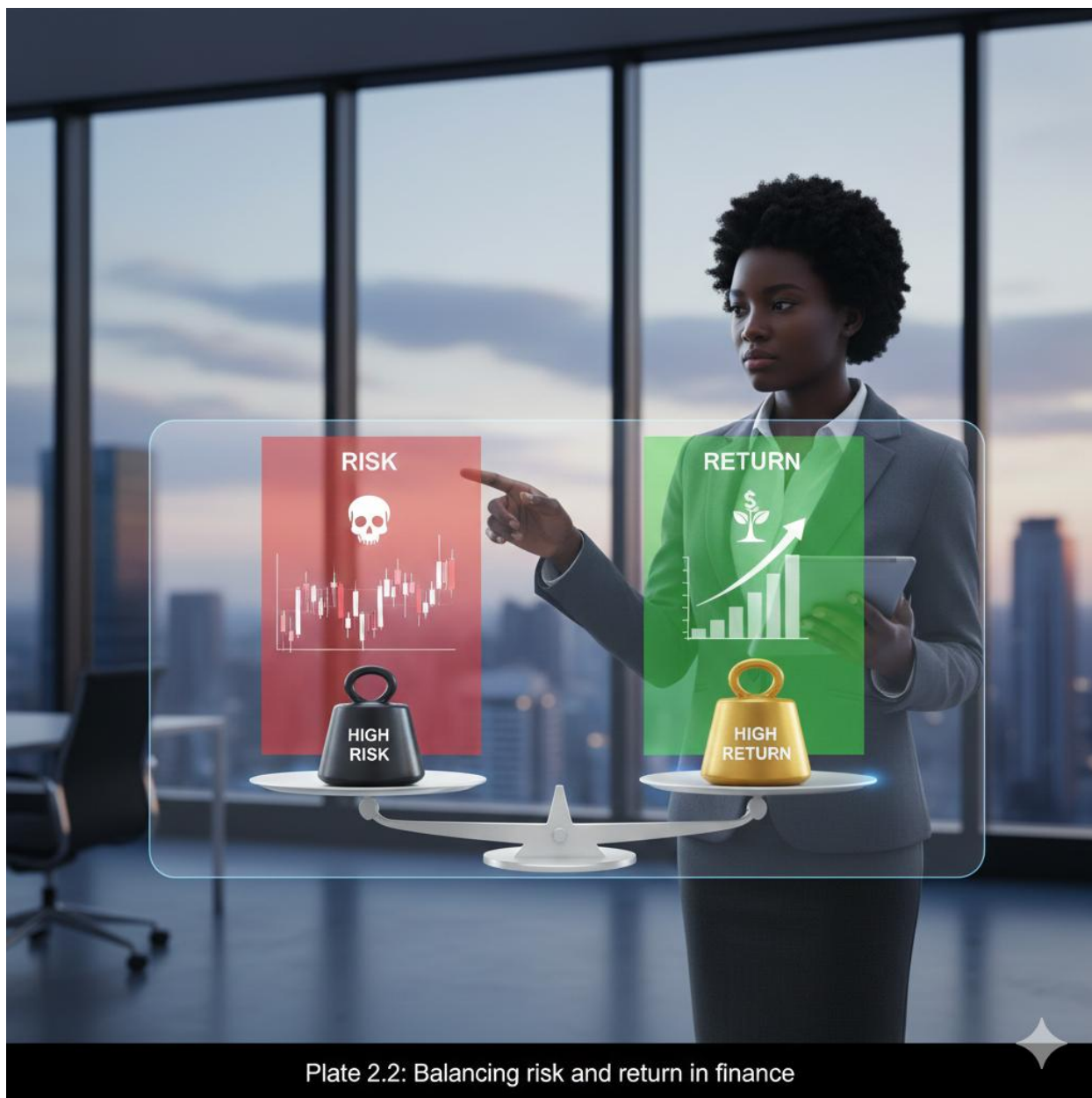
- **Cost:** Interest or dividend payments
- **Risk:** Uncertainty of repayment obligations
- **Control:** Dilution or retention of ownership
- **Availability:** Accessibility of funds

2.4.3 Balancing risk and return

Financial managers must balance **risk** and **return** when selecting sources of finance. High-risk sources may offer higher returns but could jeopardise stability, while low-risk sources may provide security but limit growth. The optimal choice depends on the organisation's financial position, market conditions, and strategic objectives.

Fill in the blank: Financial managers must balance _____ and return when selecting sources of finance.





Pilot questions 2.4

1. The cost of capital represents: a. Minimum rate of return required by investors b. Maximum profit achievable c. Tax rate imposed by government d. Dividend declared by company
2. Which of the following is not a factor influencing choice of finance? a. Cost b. Risk c. Control d. Colour of company logo
3. Control in finance refers to: a. Dilution or retention of ownership b. Interest payments c. Repayment obligations d. Accessibility of funds
4. Financial managers must balance: a. Assets and liabilities b. Risk and return c. Profit and loss d. Income and expenditure



5. High-risk sources of finance usually offer: a. Lower returns b. Higher returns c. Guaranteed returns d. No returns

2.5 Capital Budgeting Techniques

2.5.1 Payback period

The **payback period** is the time it takes for an investment to recover its initial cost from the cash inflows it generates. It is a simple technique that helps managers assess how quickly they can regain their money. Although easy to use, it does not consider the time value of money or cash flows beyond the payback point.

Fill in the blank: The payback period measures how long it takes for an investment to recover its _____ cost.



FIGURE 2.4
PAYBACK PERIOD ILLUSTRATION

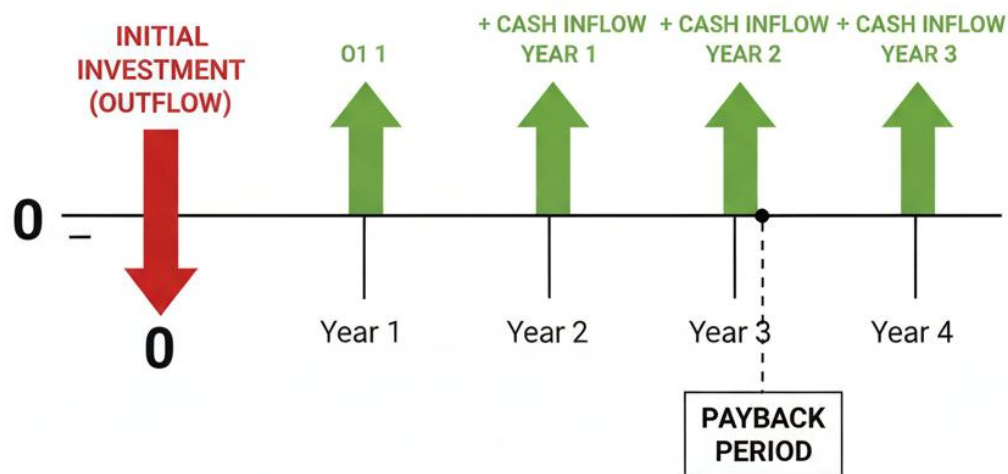


Diagram showing an initial investment outflow at time zero, followed a series of cash inflows over time, with cumulative cash inflows cash initial representing, for payback period.

2.5.2 Net Present Value (NPV)

Net Present Value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows. It incorporates the time value of money, making it a more reliable measure than the payback period. A positive NPV indicates that the investment is expected to add value to the firm.

Fill in the blank: A positive NPV indicates that the investment is expected to add _____ to the firm.



Box 2.5 Key points about NPV

- Considers time value of money
- Compares present value of inflows of outflows
- Positive NVP means value creation

2.5.3 Internal Rate of Return (IRR)

Internal Rate of Return (IRR) is the discount rate at which the present value of cash inflows equals the present value of cash outflows, making NPV equal to zero. It represents the expected rate of return from an investment. If IRR is greater than the cost of capital, the project is considered acceptable.

Fill in the blank: IRR is the discount rate at which NPV equals _____.



Table 2.5: Comparison of NPV and IRR

	NPV	IRR
Definition	Difference between PV of inflows and outflows	Discount rate making NPV = 0
Decision rule	Accept if NPV > 0	Accept if IRR > cost of capital
Focus	Value creation	Rate of return

2.5.4 Profitability index

The **profitability index (PI)** is the ratio of the present value of cash inflows to the present value of cash outflows. It shows the relative profitability of a project. A PI greater than 1 indicates that the project is worthwhile, while a PI less than 1 suggests rejection.

Fill in the blank: A profitability index greater than _____ indicates that the project is worthwhile.





Plate 2.3 Profitability index in project evaluation

Pilot questions 2.5

1. The payback period measures: a. How long it takes to recover initial investment b. The rate of return on investment c. The difference between inflows and outflows d. The ratio of inflows to outflows
2. A positive NPV means: a. The project destroys value b. The project adds value to the firm c. The project has no effect d. The project should be rejected
3. IRR is the discount rate at which: a. NPV equals zero b. Payback period is shortest c. Profitability index equals one d. Cash inflows equal dividends
4. The profitability index is calculated as: a. Cash inflows minus cash outflows b. PV of inflows divided by PV of outflows c. IRR minus cost of capital d. Payback period divided by NPV



5. A PI less than 1 indicates: a. The project is worthwhile b. The project should be rejected
c. The project adds value d. The project has infinite returns

Series summary

This Series explored the sources of finance available to organisations and the techniques used in capital budgeting. We began with short-term finance options such as trade credit, bank overdrafts, and commercial papers, before moving to medium-term sources including term loans, leasing, and venture capital. We then examined long-term finance through equity shares, preference shares, and debentures or bonds. Following this, we discussed the cost of finance and the criteria managers use to select appropriate sources, emphasising the balance between risk and return. Finally, we studied capital budgeting techniques such as payback period, Net Present Value, Internal Rate of Return, and profitability index, which provide managers with tools to evaluate investment opportunities.

By completing this Series, you should now be able to describe short-, medium-, and long-term sources of finance, explain the factors influencing their selection, and apply capital budgeting techniques to assess projects. These abilities directly reflect the Series Learning Outcomes (SLOs) and prepare you to make informed financial decisions that support organisational growth and sustainability.

Series Glossary

- **Bank overdraft:** A facility allowing businesses to withdraw more money than they have in their account, up to a limit.
- **Bond:** A long-term debt instrument issued by companies or governments, usually secured and paying fixed interest.
- **Capital budgeting:** The process of evaluating and selecting long-term investments that are consistent with organisational goals.
- **Commercial paper:** An unsecured, short-term promissory note issued by large corporations to raise funds quickly.
- **Cost of capital:** The minimum rate of return a company must earn to satisfy investors or creditors.
- **Debenture:** A long-term debt instrument, typically unsecured, issued by companies to raise funds.
- **Dividend:** A portion of company profits distributed to shareholders.
- **Equity share:** A share representing ownership in a company, with voting rights and potential dividends.
- **Hire purchase:** A financing arrangement where ownership of an asset transfers to the buyer after all payments are completed.
- **Internal Rate of Return (IRR):** The discount rate at which the present value of inflows equals the present value of outflows, making NPV zero.



- **Leasing:** A contractual arrangement where a business uses an asset owned by another party in exchange for payments, without ownership transfer.
- **Net Present Value (NPV):** The difference between the present value of cash inflows and outflows; positive NPV indicates value creation.
- **Payback period:** The time it takes for an investment to recover its initial cost from cash inflows.
- **Preference share:** A share that provides priority in dividend payments and repayment during liquidation, usually without voting rights.
- **Profitability index (PI):** The ratio of present value of inflows to outflows; PI greater than 1 indicates a worthwhile project.
- **Risk:** The possibility of outcomes differing from expectations, often involving potential loss.
- **Term loan:** A loan provided for a fixed period, typically one to five years, repaid in instalments with interest.
- **Trade credit:** An arrangement where suppliers allow businesses to purchase goods or services and pay later.
- **Venture capital:** Funding provided to start-ups and small businesses with high growth potential, often in exchange for equity.

Concept Check Questions [Series 2]

Objective questions

1. Trade credit allows businesses to: a. Pay suppliers immediately b. Delay payments for goods and services c. Borrow from banks d. Issue shares (Linked to SLO 2.1)
2. Term loans are typically provided for: a. Less than one year b. One to five years c. More than ten years d. Indefinite periods (Linked to SLO 2.2)
3. Equity shares represent: a. Ownership in a company b. Debt owed by a company c. Preference in repayment d. Government securities (Linked to SLO 2.3)
4. The cost of capital represents: a. Minimum rate of return required by investors b. Maximum profit achievable c. Tax rate imposed by government d. Dividend declared by company (Linked to SLO 2.4)
5. A positive NPV means: a. The project destroys value b. The project adds value to the firm c. The project has no effect d. The project should be rejected (Linked to SLO 2.5)

Short-answer questions

6. Define commercial papers in one sentence. (Linked to SLO 2.1)
7. Explain the difference between leasing and hire purchase. (Linked to SLO 2.2)
8. Distinguish between equity shares and preference shares. (Linked to SLO 2.3)
9. Identify two factors influencing the choice of finance. (Linked to SLO 2.4)
10. State one limitation of the payback period method. (Linked to SLO 2.5)

Long-answer questions



11. Analyse the sources of long-term finance, discussing equity shares, preference shares, and debentures or bonds. (Linked to SLO 2.3)
12. Evaluate the importance of capital budgeting techniques in financial decision-making, focusing on NPV, IRR, and profitability index. (Linked to SLO 2.5)

Answers to Concept Check Questions [Series 2]

Objective questions

1. b
2. b
3. a
4. a
5. b

Short-answer questions

6. Commercial papers are unsecured, short-term promissory notes issued by large corporations to raise funds quickly.
7. Leasing allows use of an asset without ownership transfer, while hire purchase transfers ownership after full payment.
8. Equity shares represent ownership with voting rights, while preference shares provide priority in dividends and repayment but usually no voting rights.
9. Cost and risk (other valid answers: control, availability).
10. It ignores the time value of money and cash flows beyond the payback point.

Long-answer questions

11. **Basic response:** Equity shares provide ownership and voting rights, preference shares offer priority in dividends and repayment, and debentures or bonds are debt instruments providing fixed interest. **Value-added response:** Outstanding learners may add that equity financing dilutes ownership but is permanent, preference shares combine equity and debt features, and debentures/bonds attract investors seeking steady income, making them crucial for balancing risk and return in long-term financing.
12. **Basic response:** Capital budgeting techniques help managers evaluate projects by considering profitability and risk. NPV measures value creation, IRR shows expected rate of return, and PI indicates relative profitability. **Value-added response:** Outstanding learners may add that these techniques incorporate the time value of money, support strategic decision-making, and enhance resource allocation, ensuring that investments align with corporate goals and maximise shareholder value.



Answers to Pilot Questions [Series 2]

Part 2.1

1. b
2. b
3. c
4. b
5. b

Part 2.2

1. b
2. b
3. b
4. b
5. b

Part 2.3

1. a
2. b
3. b
4. c
5. a

Part 2.4

1. a
2. d
3. a
4. b
5. b

Part 2.5

1. a
2. b
3. a
4. b
5. b



Series 3: Working Capital and Financial Statement Analysis

Series outline

3.1 Concept and components of working capital

- 3.1.1 Definition of working capital
- 3.1.2 Types: gross and net working capital
- 3.1.3 Components: current assets and current liabilities

3.2 Management of working capital

- 3.2.1 Importance of working capital management
- 3.2.2 Policies: conservative, aggressive, and moderate
- 3.2.3 Techniques for managing receivables, inventory, and cash

3.3 Financing of working capital

- 3.3.1 Sources of short-term financing for working capital
- 3.3.2 Matching principle in financing
- 3.3.3 Balancing liquidity and profitability

3.4 Introduction to financial statements

- 3.4.1 Types of financial statements: income statement, balance sheet, cash flow statement
- 3.4.2 Users of financial statements
- 3.4.3 Limitations of financial statements

3.5 Financial statement analysis techniques

- 3.5.1 Comparative and common-size analysis
- 3.5.2 Ratio analysis (liquidity, profitability, solvency, efficiency)
- 3.5.3 Trend analysis and interpretation

Introduction

Working capital and financial statement analysis are central to understanding the financial health of any organisation. Working capital ensures that a business can meet its short-term obligations and continue operating smoothly, while financial statement analysis provides insights into performance, stability, and efficiency. Together, they form the basis for sound financial decision-making and long-term sustainability.



The aim of this Series is to equip you with the knowledge and skills to manage working capital effectively and to interpret financial statements with confidence.

We shall commence this Series by defining working capital and examining its components, before moving on to strategies for managing it through policies and techniques. Next, we will explore the financing of working capital, focusing on sources and the balance between liquidity and profitability. Following this, we will introduce the main financial statements—income statement, balance sheet, and cash flow statement—along with their users and limitations. Finally, we will conclude with financial statement analysis techniques, including comparative and common-size analysis, ratio analysis, and trend analysis, which enable managers to evaluate performance and make informed decisions.

Series Learning Outcomes

Upon completing this Series, you should be able to:

- **3.1** define working capital and distinguish between its types (gross and net), as well as identify its components.
- **3.2** explain the importance of working capital management and apply policies and techniques for managing receivables, inventory, and cash.
- **3.3** analyse the financing of working capital, including sources of short-term finance and the balance between liquidity and profitability.
- **3.4** describe the main financial statements (income statement, balance sheet, cash flow statement), their users, and limitations.
- **3.5** demonstrate the use of financial statement analysis techniques such as comparative and common-size analysis, ratio analysis, and trend analysis to interpret organisational performance.

3.1 Concept and Components of Working Capital

3.1.1 Definition of working capital

Working capital refers to the difference between current assets and current liabilities. It measures a company's ability to meet its short-term obligations and maintain day-to-day operations. Positive working capital indicates that a firm can cover its debts and continue operating smoothly, while negative working capital suggests potential liquidity problems.

Fill in the blank: Working capital is the difference between current _____ and current liabilities.



FIGURE 3.1
WORKING CAPITAL CALCULATION

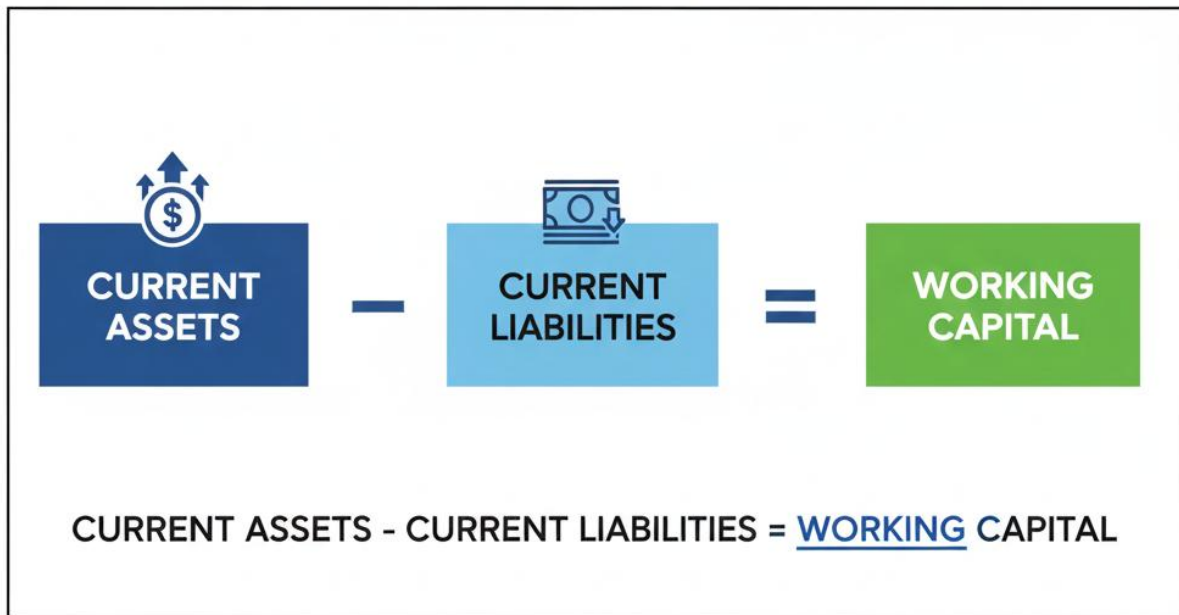


Diagram illustrating the calculation of working capital as the difference between current assets and current liabilities.

3.1.2 Types of working capital

There are two main types of working capital:

- **Gross working capital:** The total value of current assets.
- **Net working capital:** Current assets minus current liabilities.

Gross working capital shows the scale of resources available, while net working capital reflects the liquidity position of the firm.

Fill in the blank: Gross working capital refers to total current assets, while net working capital is current assets minus _____.



Box 3.1 Types of working capital

- Gross working capital = total current assets
- Net working capital = current assets – current liabilities

3.1.3 Components of working capital

Working capital is made up of **current assets** and **current liabilities**.

- **Current assets:** Cash, accounts receivable, inventory, marketable securities.
- **Current liabilities:** Accounts payable, short-term loans, accrued expenses.

The balance between these components determines whether a firm has sufficient liquidity to meet obligations.

Fill in the blank: Accounts receivable and inventory are examples of current _____.



Table 3.1

Components of working capital

Current Assets	Current Liabilities
• Cash • Accounts receivable • Inventory • Marketable securities	• Accounts payable • Short-term loans • Accrued expenses • Other current obligations

Pilot questions 3.1

- Working capital is calculated as: a. Current assets minus current liabilities b. Current liabilities minus current assets c. Total assets minus total liabilities d. Cash minus debts
- Gross working capital refers to: a. Current assets minus current liabilities b. Total current assets c. Total liabilities d. Net profit
- Net working capital is: a. Current assets minus current liabilities b. Current liabilities minus current assets c. Total assets minus liabilities d. Cash plus inventory
- Which of the following is a current asset? a. Accounts receivable b. Accounts payable c. Long-term debt d. Fixed assets



5. Which of the following is a current liability? a. Inventory b. Cash c. Short-term loan d. Marketable securities

3.2 Management of Working Capital

3.2.1 Importance of working capital management

Effective **working capital management** ensures that a business can meet its short-term obligations while maintaining smooth operations. It balances liquidity (ability to pay debts) with profitability (earning returns on assets). Poor management may lead to insolvency, while efficient management supports growth and stability.

Fill in the blank: Working capital management balances liquidity with _____.



FIGURE 3.2
Importance of working capital management

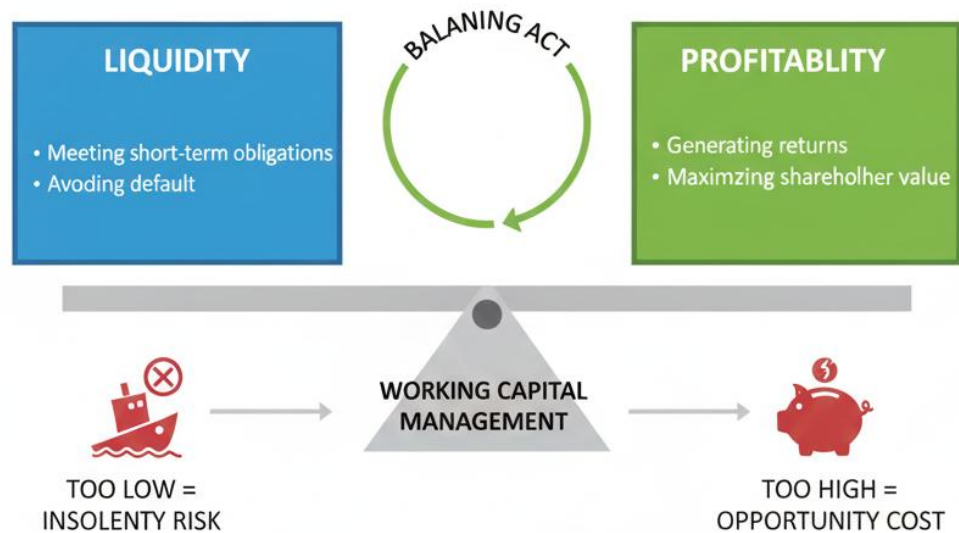


Diagram illustrating how working capital management balances liquidity and profitability to ensure financial health.

3.2.2 Policies of working capital management

There are three main policies:

- **Conservative policy:** Maintains high levels of current assets, ensuring safety but reducing profitability.
- **Aggressive policy:** Keeps low levels of current assets, maximising profitability but increasing risk.
- **Moderate policy:** Balances risk and return by maintaining average levels of current assets.

Fill in the blank: The aggressive policy maximises profitability but increases _____.



Box 3.2 Policies of working capital management

- **Conservative:** High current assets, low risk, low profitability
- **Aggressive:** Low current assets, high risk, high profitability
- **Moderate:** Balanced approach

3.2.3 Techniques for managing receivables, inventory, and cash

Financial managers use specific techniques to manage components of working capital:

- **Receivables management:** Credit policies, collection procedures, and monitoring debtor days.
- **Inventory management:** Economic Order Quantity (EOQ), Just-in-Time (JIT), and ABC analysis.
- **Cash management:** Cash budgeting, maintaining minimum cash balances, and investing surplus cash.

Fill in the blank: Just-in-Time (JIT) is an inventory management technique that reduces _____ costs.



Table 3.2
Techniques for managing working capital components

Component	Techniques	Example
Receables	Credit policies, collection procedures, debtor monitoring	Early payment discounts
Inventory	EOQ, JIT, ABC analysis	Just-in-Time (JIT) systems
Cash	Cash budgeting, minimum balances, surplus investment	Investing in short-term securities

Pilot questions 3.2

1. Working capital management ensures: a. Balance between liquidity and profitability b. Only profitability c. Only liquidity d. Neither liquidity nor profitability
2. A conservative policy maintains: a. High current assets, low risk, low profitability b. Low current assets, high risk, high profitability c. Balanced current assets d. No current assets
3. An aggressive policy is characterised by: a. High current assets b. Low current assets c. Balanced current assets d. No liabilities
4. Which of the following is an inventory management technique? a. EOQ b. JIT c. ABC analysis d. All of the above
- 5.



3.3 Financing of Working Capital

3.3.1 Sources of short-term financing for working capital

Working capital financing often relies on short-term sources to cover immediate operational needs. Common sources include:

- **Trade credit:** Suppliers allow delayed payment for goods/services.
- **Bank overdrafts:** Flexible borrowing up to an agreed limit.
- **Short-term loans:** Borrowed funds repayable within a year.
- **Commercial papers:** Unsecured promissory notes issued by large corporations.

Fill in the blank: Short-term loans used for working capital are usually repayable within _____ year.



Table 3.3 Sources of short-term financing for working capital

Source	Key Feature
Trade credit	Delayed payment to suppliers
Bank overdraft	Flexible borrowing facility
Short-term loans	Repayable within of year
Commercial papers	Unsecured notes issued by corporations

3.3.2 Matching principle in financing

The **matching principle** suggests that short-term needs should be financed with short-term sources, and long-term needs with long-term sources. This ensures that repayment schedules align with the life of the assets being financed, reducing liquidity risk.

Fill in the blank: The matching principle states that short-term needs should be financed with _____ sources.



Box 3.3 Matching principle in financing

- Short-term needs → short-term sources
- Long-term needs → long-term sources
- Aligns repayment with asset life

3.3.3 Balancing liquidity and profitability

Financing decisions must balance **liquidity** (ability to meet obligations) and **profitability** (earning returns). Excessive reliance on short-term finance may improve profitability but increase risk, while conservative financing ensures liquidity but may reduce returns. Managers must strike a balance based on the firm's risk appetite and market conditions.

Fill in the blank: Financing decisions must balance liquidity with _____.



FIGURE 3.3
Balancing liquidity and profitability in financing

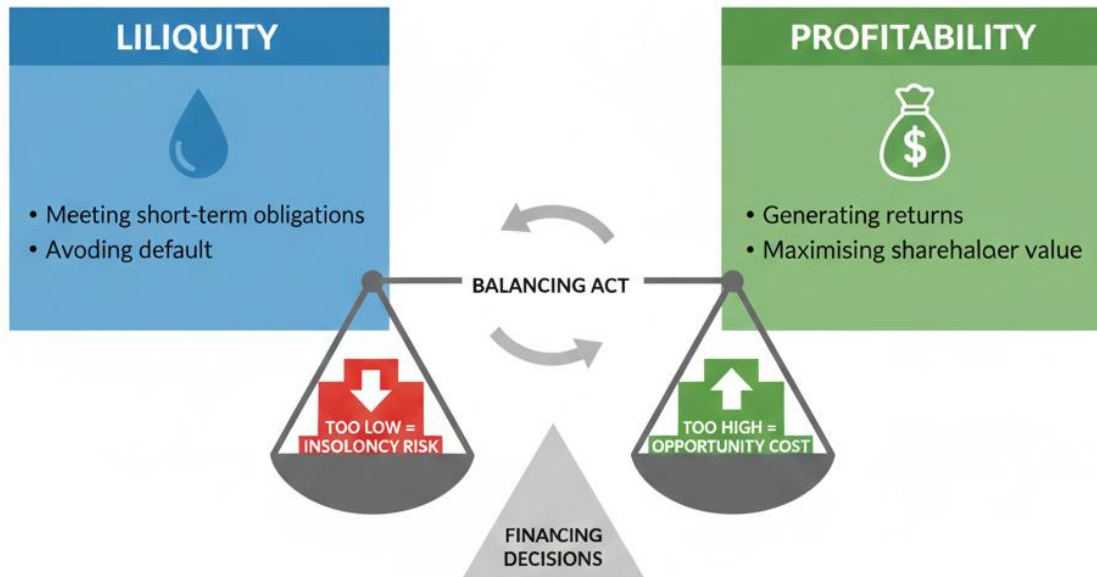


Diagram illustrating how financing decisions require a balance between ensuring sufficient liquidity and maximizing profitability.

Pilot questions 3.3

1. Which of the following is a source of short-term financing for working capital? a. Equity shares b. Bank overdrafts c. Debentures d. Bonds
2. Short-term loans for working capital are usually repayable within: a. One year b. Five years c. Ten years d. Indefinite period
3. The matching principle suggests: a. Short-term needs financed with long-term sources b. Long-term needs financed with short-term sources c. Short-term needs financed with short-term sources d. No alignment between needs and sources
4. Financing decisions must balance: a. Assets and liabilities b. Liquidity and profitability c. Income and expenditure d. Debts and equity



5. Excessive reliance on short-term finance may: a. Improve profitability but increase risk b. Reduce profitability and reduce risk c. Guarantee liquidity and profitability d. Eliminate financial risk

3.4 Introduction to Financial Statements

3.4.1 Types of financial statements

Financial statements are formal records that summarise the financial activities and position of a business. The three main types are:

- **Income statement:** Shows revenues, expenses, and profit or loss over a period.
- **Balance sheet:** Presents assets, liabilities, and equity at a specific point in time.
- **Cash flow statement:** Tracks cash inflows and outflows, highlighting operating, investing, and financing activities.

Fill in the blank: The balance sheet presents assets, liabilities, and _____ at a specific point in time.



Table 3.4 Types of financial statements

Statement		Purpose
Income statement	Revenues, expenses, profit/loss over time	Cash inflows/outflows by activity
Balance sheet	Assets, liabilities, equity at	
Cash flow statement	at a point	

3.4.2 Users of financial statements

Financial statements are used by different stakeholders for decision-making:

- **Investors:** Assess profitability and growth potential.
- **Creditors:** Evaluate ability to repay debts.
- **Managers:** Monitor performance and plan strategies.
- **Government/regulators:** Ensure compliance and taxation.
- **Employees:** Understand stability and prospects of the organisation.



Fill in the blank: Creditors use financial statements to evaluate a company's ability to repay _____.

Box 3.4 Users of financial statements

- **Investors** → profitability and growth
- **Creditors** → repayment ability
- **Managers** → performance and planning
- **Employees** → stability and prospects

3.4.3 Limitations of financial statements

While financial statements provide valuable information, they have limitations:

- **Historical nature:** They record past performance, not future prospects.
- **Accounting policies:** Different methods (e.g., depreciation) affect comparability.
- **Non-financial factors:** Do not capture employee morale, market reputation, or innovation.
- **Inflation effects:** Values may be distorted if inflation is high.



Fill in the blank: Financial statements are limited because they record _____ performance rather than future prospects.

FIGURE 3.4 Limitations of financial statements

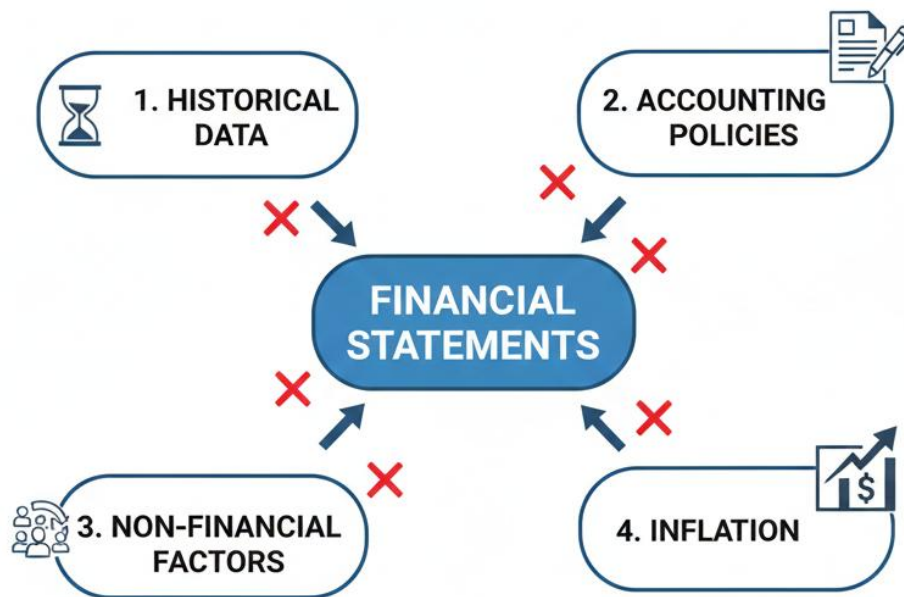


Diagram illustrating the limitations of financial statements, including on historical datas, accountinal factors, and inflation.

Pilot questions 3.4

1. The income statement shows: a. Assets and liabilities b. Revenues, expenses, and profit/loss c. Cash inflows and outflows d. Equity and debt
2. The balance sheet presents: a. Revenues and expenses b. Assets, liabilities, and equity c. Cash inflows and outflows d. Profit and loss
3. The cash flow statement tracks: a. Cash inflows and outflows b. Assets and liabilities c. Revenues and expenses d. Equity and debt



4. Which of the following is a user of financial statements? a. Investors b. Creditors c. Managers d. All of the above
5. Financial statements are limited because they: a. Record future prospects b. Record past performance c. Capture employee morale d. Eliminate inflation effects

3.5 Financial Statement Analysis Techniques

3.5.1 Comparative and common-size analysis

- **Comparative analysis** involves comparing financial statements across different periods to identify trends and changes.
- **Common-size analysis** expresses each item in the financial statement as a percentage of a base figure (e.g., total assets or sales), making it easier to compare companies of different sizes.

Fill in the blank: Common-size analysis expresses each item as a percentage of a _____ figure.



Table 3.5 Comparative vs. common-size analysis

Technique	Description	Purpose
Comparative analysis	Compare statements across periods	Identify trends and changes
Common-size analysis	Express items as % of a base figure	Compare across companies of different sizes

3.5.2 Ratio analysis

Ratio analysis uses financial ratios to evaluate performance. Key categories include:

- **Liquidity ratios:** Measure ability to meet short-term obligations (e.g., current ratio, quick ratio).
- **Profitability ratios:** Assess ability to generate profits (e.g., gross margin, return on equity).
- **Solvency ratios:** Evaluate long-term financial stability (e.g., debt-to-equity ratio).
- **Efficiency ratios:** Measure how effectively resources are used (e.g., inventory turnover, receivables turnover).



Fill in the blank: Liquidity ratios measure a company's ability to meet _____ obligations.

Box 3.5 Categories of financial ratios

- **Liquidity** → **short-term obligations**
- **Profitability** → **profit generation**
- **Solvency** → **long-term stability**
- **Efficiency** → **resource utilisation**

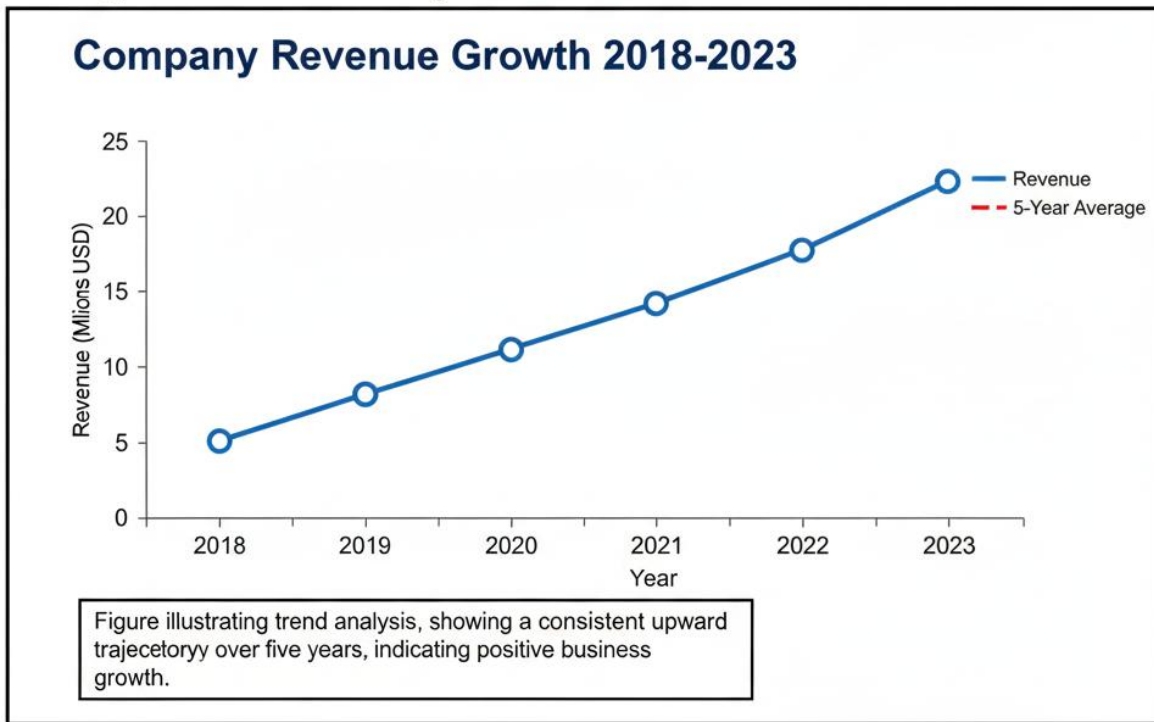
3.5.3 Trend analysis and interpretation

Trend analysis examines financial data over several periods to identify patterns, growth rates, or declines. It helps managers and investors forecast future performance and make strategic decisions. Interpretation of trends requires considering external factors such as market conditions, inflation, and industry benchmarks.

Fill in the blank: Trend analysis examines financial data over several _____ to identify patterns.



Figure 3.5 Trend analysis illustration



Pilot questions 3.5

1. Comparative analysis involves: a. Comparing financial statements across periods b. Expressing items as percentages c. Calculating ratios d. Forecasting future performance
2. Common-size analysis expresses items as: a. Absolute values b. Percentages of a base figure c. Ratios of profitability d. Forecasted values
3. Liquidity ratios measure: a. Profitability b. Long-term stability c. Ability to meet short-term obligations d. Efficiency of resource use
4. Which of the following is a solvency ratio? a. Current ratio b. Debt-to-equity ratio c. Gross margin d. Inventory turnover



5. Trend analysis helps managers: a. Identify patterns over time b. Record past performance only c. Ignore external factors d. Eliminate inflation effects

Series Summary

This Series examined how organisations manage their short-term resources and obligations, and how financial statements are used to assess performance. We began by defining working capital, distinguishing between gross and net working capital, and identifying its components. We then explored the importance of managing working capital, including policies (conservative, aggressive, moderate) and techniques for managing receivables, inventory, and cash. Next, we discussed financing of working capital, focusing on short-term sources, the matching principle, and balancing liquidity with profitability. Following this, we introduced the main financial statements—income statement, balance sheet, and cash flow statement—highlighting their users and limitations. Finally, we studied financial statement analysis techniques such as comparative and common-size analysis, ratio analysis, and trend analysis, which enable managers to interpret financial data and make informed decisions.

By completing this Series, you should now be able to define and manage working capital, analyse its financing, describe financial statements, and apply analytical techniques to evaluate organisational performance. These abilities directly reflect the Series Learning Outcomes (SLOs) and prepare you to make sound financial and managerial decisions.

Series Glossary

- **Accounts payable:** Money owed by a company to its suppliers for goods or services purchased on credit.
- **Accounts receivable:** Money owed to a company by its customers for goods or services sold on credit.
- **Aggressive policy:** A working capital management approach that minimises current assets, increasing risk but maximising profitability.
- **Balance sheet:** A financial statement showing assets, liabilities, and equity at a specific point in time.
- **Cash flow statement:** A financial statement that tracks cash inflows and outflows from operating, investing, and financing activities.
- **Comparative analysis:** Technique of comparing financial statements across different periods to identify trends.
- **Common-size analysis:** Technique that expresses each item in a financial statement as a percentage of a base figure.
- **Conservative policy:** A working capital management approach that maintains high levels of current assets, reducing risk but lowering profitability.



- **Current assets:** Assets expected to be converted into cash within one year, such as cash, receivables, and inventory.
- **Current liabilities:** Obligations due within one year, such as accounts payable and short-term loans.
- **Efficiency ratios:** Ratios that measure how effectively a company uses its resources, e.g., inventory turnover.
- **Gross working capital:** The total value of current assets.
- **Income statement:** A financial statement showing revenues, expenses, and profit or loss over a period.
- **Liquidity ratios:** Ratios that measure a company's ability to meet short-term obligations.
- **Matching principle:** Financing principle that aligns short-term needs with short-term sources and long-term needs with long-term sources.
- **Moderate policy:** A balanced working capital management approach that maintains average levels of current assets.
- **Net working capital:** Current assets minus current liabilities.
- **Profitability ratios:** Ratios that assess a company's ability to generate profits.
- **Receivables management:** Techniques used to monitor and collect payments from customers.
- **Solvency ratios:** Ratios that evaluate a company's long-term financial stability, e.g., debt-to-equity ratio.
- **Trend analysis:** Technique that examines financial data over several periods to identify patterns and forecast future performance.
- **Working capital:** The difference between current assets and current liabilities, indicating liquidity position.

Concept Check Questions

Objective questions

1. Working capital is calculated as: a. Current assets minus current liabilities b. Current liabilities minus current assets c. Total assets minus total liabilities d. Cash minus debts (Linked to SLO 3.1)
2. Which of the following is a conservative working capital policy? a. High current assets, low risk, low profitability b. Low current assets, high risk, high profitability c. Balanced current assets d. No current assets (Linked to SLO 3.2)



3. The matching principle in financing suggests: a. Short-term needs financed with short-term sources b. Long-term needs financed with short-term sources c. Short-term needs financed with long-term sources d. No alignment between needs and sources (Linked to SLO 3.3)
4. The balance sheet presents: a. Revenues and expenses b. Assets, liabilities, and equity c. Cash inflows and outflows d. Profit and loss (Linked to SLO 3.4)
5. Liquidity ratios measure: a. Profitability b. Long-term stability c. Ability to meet short-term obligations d. Efficiency of resource use (Linked to SLO 3.5)

Short-answer questions

6. Define net working capital in one sentence. (Linked to SLO 3.1)
7. Explain the difference between aggressive and conservative working capital policies. (Linked to SLO 3.2)
8. Identify two sources of short-term financing for working capital. (Linked to SLO 3.3)
9. State one limitation of financial statements. (Linked to SLO 3.4)
10. Name two categories of financial ratios used in analysis. (Linked to SLO 3.5)

Long-answer questions

11. Discuss the importance of managing working capital, highlighting policies and techniques for receivables, inventory, and cash. (Linked to SLO 3.2)
12. Evaluate financial statement analysis techniques, focusing on comparative analysis, ratio analysis, and trend analysis. (Linked to SLO 3.5)

Answers to Concept Check Questions [Series 3]

Objective questions

1. a
2. a
3. a
4. b
5. c

Short-answer questions

6. Net working capital is current assets minus current liabilities.
7. Aggressive policy minimises current assets, increasing risk but maximising profitability; conservative policy maintains high current assets, reducing risk but lowering profitability.



8. Trade credit and bank overdrafts (other valid answers: short-term loans, commercial papers).
9. Financial statements are limited because they record past performance rather than future prospects.
10. Liquidity ratios and profitability ratios (other valid answers: solvency ratios, efficiency ratios).

Long-answer questions

11. **Basic response:** Working capital management ensures liquidity and profitability. Policies include conservative, aggressive, and moderate approaches. Techniques include credit policies for receivables, EOQ and JIT for inventory, and cash budgeting for cash. **Value-added response:** Outstanding learners may add that effective management prevents insolvency, supports growth, and balances risk-return trade-offs, ensuring operational efficiency and financial stability.
12. **Basic response:** Financial statement analysis techniques help evaluate performance. Comparative analysis identifies changes over time, ratio analysis measures liquidity, profitability, solvency, and efficiency, and trend analysis forecasts future performance. **Value-added response:** Outstanding learners may add that these techniques provide insights for investors, creditors, and managers, enhance decision-making, and must be interpreted alongside external factors like market conditions and inflation.

Answers to Pilot Questions [Series 3]

Part 3.1

1. a
2. b
3. a
4. a
5. c

Part 3.2

1. a
2. a
3. b
4. d
5. d



Part 3.3

1. b
2. a
3. c
4. b
5. a

Part 3.4

1. b
2. b
3. a
4. d
5. b

Part 3.5

1. a
2. b
3. c
4. b
5. a

Series 4: Dividend Policy, Valuation, and Corporate Restructuring

Series Outline

4.1 Dividend policy concepts and theories

- 4.1.1 Meaning and importance of dividend policy
- 4.1.2 Types of dividend policies (stable, constant payout, residual)
- 4.1.3 Theories of dividend relevance and irrelevance (Walter, Gordon, Modigliani–Miller)



4.2 Factors influencing dividend decisions

- 4.2.1 Legal, financial, and contractual constraints
- 4.2.2 Market expectations and investor preferences
- 4.2.3 Company growth opportunities and liquidity position

4.3 Valuation of securities

- 4.3.1 Concept of valuation and its importance
- 4.3.2 Valuation of equity shares (dividend discount model, P/E ratio approach)
- 4.3.3 Valuation of bonds and debentures (present value of cash flows, yield to maturity)

4.4 Corporate restructuring strategies

- 4.4.1 Mergers and acquisitions: motives and types
- 4.4.2 Divestitures, spin-offs, and demergers
- 4.4.3 Leveraged buyouts and financial restructuring

4.5 Implications of dividend policy and restructuring on firm value

- 4.5.1 Impact of dividend decisions on shareholder wealth
- 4.5.2 Effect of restructuring on financial performance and market perception
- 4.5.3 Balancing shareholder interests and long-term growth

Introduction

Dividend policy, valuation, and corporate restructuring are critical aspects of financial management that directly influence shareholder wealth and the long-term sustainability of organisations. Dividend policy determines how profits are distributed between shareholders and reinvestment, valuation techniques help assess the worth of securities and companies, and corporate restructuring enables firms to adapt to changing environments, improve efficiency, or pursue growth opportunities.

The aim of this Series is to provide you with a comprehensive understanding of how dividend decisions are made, how securities are valued, and how restructuring strategies impact firm value.

We shall commence this Series by exploring the concepts and theories of dividend policy, including relevance and irrelevance approaches. Next, we will examine the factors influencing dividend decisions, such as legal constraints, market expectations, and growth opportunities. We will then study valuation techniques for equity shares, bonds, and debentures, highlighting their importance in investment decisions. Following this, we will analyse corporate restructuring strategies such as mergers, acquisitions, divestitures, and leveraged buyouts. Finally, we will conclude with the implications of dividend policy and restructuring on firm value, focusing on how these decisions affect shareholder wealth and organisational performance.



Series Learning Outcomes

Upon completing this Series, you should be able to:

- **4.1** explain the meaning and importance of dividend policy, identify types of dividend policies, and evaluate dividend theories (relevance and irrelevance).
- **4.2** analyse the factors influencing dividend decisions, including legal, financial, market, and organisational considerations.
- **4.3** apply valuation techniques to equity shares, bonds, and debentures, using models such as the dividend discount model and yield to maturity.
- **4.4** describe corporate restructuring strategies such as mergers, acquisitions, divestitures, spin-offs, and leveraged buyouts, and assess their motives.
- **4.5** evaluate the implications of dividend policy and restructuring decisions on shareholder wealth, firm value, and long-term growth.

4.1 Dividend Policy Concepts and Theories

4.1.1 Meaning and importance of dividend policy

Dividend policy refers to the guidelines a company follows in deciding how much of its profits will be distributed to shareholders as dividends and how much will be retained for reinvestment. It is important because it affects shareholder satisfaction, the firm's liquidity, and its growth prospects.

Fill in the blank: Dividend policy determines how profits are divided between dividends and _____.



FIGURE 4.1 Dividend policy decision

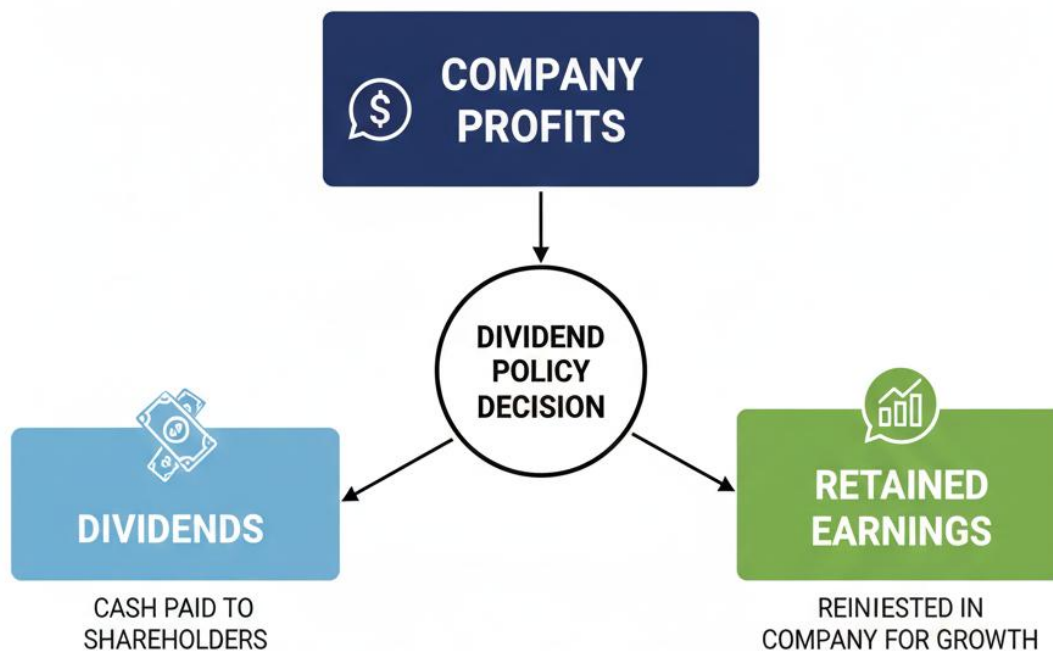


Diagram showing how a company's profits are allocated between cash dividends to shareholders and retained earnings for reinvestment.

4.1.2 Types of dividend policies

Companies may adopt different dividend policies:

- **Stable dividend policy:** Paying a fixed dividend regularly, regardless of fluctuations in profits.
- **Constant payout ratio policy:** Dividends are a fixed percentage of earnings, so they vary with profits.
- **Residual dividend policy:** Dividends are paid only after financing all profitable investment opportunities.

Fill in the blank: Under a residual dividend policy, dividends are paid only after financing all _____ opportunities.



Box 4.1 Types of dividend policies

- Stable dividend policy → fixed dividend regularly
- Constant payout ratio → fixed % of earnings
- Residual dividend policy → dividends after investment needs

4.1.3 Theories of dividend relevance and irrelevance

There are two broad schools of thought:

- **Relevance theories:**
 - *Walter's model*: Dividend policy affects firm value; firms with high returns should retain earnings.
 - *Gordon's model*: Shareholders prefer dividends due to uncertainty of future earnings ("bird in hand" theory).
- **Irrelevance theory:**



- *Modigliani–Miller (M–M) hypothesis*: Dividend policy does not affect firm value; investment decisions matter more.

Fill in the blank: According to Gordon’s model, shareholders prefer dividends due to uncertainty of future _____.

Table 4.1 Dividend theories

Theory/Model	Key Idea
Walter's model	Dividend policy affects firm value; retention depends on return vs. cost of capital
Gordon's model	Dividends preferred due uncertainty (“bird in hand”)
M–M hypothesis	Dividend policy irrelevant; firm value depends on investment decisions

Pilot questions 4.1

1. Dividend policy determines how profits are divided between dividends and: a. Retained earnings b. Taxes c. Debts d. Assets
2. A stable dividend policy means: a. Fixed dividend regularly b. Fixed % of earnings c. Dividends after investments d. No dividends at all



3. Under a residual dividend policy, dividends are paid: a. Before financing investments b. Only after financing investments c. Regardless of profits d. As fixed % of earnings
4. Gordon's model suggests shareholders prefer dividends because: a. They are tax-free b. They are certain compared to future earnings c. They increase debt d. They reduce retained earnings
5. The M–M hypothesis argues that dividend policy is: a. Relevant to firm value b. Irrelevant to firm value c. Always increasing firm value d. Always decreasing firm value

4.2 Factors Influencing Dividend Decisions

4.2.1 Legal, financial, and contractual constraints

Dividend decisions are subject to several constraints:

- **Legal constraints:** Laws may restrict dividend payments to protect creditors (e.g., dividends cannot be paid out of capital).
- **Financial constraints:** Companies must maintain sufficient liquidity and reserves before declaring dividends.
- **Contractual constraints:** Loan agreements or bond covenants may limit dividend payouts to ensure debt repayment.

Fill in the blank: Legal constraints prevent companies from paying dividends out of _____.



Box 4.2 Constraints on dividend decisions

- **Legal** → dividends cannot be paid out of capital
- **Financial** → liquidity and reserves must must be maintained
- **Contrautal** → loan agreements may restrict payouts

4.2.2 Market expectations and investor preferences

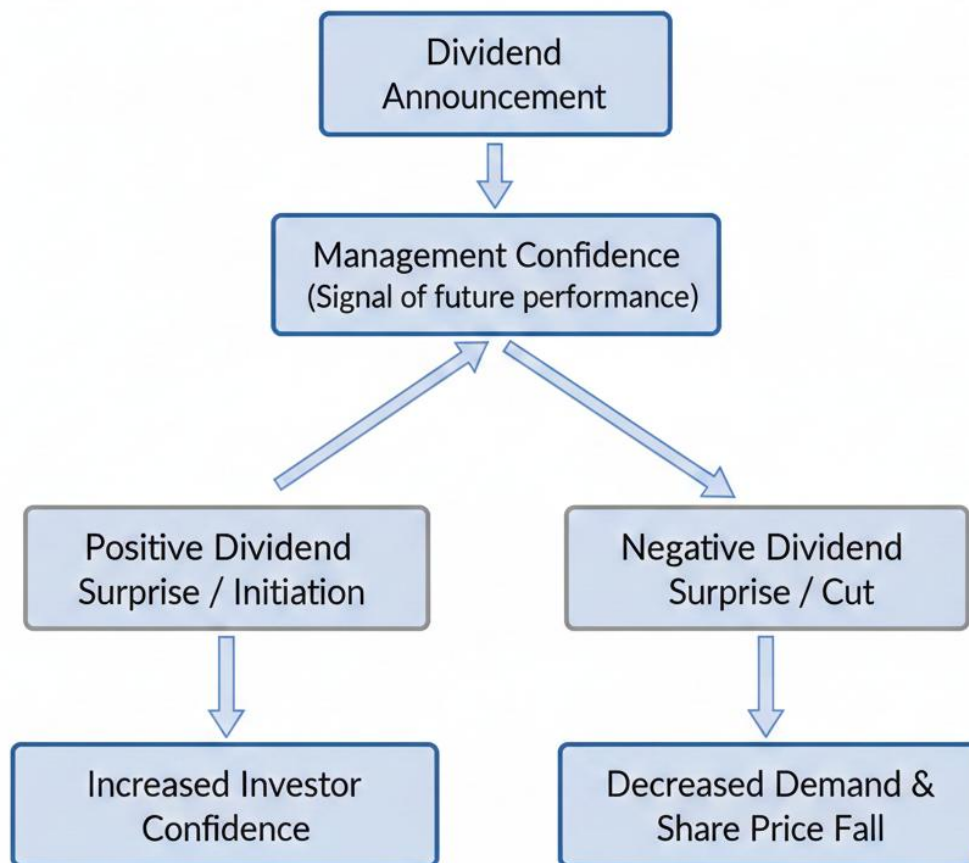
Dividend decisions are influenced by how investors and markets perceive them:

- **Market expectations:** Investors expect consistent dividends; sudden changes may affect share prices.
- **Investor preferences:** Some investors prefer regular dividends for income, while others prefer reinvestment for growth.
- **Signalling effect:** Dividend announcements may signal management's confidence in future earnings.

Fill in the blank: Dividend announcements may act as a _____ of management's confidence in future earnings.



Figure 4.2 Market expectations and signaling effect



OER diagram

4.2.3 Company growth opportunities and liquidity position

Companies with high growth opportunities often retain earnings to finance expansion, while mature firms with stable cash flows may distribute higher dividends. Liquidity also plays a crucial role—firms must ensure they have enough cash to meet obligations before declaring dividends.

Fill in the blank: Companies with high growth opportunities often retain earnings to finance _____.



Table 4.2 Growth opportunities and liquidity in dividend decisions

Factor	Impact on Dividend Policy
Growth opportunities	Retain earnings for expansion
Liquidity position	Adequate cash required before paying dividends

OER table

Pilot questions 4.2

1. Legal constraints prevent companies from paying dividends out of: a. Capital b. Profits c. Reserves d. Cash flow
2. Contractual constraints on dividends often arise from: a. Loan agreements b. Shareholder meetings c. Tax laws d. Employee contracts
3. Dividend announcements may act as a: a. Guarantee of profits b. Signal of management's confidence c. Reduction in liabilities d. Increase in debt
4. Companies with high growth opportunities usually: a. Retain earnings for expansion b. Pay high dividends c. Reduce reserves d. Increase liabilities



5. Liquidity position affects dividend decisions because firms must: a. Maintain adequate cash before paying dividends b. Ignore cash levels c. Pay dividends regardless of liquidity d. Always reinvest earnings

4.3 Valuation of Securities

4.3.1 Concept of valuation and its importance

Valuation is the process of determining the present worth of an asset or security. It is important because it guides investment decisions, helps assess risk, and supports corporate finance strategies. Accurate valuation ensures that investors pay a fair price and companies raise capital efficiently.

Fill in the blank: Valuation is the process of determining the present _____ of an asset or security.



Figure 4.3 Importance of valuation



OER diagram

4.3.2 Valuation of equity shares

Equity shares represent ownership in a company. Common valuation methods include:

- **Dividend Discount Model (DDM):** Value of a share = Present value of expected future dividends.
- **Price/Earnings (P/E) ratio approach:** Value of a share = Earnings per share $\times$ P/E multiple.
- **Book value and market value comparison:** Assessing intrinsic worth vs. market price.

Fill in the blank: The Dividend Discount Model values a share based on expected future _____.



Method	Formula/Approach	Key Idea
Dividend Discount Model (DDM)	Present Value (PV) of expected future dividends	The value of a stock is the present value of the expected future stream of dividends it is likely to generate.
P/E ratio approach	Earnings Per Share (EPS) $\times$ P/E multiple (from comparable firms/industry)	Value is determined by multiplying the company's earnings by an appropriate market multiple , reflecting market expectations for earnings.
Book vs. Market Value	Compare Book Value per Share (Total Equity/Shares Outstanding) against the Market Price per Share	This comparison identifies potential over- or under-valuation by checking if the market price is justified by the company's net asset value.

4.3.3 Valuation of bonds and debentures

Bonds and debentures are debt instruments. Their valuation is based on the present value of future cash flows:

- **Coupon payments:** Regular interest payments.
- **Principal repayment:** Amount repaid at maturity.
- **Yield to Maturity (YTM):** Discount rate that equates present value of cash flows to current market price.

Fill in the blank: Yield to Maturity (YTM) is the discount rate that equates present value of cash flows to current _____ price.



Box 4.3 Bond valuation components

- Coupon payments → regular interest
- Principal repayment → maturity value
- YTM → discount rate equating PV to market price

OER summary

Pilot questions 4.3

1. Valuation is the process of determining the present: a. Worth of an asset or security b. Future profits c. Past performance d. Market trends
2. The Dividend Discount Model values a share based on: a. Future dividends b. Market multiples c. Book value d. Past profits
3. The P/E ratio approach values a share using: a. Dividends b. Earnings per share $\times$ P/E multiple c. Market price only d. Book value only



4. Bond valuation is based on: a. Present value of future cash flows b. Past coupon payments only c. Market trends only d. Book value of equity
5. Yield to Maturity (YTM) is the discount rate that equates PV of cash flows to: a. Current market price b. Future profits c. Book value d. Dividend payout

4.4 Corporate Restructuring Strategies

4.4.1 Mergers and acquisitions: motives and types

Mergers and acquisitions (M&A) involve combining two or more companies to achieve strategic objectives.

- **Motives:** Growth, diversification, economies of scale, market expansion, synergy.
- **Types:**
 - Horizontal merger → between firms in the same industry.
 - Vertical merger → between firms at different stages of production.
 - Conglomerate merger → between firms in unrelated industries.

Fill in the blank: A horizontal merger occurs between firms in the same _____.

Type	Example/Description
Horizontal merger	Two or more firms operating in the same industry and at the same stage of production (e.g., two competing banks merging). The goal is usually to gain market share or achieve economies of scale.
Vertical merger	A firm merges with another firm that is either a supplier (backward integration) or a customer (forward integration) in the production chain (e.g., a car manufacturer merging with a parts supplier).
Conglomerate merger	Firms in completely unrelated industries merge (e.g., a technology company merging with a food manufacturer). This is often done to achieve diversification.

4.4.2 Divestitures, spin-offs, and demergers

Companies may restructure by selling or separating parts of their business:

- **Divestiture:** Selling a business unit or asset to focus on core operations.
- **Spin-off:** Creating a new independent company by distributing shares of a subsidiary to existing shareholders.



- **Demerger:** Splitting a company into two or more separate entities.

Fill in the blank: A spin-off creates a new independent company by distributing shares of a _____ to shareholders.

Box 4.4 Corporate restructuring forms

- Divestiture → selling a unit
- Spin-off → new independent company
- Demerger → splitting into separate entities

OER summary

4.4.3 Leveraged buyouts and financial restructuring

- **Leveraged buyout (LBO):** Acquisition of a company using borrowed funds, with assets of the acquired firm often serving as collateral.
- **Financial restructuring:** Reorganising capital structure by altering debt and equity mix, often to reduce financial distress or improve efficiency.

Fill in the blank: In a leveraged buyout, a company is acquired using borrowed _____.



Figure 4.4 Leveraged Buyout process



OER diagram

Pilot questions 4.4

1. A horizontal merger occurs between firms in the same: a. Industry b. Production stage c. Country d. Market size
2. A vertical merger occurs between firms at: a. The same industry level b. Different stages of production c. Unrelated industries d. Different countries
3. A spin-off creates: a. A new independent company b. A merger of two firms c. A sale of assets d. A conglomerate
4. A demerger involves: a. Splitting a company into separate entities b. Selling a unit c. Acquiring another firm d. Issuing new shares



5. In a leveraged buyout, a company is acquired using: a. Borrowed funds b. Equity only c. Government grants d. Retained earnings

4.5 Implications of Dividend Policy and Restructuring on Firm Value

4.5.1 Impact of dividend decisions on shareholder wealth

Dividend decisions directly affect shareholder wealth and perceptions of firm stability.

- **High dividends:** Provide immediate income but may reduce funds available for reinvestment.
- **Low dividends/retention:** Support growth and expansion but may disappoint income-seeking investors.
- **Signalling effect:** Stable or increasing dividends often signal strong financial health, boosting share prices.

Fill in the blank: Stable or increasing dividends often signal strong _____ health to investors.



Figure 4.5 Dividend decisions and shareholder wealth



OER diagram

4.5.2 Effect of restructuring on financial performance and market perception

Corporate restructuring can reshape a firm's financial performance and how it is perceived in the market:

- **Mergers and acquisitions:** May create synergies, increase market share, and improve efficiency.
- **Divestitures and spin-offs:** Allow focus on core operations, potentially increasing profitability.
- **Leveraged buyouts:** Can improve efficiency but increase financial risk due to high debt.

Fill in the blank: Mergers and acquisitions may create _____, increasing efficiency and market share.



Table 4.5 Effects of restructuring strategies

Strategy	Effect on Performance/Perception
Horizontal merger	Synergies, efficiency, market share growth
Divestitures/spin-offs	Focus on core operations, profitability
Leveraged buyouts	Efficiency gains, higher financial risk

OER table

4.5.3 Balancing shareholder interests and long-term growth

Managers must balance short-term shareholder interests (dividends, immediate returns) with long-term growth (retained earnings, restructuring).

- **Short-term focus:** High dividends satisfy investors but may limit reinvestment.
- **Long-term focus:** Retained earnings and restructuring support growth but may reduce immediate payouts.
- **Optimal balance:** Aligning dividend policy and restructuring strategies with firm objectives ensures sustainable value creation.

Fill in the blank: Managers must balance short-term shareholder interests with long-term _____.



Box 4.5 Balancing interests and growth

- Short-term → dividends, immediate returns
- Long-term → reinvestment, restructuring, growth, growth
- Optimal balance → sustainable value creation

OER summary

Pilot questions 4.5

1. Stable or increasing dividends often signal strong: a. Financial health b. Debt levels c. Market risk d. Tax burden
2. Mergers and acquisitions may create: a. Synergies b. Higher taxes c. Lower efficiency d. Reduced market share
3. Divestitures and spin-offs allow firms to: a. Focus on core operations b. Increase debt c. Reduce profitability d. Avoid compliance
4. Leveraged buyouts can improve efficiency but increase: a. Financial risk b. Market share c. Dividend payouts d. Liquidity reserves



5. Managers must balance short-term shareholder interests with long-term: a. Growth b. Debt c. Taxes d. Dividends only

Series Summary

This Series explored how dividend policy, valuation, and corporate restructuring shape financial management and firm value. We began with the meaning and importance of dividend policy, examining types such as stable, constant payout, and residual, as well as theories of relevance (Walter, Gordon) and irrelevance (Modigliani–Miller). Next, we analysed factors influencing dividend decisions, including legal, financial, and contractual constraints, market expectations, investor preferences, and company growth opportunities. We then studied valuation of securities, covering equity shares through models like the Dividend Discount Model and P/E ratio, and bonds/debentures through present value and yield to maturity approaches. Following this, we examined corporate restructuring strategies such as mergers, acquisitions, divestitures, spin-offs, demergers, and leveraged buyouts. Finally, we assessed the implications of dividend policy and restructuring on firm value, highlighting their impact on shareholder wealth, financial performance, and the balance between short-term interests and long-term growth.

By completing this Series, you should now be able to explain dividend policies and theories, analyse influencing factors, apply valuation techniques, describe restructuring strategies, and evaluate their implications for firm value and shareholder wealth.

Series Glossary

- **Aggressive dividend policy:** Paying low dividends and retaining more earnings for growth.
- **Balance sheet:** Statement showing assets, liabilities, and equity at a point in time.
- **Conglomerate merger:** Merger between firms in unrelated industries.
- **Constant payout ratio:** Dividend policy where dividends are a fixed percentage of earnings.
- **Debt-to-equity ratio:** Solvency ratio measuring long-term financial stability.
- **Demerger:** Splitting a company into two or more separate entities.
- **Dividend Discount Model (DDM):** Valuation method based on present value of expected dividends.
- **Dividend policy:** Guidelines for deciding how profits are distributed between dividends and retained earnings.
- **Divestiture:** Selling a business unit or asset to focus on core operations.
- **Earnings per share (EPS):** Profit attributable to each share of common stock.



- **Financial restructuring:** Reorganising debt and equity mix to improve efficiency or reduce distress.
- **Gordon's model:** Dividend relevance theory suggesting shareholders prefer dividends due to uncertainty of future earnings.
- **Horizontal merger:** Merger between firms in the same industry.
- **Leveraged buyout (LBO):** Acquisition financed primarily with borrowed funds, often collateralised by assets.
- **Liquidity position:** Availability of cash and current assets to meet obligations.
- **Modigliani–Miller hypothesis (M–M):** Dividend irrelevance theory stating dividend policy does not affect firm value.
- **P/E ratio approach:** Valuation method using earnings per share multiplied by market P/E multiple.
- **Residual dividend policy:** Paying dividends only after financing profitable investment opportunities.
- **Shareholder wealth:** Value created for shareholders through dividends, capital gains, and firm growth.
- **Spin-off:** Creating a new independent company by distributing shares of a subsidiary to shareholders.
- **Stable dividend policy:** Paying a fixed dividend regularly, regardless of profit fluctuations.
- **Synergy:** Combined benefits from mergers or acquisitions that exceed individual firm performance.
- **Valuation:** Process of determining the present worth of an asset or security.
- **Vertical merger:** Merger between firms at different stages of production.
- **Walter's model:** Dividend relevance theory linking dividend policy to firm value based on return vs. cost of capital.
- **Yield to Maturity (YTM):** Discount rate equating present value of bond cash flows to current market price.

Concept Check Questions

Objective questions



1. Dividend policy determines how profits are divided between: a. Dividends and retained earnings b. Taxes and debts c. Assets and liabilities d. Cash and reserves (Linked to SLO 4.1)
2. Which of the following is a legal constraint on dividend decisions? a. Dividends cannot be paid out of capital b. Investors prefer dividends c. Market expectations d. Growth opportunities (Linked to SLO 4.2)
3. The Dividend Discount Model values a share based on: a. Expected future dividends b. Market multiples c. Book value only d. Past profits (Linked to SLO 4.3)
4. A horizontal merger occurs between firms in the same: a. Industry b. Production stage c. Country d. Market size (Linked to SLO 4.4)
5. Stable or increasing dividends often signal strong: a. Financial health b. Debt levels c. Market risk d. Tax burden (Linked to SLO 4.5)

Short-answer questions

6. Define dividend policy in one sentence. (Linked to SLO 4.1)
7. Identify two factors that influence dividend decisions. (Linked to SLO 4.2)
8. State one method of equity share valuation and one method of bond valuation. (Linked to SLO 4.3)
9. Explain the difference between a spin-off and a demerger. (Linked to SLO 4.4)
10. How do dividend decisions impact shareholder wealth? (Linked to SLO 4.5)

Long-answer questions

11. Discuss the theories of dividend relevance and irrelevance, highlighting Walter's model, Gordon's model, and the M-M hypothesis. (Linked to SLO 4.1)
12. Evaluate the implications of corporate restructuring strategies (mergers, acquisitions, divestitures, leveraged buyouts) on firm value and market perception. (Linked to SLO 4.4, 4.5)

Answers to Concept Check Questions [Series 4]

Objective questions

1. a
2. a
3. a
4. a
5. a



Short-answer questions

6. Dividend policy is the guideline a company follows in deciding how profits are distributed between dividends and retained earnings.
7. Legal constraints and market expectations (other valid answers: financial constraints, contractual constraints, growth opportunities, liquidity).
8. Equity share valuation → Dividend Discount Model; Bond valuation → Yield to Maturity.
9. A spin-off creates a new independent company by distributing shares of a subsidiary, while a demerger splits a company into separate entities.
10. Dividend decisions affect shareholder wealth by providing immediate income or supporting long-term growth through reinvestment.

Long-answer questions

11. **Basic response:** Walter's model and Gordon's model argue that dividend policy affects firm value (relevance), while the M–M hypothesis argues that dividend policy is irrelevant to firm value. **Value-added response:** Outstanding learners may add that Walter's model links retention to return vs. cost of capital, Gordon's model emphasises certainty of dividends ("bird in hand"), and M–M stresses investment decisions as the true driver of firm value.
12. **Basic response:** Corporate restructuring strategies affect firm value and perception. Mergers and acquisitions create synergies, divestitures and spin-offs improve focus, and leveraged buyouts increase efficiency but raise financial risk. **Value-added response:** Outstanding learners may add that restructuring can enhance shareholder wealth, improve competitiveness, and signal strategic repositioning, but outcomes depend on execution, industry conditions, and financial structure.

Answers to Pilot Questions [Series 4]

Part 4.1

1. a
2. a
3. b
4. b
5. b

Part 4.2

1. a



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Part 4.3

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Part 4.4

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Part 4.5

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Series 5: Financial Risk, Capital Structure, and Banking Systems

Series Outline



5.1 Financial risk concepts and types

- 5.1.1 Meaning of financial risk
- 5.1.2 Types of financial risk (market risk, credit risk, liquidity risk, operational risk)
- 5.1.3 Measuring and managing financial risk

5.2 Capital structure theories and determinants

- 5.2.1 Meaning and importance of capital structure
- 5.2.2 Theories of capital structure (Net Income approach, Net Operating Income approach, Traditional theory, Modigliani–Miller theorem)
- 5.2.3 Factors influencing capital structure decisions (cost of capital, risk, control, flexibility)

5.3 Capital structure in practice

- 5.3.1 Optimal capital structure and trade-off between debt and equity
- 5.3.2 Leverage and its impact on earnings per share (EPS)
- 5.3.3 Capital structure policies in different industries

5.4 Banking systems and financial intermediation

- 5.4.1 Role of banking systems in financial management
- 5.4.2 Types of banking systems (commercial banks, investment banks, central banks)
- 5.4.3 Functions of banks: deposit mobilisation, lending, payments, and risk management

5.5 Regulation and risk management in banking

- 5.5.1 Banking regulations and prudential norms
- 5.5.2 Basel Accords and capital adequacy requirements
- 5.5.3 Risk management practices in banks (credit appraisal, stress testing, liquidity management)

Introduction

Financial risk, capital structure, and banking systems are interconnected pillars of financial management. Every organisation faces risks—whether from markets, credit, liquidity, or operations—that must be measured and managed to ensure stability. Capital structure decisions determine the mix of debt and equity financing, influencing both risk and return. Banking systems, as financial intermediaries, play a vital role in mobilising funds, providing credit, and maintaining financial stability, while regulations ensure soundness and resilience.

The aim of this Series is to equip you with a clear understanding of financial risk types and management, capital structure theories and practices, and the role of banking systems in financial management.



We shall commence this Series by exploring the concepts and types of financial risk, along with methods of measurement and management. Next, we will examine capital structure theories and determinants, including traditional and modern approaches. We will then study capital structure in practice, focusing on optimal debt–equity mix, leverage, and industry policies. Following this, we will analyse banking systems and their functions as financial intermediaries. Finally, we will conclude with regulation and risk management in banking, covering prudential norms, Basel Accords, and practices such as credit appraisal and liquidity management.

Series Learning Outcomes

Upon completing this Series, you should be able to:

- **5.1** explain the meaning of financial risk, identify its types (market, credit, liquidity, operational), and outline methods of measurement and management.
- **5.2** describe capital structure theories (Net Income, Net Operating Income, Traditional, Modigliani–Miller) and analyse determinants of capital structure decisions.
- **5.3** evaluate capital structure in practice, including optimal debt–equity mix, leverage effects on earnings per share, and industry-specific policies.
- **5.4** explain the role of banking systems in financial management, distinguish between types of banks (commercial, investment, central), and describe their functions.
- **5.5** assess regulation and risk management in banking, including prudential norms, Basel Accords, and practices such as credit appraisal, stress testing, and liquidity management.

5.1 Financial Risk Concepts and Types

5.1.1 Meaning of financial risk

Financial risk refers to the possibility of a company or investor experiencing losses due to factors that affect financial performance. It arises from uncertainty in markets, credit, liquidity, or operations, and managing it is essential for stability and growth.

Fill in the blank: Financial risk refers to the possibility of experiencing _____ due to uncertainty in financial performance.

5.1.2 Types of financial risk

- **Market risk:** Losses due to changes in market prices, interest rates, or exchange rates.
- **Credit risk:** Risk that borrowers may default on obligations.
- **Liquidity risk:** Inability to meet short-term obligations due to lack of cash or liquid assets.
- **Operational risk:** Losses due to failures in processes, systems, or human error.

Fill in the blank: Credit risk arises when borrowers may _____ on their obligations.



5.1.3 Measuring and managing financial risk

- **Measurement tools:** Value at Risk (VaR), stress testing, credit scoring, liquidity ratios.
- **Management strategies:** Diversification, hedging, maintaining reserves, strong internal controls.
- **Role of managers:** Identify risks, assess exposure, and implement mitigation strategies.

Fill in the blank: Diversification and hedging are strategies used to _____ financial risk.

Pilot questions 5.1

1. Financial risk refers to the possibility of experiencing: a. Losses due to uncertainty b. Guaranteed profits c. Stable returns d. Tax savings
2. Market risk arises from: a. Changes in prices, interest rates, or exchange rates b. Borrowers defaulting c. Failures in processes d. Lack of liquidity
3. Credit risk arises when borrowers: a. Default on obligations b. Pay early c. Increase collateral d. Reduce debt
4. Liquidity risk means: a. Inability to meet short-term obligations b. Guaranteed access to cash c. Stable reserves d. Excess profits
5. Diversification and hedging are strategies used to: a. Manage financial risk b. Increase debt c. Eliminate profits d. Reduce reserves

5.2 Capital Structure Theories and Determinants

5.2.1 Meaning and importance of capital structure

Capital structure refers to the mix of debt and equity a company uses to finance its operations and growth. It is important because it affects the cost of capital, risk profile, control of the firm, and ultimately shareholder wealth.

Fill in the blank: Capital structure refers to the mix of _____ and equity used to finance a company.

5.2.2 Theories of capital structure

Several theories explain the relationship between capital structure and firm value:

- **Net Income (NI) approach:** Increasing debt reduces cost of capital and increases firm value.
- **Net Operating Income (NOI) approach:** Capital structure is irrelevant; firm value depends on operating income.
- **Traditional theory:** There is an optimal capital structure where firm value is maximised.
- **Modigliani–Miller (M–M) theorem:** In perfect markets, capital structure is irrelevant; with taxes, debt provides a tax shield.



Fill in the blank: According to the Modigliani–Miller theorem, capital structure is irrelevant in _____ markets.

5.2.3 Factors influencing capital structure decisions

Capital structure decisions depend on several determinants:

- **Cost of capital:** Firms aim to minimise overall cost of financing.
- **Risk:** Higher debt increases financial risk.
- **Control:** Issuing equity may dilute ownership; debt preserves control.
- **Flexibility:** Firms prefer structures that allow adjustment to changing conditions.
- **Industry norms:** Different industries have typical debt–equity patterns.

Fill in the blank: Issuing equity may dilute ownership, while debt helps preserve _____.

Pilot questions 5.2

1. Capital structure refers to the mix of: a. Debt and equity b. Assets and liabilities c. Profits and losses d. Cash and reserves
2. The Net Income approach suggests that increasing debt: a. Reduces cost of capital and increases firm value b. Increases cost of capital c. Has no effect on firm value d. Dilutes ownership
3. The Net Operating Income approach argues that firm value depends on: a. Operating income, not capital structure b. Debt levels only c. Equity levels only d. Market risk
4. The Traditional theory suggests there is: a. An optimal capital structure that maximises firm value b. No relationship between capital structure and value c. A fixed debt ratio for all firms d. Unlimited benefit from debt
5. Issuing equity may dilute ownership, while debt helps preserve: a. Control b. Risk c. Flexibility d. Industry norms

5.3 Capital Structure in Practice

5.3.1 Optimal capital structure and trade-off between debt and equity

In practice, firms aim for an **optimal capital structure**—the mix of debt and equity that minimises the overall cost of capital and maximises firm value.

- **Debt advantages:** Tax shield on interest, lower cost compared to equity.
- **Debt disadvantages:** Increased financial risk, potential for bankruptcy.
- **Equity advantages:** No repayment obligation, strengthens financial flexibility.
- **Equity disadvantages:** Higher cost, dilution of ownership. The trade-off involves balancing the benefits of debt (tax savings) against the risks of financial distress.



Fill in the blank: The optimal capital structure minimises the overall _____ of capital and maximises firm value.

5.3.2 Leverage and its impact on earnings per share (EPS)

Leverage refers to the use of debt financing. It magnifies both gains and losses:

- **Positive leverage:** When return on investment exceeds cost of debt, EPS increases.
- **Negative leverage:** When return on investment is less than cost of debt, EPS decreases. Leverage therefore affects shareholder returns and risk exposure.

Fill in the blank: Positive leverage occurs when return on investment is greater than the cost of _____.

5.3.3 Capital structure policies in different industries

Capital structures vary across industries due to differences in risk, asset structure, and cash flow stability:

- **Manufacturing firms:** Often use higher debt due to tangible assets that can serve as collateral.
- **Technology firms:** Prefer equity financing due to high risk and intangible assets.
- **Utilities:** Typically have stable cash flows, allowing higher debt ratios.

Fill in the blank: Technology firms often prefer _____ financing due to high risk and intangible assets.

Pilot questions 5.3

1. The optimal capital structure minimises the overall: a. Cost of capital b. Debt ratio c. Equity dilution d. Tax shield
2. Positive leverage occurs when ROI is greater than: a. Cost of debt b. Cost of equity c. Market risk d. Liquidity reserves
3. Negative leverage occurs when ROI is: a. Less than cost of debt b. Greater than cost of debt c. Equal to cost of equity d. Higher than market return
4. Manufacturing firms often use higher debt because they have: a. Tangible assets for collateral b. Intangible assets only c. No cash flows d. High risk profiles
5. Technology firms often prefer: a. Equity financing b. Debt financing c. Government grants d. No financing at all

5.4 Banking Systems and Financial Intermediation

5.4.1 Role of banking systems in financial management



Banking systems act as **financial intermediaries**, connecting savers and borrowers. They mobilise deposits, provide loans, facilitate payments, and support economic growth. Banks also play a stabilising role by ensuring liquidity and managing risks in the financial system.

Fill in the blank: Banking systems act as _____, connecting savers and borrowers.

5.4.2 Types of banking systems

- **Commercial banks:** Accept deposits, provide loans, and offer payment services.
- **Investment banks:** Specialise in raising capital, underwriting securities, and advising on mergers and acquisitions.
- **Central banks:** Regulate monetary policy, issue currency, and oversee financial stability.

Fill in the blank: Central banks regulate _____ policy and oversee financial stability.

5.4.3 Functions of banks: deposit mobilisation, lending, payments, and risk management

Banks perform several critical functions:

- **Deposit mobilisation:** Collect savings from individuals and institutions.
- **Lending:** Provide credit to businesses and households.
- **Payments:** Facilitate transactions through cheques, transfers, and digital platforms.
- **Risk management:** Assess creditworthiness, diversify portfolios, and maintain reserves.

Fill in the blank: Banks facilitate transactions through cheques, transfers, and _____ platforms.

Pilot questions 5.4

1. Banking systems act as: a. Financial intermediaries b. Regulators only c. Borrowers only d. Tax collectors
2. Central banks regulate: a. Monetary policy b. Taxation c. Company law d. Shareholder meetings
3. Commercial banks primarily provide: a. Deposits, loans, and payment services b. Capital raising and underwriting c. Currency issuance d. Tax collection
4. Investment banks specialise in: a. Raising capital and advising on M&A b. Issuing currency c. Collecting deposits d. Regulating monetary policy
5. Banks facilitate transactions through cheques, transfers, and: a. Digital platforms b. Tax offices c. Shareholder meetings d. Government grants

5.5 Regulation and Risk Management in Banking

5.5.1 Banking regulations and prudential norms

Banking regulations are designed to ensure the stability and integrity of the financial system.



- **Objectives:** Protect depositors, maintain public confidence, and prevent systemic crises.
- **Prudential norms:** Rules on minimum capital requirements, asset classification, provisioning, and exposure limits.
- **Supervision:** Regulatory authorities monitor compliance and enforce corrective measures.

Fill in the blank: Banking regulations aim to protect _____ and maintain public confidence in the financial system.

5.5.2 Basel Accords and capital adequacy requirements

The **Basel Accords** are international regulatory frameworks developed by the Basel Committee on Banking Supervision.

- **Basel I:** Introduced capital adequacy standards based on risk-weighted assets.
- **Basel II:** Expanded to include operational risk and improved risk sensitivity.
- **Basel III:** Strengthened capital requirements, introduced liquidity standards, and leverage ratios.
- **Capital adequacy ratio (CAR):** Ensures banks hold sufficient capital to absorb losses.

Fill in the blank: Basel III introduced liquidity standards and _____ ratios to strengthen banking resilience.

5.5.3 Risk management practices in banks

Banks adopt various practices to manage risks effectively:

- **Credit appraisal:** Assessing borrower creditworthiness before lending.
- **Stress testing:** Simulating adverse scenarios to evaluate resilience.
- **Liquidity management:** Ensuring adequate liquid assets to meet obligations.
- **Diversification:** Spreading exposures across sectors and borrowers.

Fill in the blank: Stress testing involves simulating adverse _____ to evaluate a bank's resilience.

Pilot questions 5.5

1. Banking regulations aim to protect: a. Depositors b. Shareholders only c. Regulators d. Competitors
2. Prudential norms include rules on: a. Capital adequacy and asset classification b. Marketing strategies c. Employee training d. Tax collection
3. Basel III introduced liquidity standards and: a. Leverage ratios b. Tax incentives c. Marketing rules d. Customer service guidelines



4. Stress testing involves simulating adverse: a. Scenarios b. Profits c. Customer demands d. Marketing campaigns
5. Liquidity management ensures banks have adequate: a. Liquid assets to meet obligations b. Marketing budgets c. Tax reserves d. Shareholder dividends

Series Summary

This Series examined the interplay between financial risk, capital structure, and banking systems in financial management. We began by defining financial risk and exploring its types—market, credit, liquidity, and operational—along with methods of measurement and management. Next, we studied capital structure theories (Net Income, Net Operating Income, Traditional, Modigliani–Miller) and determinants such as cost of capital, risk, control, and flexibility. We then analysed capital structure in practice, focusing on optimal debt–equity mix, leverage effects on earnings per share, and industry-specific policies. Following this, we explored banking systems as financial intermediaries, distinguishing between commercial, investment, and central banks, and their functions in deposit mobilisation, lending, payments, and risk management. Finally, we reviewed regulation and risk management in banking, including prudential norms, Basel Accords, and practices such as credit appraisal, stress testing, and liquidity management.

By completing this Series, you should now be able to explain financial risk and its management, analyse capital structure theories and practices, describe the role of banking systems, and evaluate regulatory frameworks and risk management strategies in banking.

Series Glossary

- **Basel Accords:** International regulatory frameworks for banking capital adequacy and risk management.
- **Capital adequacy ratio (CAR):** Measure ensuring banks hold sufficient capital to absorb losses.
- **Capital structure:** Mix of debt and equity used to finance a company.
- **Commercial banks:** Institutions that accept deposits, provide loans, and facilitate payments.
- **Credit risk:** Risk of borrower default on obligations.
- **Credit appraisal:** Process of assessing borrower creditworthiness before lending.
- **Debt financing:** Raising funds through borrowing, typically with interest obligations.
- **Diversification:** Risk management strategy of spreading exposures across sectors or borrowers.
- **Equity financing:** Raising funds by issuing shares, diluting ownership but avoiding repayment obligations.



- **Financial risk:** Possibility of losses due to uncertainty in financial performance.
- **Leverage:** Use of debt financing to magnify returns (positive or negative).
- **Liquidity management:** Ensuring adequate liquid assets to meet obligations.
- **Liquidity risk:** Inability to meet short-term obligations due to insufficient cash.
- **Modigliani–Miller theorem:** Theory stating capital structure is irrelevant in perfect markets.
- **Monetary policy:** Regulation of money supply and interest rates by central banks.
- **Net Income approach:** Theory suggesting more debt reduces cost of capital and increases firm value.
- **Net Operating Income approach:** Theory arguing capital structure is irrelevant; firm value depends on operating income.
- **Operational risk:** Losses due to failures in processes, systems, or human error.
- **Optimal capital structure:** Debt–equity mix that minimises cost of capital and maximises firm value.
- **Prudential norms:** Regulatory rules on capital adequacy, asset classification, and provisioning.
- **Stress testing:** Simulating adverse scenarios to evaluate resilience of banks.
- **Synergy:** Combined benefits from mergers or acquisitions exceeding individual firm performance.
- **Traditional theory:** Suggests an optimal capital structure exists where firm value is maximised.

Concept Check Questions

Objective questions

1. Financial risk refers to the possibility of experiencing: a. Losses due to uncertainty b. Guaranteed profits c. Stable returns d. Tax savings (Linked to SLO 5.1)
2. According to the Net Income approach, increasing debt: a. Reduces cost of capital and increases firm value b. Increases cost of capital c. Has no effect on firm value d. Dilutes ownership (Linked to SLO 5.2)
3. Positive leverage occurs when: a. $ROI > \text{Cost of debt}$ b. $ROI < \text{Cost of debt}$ c. $ROI = \text{Cost of equity}$ d. $ROI < \text{Market return}$ (Linked to SLO 5.3)
4. Central banks regulate: a. Monetary policy and financial stability b. Taxation and fiscal policy c. Company law d. Shareholder meetings (Linked to SLO 5.4)



5. Basel III introduced liquidity standards and: a. Leverage ratios b. Tax incentives c. Marketing rules d. Customer service guidelines (Linked to SLO 5.5)

Short-answer questions

6. Define financial risk in one sentence. (Linked to SLO 5.1)
7. Identify two theories of capital structure. (Linked to SLO 5.2)
8. Explain the difference between positive and negative leverage. (Linked to SLO 5.3)
9. State one function of commercial banks and one function of investment banks. (Linked to SLO 5.4)
10. What is stress testing in banking risk management? (Linked to SLO 5.5)

Long-answer questions

11. Discuss the types of financial risk (market, credit, liquidity, operational) and methods of managing them. (Linked to SLO 5.1)
12. Evaluate the implications of Basel Accords on banking regulation and risk management practices. (Linked to SLO 5.5)

Answers to Concept Check Questions [Series 5]

Objective questions

1. a
2. a
3. a
4. a
5. a

Short-answer questions

6. Financial risk is the possibility of losses due to uncertainty in financial performance.
7. Net Income approach and Modigliani–Miller theorem (other valid answers: Net Operating Income, Traditional theory).
8. Positive leverage occurs when $ROI > \text{cost of debt}$, increasing EPS; negative leverage occurs when $ROI < \text{cost of debt}$, reducing EPS.
9. Commercial banks → accept deposits and provide loans; Investment banks → raise capital and advise on mergers/acquisitions.
10. Stress testing is simulating adverse scenarios to evaluate a bank's resilience.



Long-answer questions

11. **Basic response:** Market risk arises from price changes, credit risk from borrower defaults, liquidity risk from inability to meet obligations, and operational risk from process failures. Management methods include diversification, hedging, maintaining reserves, and strong controls. **Value-added response:** Outstanding learners may add measurement tools like Value at Risk (VaR), credit scoring, liquidity ratios, and stress testing, linking them to practical applications.

12. **Basic response:** Basel Accords set international standards for capital adequacy and risk management. Basel I introduced risk-weighted capital requirements, Basel II added operational risk, and Basel III strengthened capital, liquidity, and leverage standards. **Value-added response:** Outstanding learners may add that Basel frameworks enhance global banking stability, reduce systemic risk, and encourage better risk management practices, though implementation challenges vary across countries.

Answers to Pilot Questions [Series 5]

Part 5.1

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Part 5.2

1. a
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Part 5.3

1. a
2. a
3. a
4. a



5. a

Part 5.4

1. a

2. a

3. a

4. a

5. a

Part 5.5

1. a

2. a

3. a

4. a

5. a

