



EDO UNIVERSITY, IYAMHO
EDO STATE, NIGERIA



DEPARTMENT OF ACCOUNTING AND ECONOMICS
FACULTY OF ARTS, MANAGEMENT AND SOCIAL SCIENCES

15/01/2018

ACC 312
CORPORATE FINANCIAL
UNIT: 3

COURSE WARE

- (1) Meaning, scope, objective and concept of corporate finance (risk and return): week 1-2
- (2) Types of investment and valuation methods: risk and return, discounted cash flow: week 3-4
- (3) Dividend policy decision and dividend growth model : week 5
- (4) Financial derivatives market and money market: week 6
- (5) Efficient Market Hypothesis: week 7
- (6) Working Capital Management (Cash, inventory, receivables): week 8
- (7) Capital budgeting and capital structure: week 9
- (8) Mergers and acquisition: week 10-11
- (9) Impact of information and communication technology on financial management practice: week 12.

COURSE LECTURERS

- (1) Dr Dabor, A. O.
- (2) Mr Iyoha, A. I.

ASSESSMENT

- *Continuous assessment shall be 30% of final grade which comprised of Mid semester test, Class work, Home work etc*
- *Examinations:
-Final, comprehensive (according to University schedule): 70% of final grade*

ACADEMIC ETHICS

- *All class and home work must be done independently, unless explicitly stated otherwise.*
- *You may discuss general approaches to problems, but must write up the solution yourself and independently of any other person.*

- *No late home work is accepted:*
 - Turn in what you have at the time it's due*
 - All home works are due at the start of class*
 - If you will be away, turn in the homework early*
- *All students should be seated in class ten (10) minutes before the commencement of the class*

RECOMMENDED TEXT BOOKS

- (1) Financial Management by I.M Pandey
- (2) Corporate finance by Isenmila, P.A., Eragbhe, E., & Ogiedu, K.O.

MODULE ONE.

MEANING, SCOPE, OBJECTIVES AND CONCEPT OF CORPORATE FINANCE

The intending learning objectives for this study are to:

- (1) understand the concept of finance;
- (2) understand the concept of corporate finance;
- (3) understand the concept of financial management;
- (4) examine the functions of financial manager; and
- (5) understand the goal of financial management.

INTRODUCTION

The economic activities from industrial revolution in the beginning of the 20th century saw the emergence of finance as a separate field of study. It was initially a branch of economics until early 20th century, however it draws heavily on economics for its theoretical concepts. The subject of finance, by 1930s revolved around topics like liquidity, preservation of capital, corporate restructuring, and bankruptcy and liquidation process. In the 1950s, the concept had become more analytical and had advanced into areas such as decision process of allocation financial capital (money) for the acquisitions of noncurrent assets such as plant, machinery and equipment. Other analytical areas that were covered included decision making process such as cash and inventory management, capital structure theory and dividend policy. Giving the emergence of finance traceable to the industrial revolution of the 20th century, it will not be out of place to opine that finance cut across other activities such as production, marketing etc which are part of the major activities of a business firm.

CONCEPT OF FINANCE

Several definition have been given: It is the science of generating and expending the public expenditure; it is the commercial activity of providing funds and capital; it is the science

management; the branch of economics that studies the management of other assets; it is the management of money and credit, banking and investments. From the foregoing definitions, it means the concept deals with the provision of funds and capital to an organization in an economic manner and the management of such funds. The concept of time, money and risk are inevitable areas in the practice of finance. By classification, the concept of finance falls under two broad areas: **public finance; and private finance.**

The public finance deals with the allocation of the resources of government or public enterprises. It is closely connected to issues of income distribution and social equity. It is that branch of economics which identifies and appraises the means and effects of the policies of government. On the other hand, private finance deals with finance in the non-public sector (individual and corporate level). However, the aspect of corporate private finance is the interest of this course, the commercial activity of providing funds and capital for corporate entity. This c=takes us to the next concept, corporate finance

CONCEPT OF CORPORATE FINANCE

This concept involves business activity concerned with the acquisition and conservation of capital funds in meeting financial needs and overall activities of business enterprises. It tries to maximize the goals of a business organization by estimating future assets requirements and then allocating funds to the various needs according to the funds available and in an efficient manner. It deals with monetary provisioning and management at the commercial level rather than the individual or government level. Other definitions are: It deals with the promotion, organization, capitalization, financing, investing and financial administration of the corporation from the company's point of view; it is also the acquisition and allocation of a company's funds or resource with the goal of minimizing shareholders wealth. It should be noted that corporate finance utilizes tools from

almost all areas of finance and some of the tools designed for companies (corporation) have broad application to other organizations other than companies, such as partnership, sole proprietorship, governments, personal wealth management etc. Corporate finance developed into a discipline of its own because it deals with quantities of money much greater than individuals. From the foregoing, the act of managing finance at corporate level is a means to an end, and not an end in itself. The corporate entity should be able to plan, control and utilized these resources in order to maximized shareholders wealth, this is the domain of financial management.

CONCEPT OF FINANCIAL MANAGEMENT

According to Arowoshegbe (2009), financial management is the efficient allocation of resources effectively with a view of maximizing the company level of profitability. Technically, it is the maximization of shareholders wealth arising from investment. It is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. It is the skillful planning, controlling and execution of firms' financial resources with a view to improving shareholders. Financial management is considered a vital and integral part of overall management system, it is the wise use of fund and the central process involved is a rational matching of advantages of potential uses against the cost of alternative potential sources so as to achieve the broad financial goals which an enterprise sets for itself. An individual who is saddled with the responsibility of skillfully planning, controlling and executing the financial resources is called a **financial managers**. He is a person who is responsible, in a significant way, to carry out the finance functions. In a modern enterprise, the financial manager occupies a key position. The finance manager in the modern enterprises is mainly involved in the managerial finance functions; executives at lower levels carry out the routine finance functions. Financial managers' involvement in the routine functions is confined to setting up of rules of procedures, selecting forms to be used,

establishing standards for the employment of competent personnel and to check up the performance to see that the rules are observed and that the forms are properly used.

FUNCTIONS OF FINANCIAL MANAGERS

There are two broad approaches to financial managers' role in a financial management system:

- (a) Traditional approach; and
- (b) Modern approach

The traditional approach entails:

- (1) The sourcing of funds from financial institutions;
- (2) The use of financial instruments like shares, bonds, debentures, options
- (3) The relationship between a corporation and its sources of funds from legal and accounting perspectives.

The above approach suffer the following inherent defects:

- (1) The approach places little emphasis on the allocation of funds, which is the very essence of the sourcing of funds;
- (2) It adopts the outsider looking-in-approach. In other words, the traditional approach sees financial management only from the perspective of the outsiders (i.e. fund providers);
- (3) It ignores routine financial management problems facing the organization;
- (4) The traditional approach concentrated on corporate bodies and completely ignored non-corporate entities;
- (5) The time value of money is not considered in the traditional approach.

The modern approach has remedied some of the limitations of the traditional approach. According to the modern approach, the term financial management provided a conceptual and analytical

framework for financial decision making. In other words, the finance function covers both the acquisition and their allocation. The modern approach views financial management as an integral part of overall management. From the modern perspective, financial management involves the process of taking four broad decisions:

- (1) Financing decision;
- (2) Investment decision;
- (3) Liquidity decisions; and
- (4) Dividend decision.

Financial managers perform finance functions simultaneously and continuously in the normal course of the business. They do not necessarily occur in a sequence.

INVESTMENT DECISION

Investment decision, also called capital budgeting involves the decision of allocation of capital or commitment of funds too long-term assets that would yield benefits in the future. Two important aspects of the investment decision are: (a) the evaluation of the prospective profitability of new investments; and (b) the measurement of a cut-off rate against that the prospective return of new investments could be compared. Future benefits of investments are difficult to measure and cannot be predicted with certainty. Because of the uncertain future, investment decisions involve risk. Investment proposals should, therefore, be evaluated in terms of both expected return and risk. Besides the decision to commit funds in new investment proposals, capital budgeting also involves decision of recommitting funds when an asset becomes less productive or no-profitable. There is a broad agreement that the correct cut-off rate is the required rate of return or the opportunity cost of capital. However, there are problems in computing the opportunity cost of capital in practice from the available data and information. A decision maker should be aware of these problems.

FINANCING DECISION

This is the second important decision of financial managers. He must decide when, where and how to acquire funds to meet the firm's investment needs. The central issue before him is to determine the proportion of equity and debt. The mix of debt and equity is known as the firm's capital structure. The financial managers must strive to obtain the best financing mix or the optimum capital structure for his or her firm. The firm's capital structure is considered to be optimum when the market value of shares is maximized. The use of debt affects the return and risk of shareholders, it may increase the return on equity funds but it always increase risk. A proper balance will have to be struck between return and risk. When the shareholders return is maximized with minimum risk, the market value per share will be maximized and the firm's capital structure would be considered optimum. Once the financial manager is able to determine the best combination of debt and equity, he or she must raise the appropriate amount through the best available sources.

DIVIDEND DECISION

Dividend decision is the third major financial decisions. The financial manager must decide whether the firm should distribute all profits or retain them, or distribute a portion and retain the balance. Like the debt policy, the dividend policy should be determined in terms of its impact on the shareholders' value. The optimum dividend policy is one that maximizes the market value of the firm's shares. Thus, if shareholders are not indifferent to the firm's dividend policy, the financial manager must determine the optimum dividend-payout ratio. The payout ratio is equal to the percentage of dividends to earnings available to shareholders. The financial manager should also consider the questions of dividend stability, bonus shares and cash dividends in practice. Most profitable companies pay cash dividends regularly. Periodically, additional shares, called bonus

shares (or stock dividend) are also issued to the existing shareholders in addition to the cash dividend.

LIQUIDITY DECISION

The finance manager should ensure that current assets management is effective. Investment in current assets affects the firm's profitability, liquidity and risk. A trade-off exist between liquidity and profitability. The term liquidity means a firm's ability to meet its current obligation as they fall due while profitability entails returns from investment made. The trade-off between these two concepts is that, a financial manager that pursue high investment policy, this can constrain liquidity position, although having in mind to generate profit, however retainment of current asset enhances liquidity position, however, constrain ability to make profit. It is the duty of the financial manager to strike a healthy financial policy, not compromising the current capital management and the profit drive of the corporate entity.

Apart from the above, other responsibilities of financial managers are:

- (1) Development of financial strategy;
- (2) Determination of financial policies;
- (3) Determination of short and long term planning;
- (4) Authorization of recurrent and capital expenditure as approved by the directors;
- (5) Treasury management;
- (6) Control of working capital;
- (7) Cash forecasting i.e. management of cash or cash budget;
- (8) Investment of surplus funds;
- (9) Establishment of credit policy; and
- (10) Raising of long and short term finance.

GOAL OF FINANCIAL MANAGEMENT

The end result of financial management is shareholders wealth maximization (SWM). SWM means maximizing the net present value of a course of action to shareholders. NPV or wealth of a course of action is the difference between the present value of its benefit and the present value of its cost. A financial action that has a positive NPV creates wealth for shareholders and, therefore desirable. A financial action resulting in negative NPV should be rejected since it would destroy shareholders' wealth. Thus, the broad goal of the firm can be seen if it is said that the firm should attempt to maximize the wealth of the firm's shareholders through the achievement of the highest possible value for the firm. This implies that the firm will seek the best possible outcome from a given set of circumstances. However, the best possible outcome contains an evaluation of the company's attitude to risk in making business and financial decisions. There are three variables that directly affect shareholders wealth:

- (1) The magnitude of the cash flow;
- (2) The timing of such cash flow; and
- (3) The risk associated with them.

An indicator that is usually acceptable as a surrogate indicator of shareholders wealth is the firm's share price. This makes shareholders' wealth maximization a complex task, since the firm cannot directly control its stock price. The only thing the finance manager can do in this case is to act in a way consistent with the desire of the shareholder. Shareholders' wealth maximization is justifiable on the following grounds:

- (1) The shareholders are the legal owners of the company. Therefore, their economic welfare should take precedence ultimately above other stakeholders;

- (2) As residual investors, any excess returns belong to them. The firm should rationally seek to maximize the excess return; and
- (3) Wealth maximization is all embracing, it encompasses other objectives including maximization of profits, sales revenue, maximize target market share.

ASSIGNMENT

Three most important activities of a business firm are: production; marketing; and finance. Discuss each of these concepts and their interrelationship in realizing a firm economic objective.

ASSIGNMENT

The concept of finance, corporate finance and financial management are similar but not the same. In details, discuss the interrelationship among these concept.

ASSIGNMENT

The goal of financial management goes beyond, profit maximization to shareholders wealth maximization. Discuss, with reference to the schematic diagram of financial management overview above.

MODULE TWO

TYPES OF INVESTMENT AND VALUATION METHODS

The intending learning objectives are to:

- (1) Understand the traditional method of valuing investment
 - (a) Payback period
 - (b) Accounting Rate of Return
- (2) Understand the modern method of valuing investment:
 - (a) Net present value
 - (b) Internal Rate of Return

INTRODUCTION

The aim of financial management is the maximization of shareholders wealth (SWM). In doing this, the financial manager must ensure that its decisions yield a positive net present value of its course of action. One of such areas in its decisions making is in investment choices. There are of two kinds: short and long term, however this study is concerned with the latter. The latter being long term in nature is termed capital investment, investment that spans over a year.

It is therefore imperative for the financial managers to critically examine capital investment at its disposal before committing financial resources to them. Some of the factors that the financial manager should give due consideration to when making decisions in this regard are:

- (1) Availability of investment capital and its alternative uses;
- (2) The huge expenditure cash outlay;
- (3) The gestation period between initial expenditure and returns; and
- (4) The expectation of higher returns because of the above factors

In making its decision, he must be able to evaluate each of the capital investment choice, this can be done with capital budgeting techniques. These techniques are classified into two:

- (a) The non-discounted cash flow method often referred to as the traditional method; and
- (b) The discounted cash flow method often refer to as the modern techniques

Examples of capital budgeting technique in the former classification are:

- (1) Payback period (PBP)
- (2) Accounting Rate of Return (ARR)

Examples of capital budgeting technique in the latter classification are:

- (1) Net present value (NPV)
- (2) Internal Rate of Return (IRR).

TRADITIONAL METHOD

PAY BACK PERIOD (PBP)

This technique measures projects on the basis of the period over which the investment pays back itself or the period of recovery of the initial investment. The period the investment pays back itself is often expressed in number of years and the shorter the number years, the more viable the project.

MERITS

- (1) It is simple to calculate and understand
- (2) Of all the methods of capital budgeting, it least exposes the firms to problems of uncertainty, since it focuses on shortness of project to pay back the initial outlay
- (3) It is a fast screening techniques, especially for the firms that have liquidity problems.

DEMERITS

- (1) It doesn't incorporate time value of money.
- (2) It ignores cash flows after the payback periods
- (3) It does not take into account the risks associated with ach projects and the attitude of the company to risk.

ILLUSTRATION 1

ANICIN Limited is into manufacturing, having a project which involves an immediate cash outlay of #100,000. The company estimates that the net cash inflows from the project will be as follow is:

Year	Cash flows (#)
1	10,000
2	20,000
3	110,000
4	40,000

Required:

Calculate the PBP for the above projects

Solution

ANICIN LIMITED

Year	cash flows	cumulative cash flows
0	(100,000)	(100,000)
1	10,000	(90,000)
2	20,000	(70,000)
3	110,000	40,000

$PBP = 2 \text{ years} + \frac{70,000}{110,000} \times 12/1$

2 years+8months

2 years, 8 months

The decision is rule is to:

- (1) Accept all projects whose PBP are shorter than the company's predetermined minimum acceptable PBP
- (2) If mutually exclusive projects are involved, whereby only one of the projects can be undertaken and others rejected, the rule is to accept the project with the shortest PBP

ASSIGNMENT 5

ANICIN Limited is contemplating investing between two investments: A & B. Both investment have same initial outlay of #200,000, however differing estimated cash inflows giving below:

Year	Cash flows (#)	
	A	B
1	20,000	18,000
2	34,000	42,000
3	195,000	210,000
4	71,000	84,000

Required:

Using the PBP, which of the investment should be taken.

ASSIGNMENT 6

ANICIN is contemplating making investment in a project. However, the benchmark set the financial manager upon which the investment should pay itself is 3 years. The initial outlay of the project is #420,000. The estimated net cash inflows are:

Year	Cash flows (#)
1	56,000
2	81,000
3	210,000
4	49,000
5	92,000

REQUIRED

Using the PBP, should the financial managers embark on this investment.

ACCOUNTING RATE OF RETURN

This concept is all about the measure of an investment return in relation to capital invested or assets employed, hence often called return on investment (ROI) or capital employed (ROCE).

Mathematically, it is given as:

Average annual accounting profit after depreciation, but before tax/initial investment * 100

Or

Average annual accounting profit after depreciation, but before tax/average initial investment * 100

MERITS

- (1) It is easy to calculate
- (2) Unlike the PBP, it makes use of all the profits for the project's life

- (3) For divisionalized companies, managers would find the techniques easier to understand because it is similar to their normal annual performance evaluation techniques.

DEMERITS

- (1) It does not recognize the time value of money
- (2) It is an average concept and as such will hide the sizes and timing of individual cash flows
- (3) It is based on accounting profits which may differ as a result of differences in accounting methods and does not necessarily represent relevant cash flows
- (4) It does not take into consideration the risk associated with each project as well as the attitude of the management of the company to risk
- (5) There is no unique definition of ARR. For instance, average profits may be profits after depreciation, interest and before tax or profit after depreciation, interest and tax, Initial investment could be initial investment plus scrap value or just initial investment.

ILLUSTRATION 2

ANICIN Limited recently convinced his friends and relations to grant him a loan of #200,000, which he intends to invest in a farming project. He estimates that the project will yield the following returns annually for the next five years:

Year	#
1	60,000
2	60,000
3	80,000
4	60,000
5	40,000

There was no scrap value at the end of the fifth year and the company desires to evaluate the project on the basis of accounting rate of return.

REQUIRED:

Provide the accounting rate of return of this project on two assumptions: ARR with initial investment and ARR with average investment.

Using average profit/ initial investment *100

Average profit = #60,000

Therefore= $60,000/200,000*100= 30\%$

Using average profit/average investment *100

Average investment = #100,000

Therefore= $60,000/100,000*100=60\%$

The decision rule:

- (1) The rule is to invest in all projects whose accounting rate of return are higher than the company's predetermined minimum acceptable ARR
- (2) Where mutually exclusive projects are concerned, the rule is to accept the project with the highest ARR.

ASSIGNMENT 7

ANICIN Limited is contemplating investing between two investments: A & B. Both investment have same initial outlay of #200,000, however differing estimated cash inflows giving below:

Year	Cash flows (#)	
	A	B
1	20,000	18,000
2	34,000	42,000
3	195,000	210,000
4	71,000	84,000

Required:

Using the ARR, which of the investment should be taken.

ASSIGNMENT 8

ANICIN is contemplating making investment in a project. However, the benchmark set by the financial manager is that the investment should generate a minimum return of 35%. The initial outlay of the project is #420,000. The estimated net cash inflows are:

Year	Cash flows (#)
1	56,000
2	81,000
3	210,000
4	49,000
5	92,000

REQUIRED

Using the ARR, should the financial managers embark on this investment.

DISCOUNTED PAY BACK PERIOD

This method of capital budgeting technique is similar to the normal PBP except that the cash flows are discounted to their present value at a given or appropriate cost of capital. Thus, it considers the time value concept unlike the normal PBP. The present value of the future stream of earnings are computed using the discount factor:

ASSIGNMENT 9

The facts are the same in illustration 1 except that you are expected to evaluate the project using DPBP, if the cost of capital is 10% p.a.

ASSIGNMENT 10

The facts are the same in assignment 5 except that you are required to evaluate the project using DPBP, if the cost of capital is 5%.

MEDERN METHOD

NET PRESENT VALUE

The net present value (NPV) technique of investment appraisal is the summation of all the discounted cash flows (DCF) associated with a project that is, the difference between the PV of cash outlay or outflow and the positive PV of the cash inflows.

Note that the present value of the future stream of earnings is computed multiplying the discount factor by the future stream of earnings. The discount factor is giving as $1/(1+r)^n$

The decision rule is to

- (1) Accept all projects that produces positive NPV
- (2) If mutually exclusive projects are involved, the rule is to accept the project that produces the highest positive NPV.

MERITS

- (1) The time value of money is recognized
- (2) It measures the absolute terms, the increase in the wealth of the shareholders
- (3) It is additive, in that decisions can be reached on a combination of projects, through the addition of their respective NPVs
- (4) Unlike the PBP, it measures projects by the utilization of all cash flows of the projects
- (5) It is more preferable to IRR in decision under capital rationing, that is, shortage of investments funds

DEMERITS

- (1) It is more difficult to calculate that PBP and ARR
- (2) It relies heavily on the correct estimation of the cost of capital, that is, where errors occur in the cost of capital used for discounting the decision , using NPV would be misleading
- (3) Unlike the IRR, non-accounting managers may not be conversant with the decision rule 2of NPV, especially in large decentralized organizations
- (4) Like all the other methods, it does not take risk into accounts
- (5) It ignores inflation.

ILLUSTRATION 3

The facts are the same in illustration 2 except that you are required to calculate the NPV using 10% cost of capital

ASSIGNMENT 11

The facts are the same in assignment 6 except that you are required to make a choice from both projects assuming both have same cost of capital to be 5%.

INTERNAL RATE OF RETURN

This technique produces a cost of capital or return that will produce an NPV of zero if applied to a project. It is a break-even point cost of capital. It is also the cost of capital or discount rate that will equate the cash inflows of a project with the cash outflows of that project. In order to generate the cost of capital that will produce exactly zero NPV, the following procedures may be followed:

- (1) Generate two (2) opposite values of NPV (+ and – values) using two different discount rates earlier calculated
- (2) Interpolate between the two discount rates generated in (1) above in order to estimate the cost of capital that will produce an NPV of zero. The assumption here is that there is a linear relationship between the cost of capital and the NPV. Moreover, it is implied that the higher the cost of capital, the lower the NPV and vice-versa
- (3) The interpolation formulae can be defined as:
$$IRR = R1 + \frac{NPV1}{NPV1 + NPV2} * (R2 - R1)$$

MERITS

- (1) It recognizes the time value of money
- (2) It is more attractive to divisional managers in large organizations since they are used to the return approach in evaluation
- (3) It provides a margin of safety in the calculation of a company's cost of capital

DEMERITS

- (1) It is difficult to calculate that other previous methods
- (2) Where the cash flows of a project are unconventional in which case, cash inflows occur in between cash outflows and vice-versa, the IRR technique will produce more than one IRR for a project. It can lead to a situation of sub-optimal decision.
- (3) Where mutually exclusive projects are being considered, the IRR may produce a decision that will conflict with the NPV decision in that IRR being a rate of return does not recognize the size or scale of project.

ASSIGNMENT 11

- (1) Compare and contrast both NPV and IRR.

ASSIGNMENT 12

The cost of a project is #200,000 with the following projected cash inflow:

- Year 1: 60,000
- 2: 60,000
- 3: 80,000
- 4: 60,000
- 5: 50,000

Giving cost of capital to be 10%, calculate the project using IRR.

