

INTRODUCTION

The course **ACC 405: Corporate Finance** is a semester course of three credit units. It is available to all students of Bachelor of Science (BSc) in Accounting of the School of Management Sciences.

The course consists of 4 modules and 20 units among which are: Overview of Corporate Finance, Understanding Financial Statement, Investment and Financing Decisions, Dividend Decision, Corporate Strategy and Firm Value. The idea is to enable students apply complex theory to real firms, to help them understand that any decision that involves the use of money is a corporate financial decision.

The course guide tells you what the course ACC 405 is all about, the materials you will be using and how to make use of the materials to ensure adequate success. Other information that is contained in the course includes how to make use of your time and information on tutor-marked assignments and questions.

WHAT YOU WILL LEARN IN THIS COURSE

In this course you will learn about the decisions made by firms which have financial implications. It consists of 4 modules and 20 units and discusses in detail corporate financial analysis. The tools and techniques that are used on a day to day basis. How these tools and techniques are fitted together and the common principles that apply across all of them.

COURSE AIMS

In today's business environment where there is a corporate financial aspect to almost every action taken by a firm, students of Bachelor of Science degree in Accounting are meant to be well-grounded in Corporate Finance so that they will be able to cope with technicalities of investment, financing and dividend decisions.

Therefore, aim of this course is geared towards acquainting you with the policies and procedures as well as problems encountered in the course of acquisition and utilisation of funds in corporate organisations.

COURSE OBJECTIVES

To achieve the aim stated above, it is therefore expected that at the end of this course, you should be able to:

- explain the nature and concept of corporate finance
- define financial market and the corporation
- identify the problems of corporations and how to control them

- analyse financial statement and financial ratios
- discuss financial planning and control
- explain working capital management
- describe how capital structure decision can be made
- explain cost of capital and risk associated with cost of capital
- mention different types of securities
- discuss mergers and acquisitions.

WORKING THROUGH THIS COURSE

To complete this course, you are expected to read thoroughly the various study units and text books recommended. In this course, each unit consists of exercises to test your understanding from time to time. At the end of the course is a final examination.

Below, you will find a list of the component of the course, what you have to do and how you should allocate time to each unit in order to complete the course on time.

COURSE MATERIALS

Major components of the course are:

1. Course Guide
2. Study Units
3. Textbooks and References
4. Tutor- Marked Assignments

STUDY UNITS

The course has a total of 20 units in 4 modules. You are required to study each carefully before proceeding to the next.

Module 1 Overview of Corporate Finance

- | | |
|--------|---|
| Unit 1 | Introduction to Corporate Finance |
| Unit 2 | Objective Function in Corporate Finance |
| Unit 3 | Forms of Business |
| Unit 4 | Agency Problems and Control of Corporations |
| Unit 5 | Financial Market and the Corporation |

Module 2 Understanding Financial Statement

- | | |
|--------|-------------------------------|
| Unit 1 | Principal Financial Statement |
| Unit 2 | Financial Ratios |
| Unit 3 | Analysis of Financial Ratios |

UNIT 2 OBJECTIVE FUNCTION IN CORPORATE FINANCE

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 The Need for an Objective Function
 - 3.2 The Characteristics of the 'Right' Objective Function
 - 3.3 The Classical Objective
 - 3.4 Choosing an Alternative Objective Function
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

An objective function describes what a decision maker wants to accomplish and in doing so, a framework used in analysing the different decision rules is provided. In some cases, objective function is stated in terms of maximising some functions or variables (profits, size, value, social welfare) or minimising some functions or variables (risk, costs). This unit will take you through the models developed in corporate finance to maximise shareholders' wealth.

2.0 OBJECTIVES

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

- state the assumptions that we need to make to justify the focus on maximising stakeholders' wealth
- explain some of the conflicts associated with these assumptions
- explain the alternatives to maximising stakeholders' wealth
- explain how we can reduce the side costs associated with stakeholders' wealth maximisation.

3.0 MAIN CONTENT

3.1 The Need for an Objective Function

Overtime, there had been this controversy over the 'right' objective function to use in corporate finance, though this may seem somehow difficult to develop. Sometimes, questions could arise, why objective function, why not have multiple objective functions that try to satisfy all

UNIT 4 AGENCY PROBLEMS AND CONTROL OF CORPORATIONS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Agency Relationship
 - 3.2 Managerial Compensation
 - 3.3 Control of the Firm
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

1.0 INTRODUCTION

In the previous unit, we have seen that managers act in the best interests of the shareholders by taking action that increases the value of the stock. We have also seen that in large corporations, ownership is spread among many members (shareholders). In this unit, you will be learning if management really acts in the best interest of the shareholders or if management pursues its own goal at the expense of the shareholders.

2.0 OBJECTIVES

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

- explain what an agency relationship is
- state what agency problems are and how they arise
- enumerate the incentives available for managers in large corporations to motivate them to maximise share value.

3.0 MAIN CONTENT

3.1 Agency Relationship

The relationship between shareholders and management is called agency relationship. Such a relationship exists whenever someone (principal) hires another (the agent) to represent his interests. For instance, you might hire someone (an agent) to sell your car while you are away at school. In this relationship, there is a possibility of conflict of interest between the principal and the agent. Such a conflict is called agency problem.

different from market values. The aim of financial management is to maximise the market value of the stock not its book value.

5.0 SUMMARY

Financial statements remain the primary source of information for most investors and analyst. This unit attempts to explain the basis of financial statement and the generally accepted accounting principles that underlie their construction. As long as there is recognition that financial statements are means to an end- which is the understanding and valuing the firm – it is useful.

6.0 TUTOR-MARKED ASSIGNMENT

1. Under what conditions will switching from cash-based to an accrual-based accounting statements increase or decrease income? State the reason(s).
2. In company accounting net income and operating cash flow, name two items you typically find in net incomes that are not in operating cash flow.
3. Suppose a company's cash flow from asset was negative for a particular period. Is this necessarily a good sign or a bad sign?

7.0 REFERENCES / FURTHER READING

Damodaran, A. (1997). *Corporate Finance: Theory and Practice*. USA: John Wiley & Sons Inc.

Ross, S. A. et al. (2006). *Fundamentals of Corporate Finance*. USA: McGraw – Hill Inc.

- ratios, operating expenses ratios, contribution ratios and working capital ratios.
- ii. **Owners View Point:** The ratios owners are interested in include; net profit to equity share capital ratios, earnings per share, etc.
 - iii. **Lenders' Evaluation:** Lenders are mostly interest in the liquidity position and going concern of the firms. The ratios include: Current ratio, quick ratio, solvency ratios, profitability ratio etc.

(c) Fundamental Classification Basis

Ratios under this classification are grouped according to a basic function relevant to financial analysis. Five of such groups have been generally recognised, they are:

- i. **Liquidity Ratios:** These are ratios that measures firm's ability to meet its maturing short term obligations. Examples include the current ratio and quick ratio.
- ii. **Leverage Ratios:** These are ratio that measures the extent to which a firm has been financed by debt and its ability to meet interest and other fixed charges obligations. Examples include debt to total asset; times interest earned, and fixed charges coverage ratios.
- iii. **Activity Ratios:** These are ratios that measure the effectiveness with which a firm is using its resources: Examples include, inventory turnover, average collection period, fixed asset turnover and total asset turnover.
- iv. **Profitability Ratios:** These ratios measure the efficiency of the activities of a firm and its ability to generate profit. Examples includes, profit (net or gross) margin, return on investment, net profit to network, etc.
- v. **Investment Ratios:** These ratios measured the ability of a firm to create market values in excess of investment costs. Examples are price earnings ratios, and market /book value ratios.

The fundamental classification is the most extensively used mode of presenting financial statement analysis. We shall adopt fundamental classification in our subsequent discussions of financial analysis.

3.4 The Norms for Evaluation of Financial Ratios

You may be wondering how to control activities through ratios. The answer is not difficult to seek. Ratios that have been identified for control of activities measure relationships between key elements at any point in time. Such a measure is then compared with some "norm" and the cause for deviations investigated. An action plan is then prepared and implemented to remove the caused. The following appears to be the ways for evaluating the figures:

unwilling to sell goods on credit to firms that are always having liquidity problems.

Assessment of a firm's liquidity position is done using the following ratios:

- i. **Current Ratio:** This ratio compares all current assets with current liabilities and indicates a firm's ability to meet its short term obligation with its current assets.

Current Assets

Current Liabilities

As a convention, a current ratio of 2:1 is considered satisfactory. Too high a ratio will suggest too much fund tied up in a current asset, and low a ratio could be an indication of danger of not being able to pay creditor when they come to ask for quick payment.

- ii. **Quick or Acid Test Ratio:** This ratio is a more conservative measure of liquidity. It excludes inventory (stocks) from the current assets in the determination of liquidity. The ratio emphasises more on assets that can easily be converted into cash at a reasonable time without loss of value. Quick ratio is given by:

Current Assets – Inventory (Stocks)

Current liabilities

Generally, a quick ratio of 1:1 is considered to represent a satisfactory current financial condition of a firm.

- iii. **Cash Ratio:** This ratio takes a more stringent view of liquidity. It examines only cash and its equivalent (i.e. marketable security) in relation to current liabilities. It is a measure of most liquid asset of a firm as it considers only cash and marketable securities in the current assets as the numerators. Cash ratio is given by.

Cash + Marketable securities

Current liabilities

3.5.2 Profitability Ratios

Profit is the difference between revenues and expenses over a period of time (usually one year). Profitability ratios are used to measure the operating efficiency of a firm. All stakeholders of a firm are interested in the profitability of the enterprises. Profitability is measured by the following ratios:

- i. **Gross Profit Margin:** This ratio shows the profits relative to sales after the direct production costs are deducted. It can be used as an indicator of the efficiency of the production operation and the relationship between selling price and production costs.

Gross Profit Margin (GPM) is given by:

Sales – Cost of Goods Sold x 100

Sales

- iii. **Long Term Debt – to Total Capitalisation:** This ratio measures the relative weight of long-term capital to the capital structure (long-term financing) of the firm. Long-term debt-to-total capitalisation is given by:

$$\frac{\text{Long-term debt} \times 100}{\text{Total capitalisation}}$$

Total capitalisation

Total capitalisation means capital employed (long-term debt + equity). This ratio measures the extent to which a firm is financed by long-term loans, the lower the ratio the lower the financial risk of the firm. This ratio is also called gearing ratio.

- iv. **Times Interest Earned:** This ratio measures how satisfactorily a firm will meet its interest payment. Times interest earned is given by.

$$\frac{\text{Earnings before Interest and Tax}}{\text{Interest Charges}}$$

Interest Charges

As this ratio serves as one measure of firm's ability to meet its interest payments and thus avoid bankruptcy, the higher the ratio the greater the likelihood that the firm could cover (i.e. settle) its interest payments without difficulty. It also sheds some light on the firm's capacity to take on new debt.

- v. **Fixed charge coverage:** This ratio is similar to interest earned ratio but it is more inclusive in that it recognises that many firms lease assets and incur long-term obligations under lease contracts for the payment of lease premium. This ratio is given by.

$$\frac{\text{Earnings before interest and tax} + \text{lease obligation}}{\text{Interest charge} + \text{Lease obligation}}$$

Interest charge + Lease obligation

Nowadays, leasing is becoming widespread in financing businesses; this ratio is preferable to the time interest earned ratio for making financial analyses.

- vi. **Return on Investment:** This ratio measures the overall effectiveness of a firm in generating profits with available assets. Return on Investment (ROI) is given by:

$$\frac{\text{Net Profit after Taxes}}{\text{Total Assets}} \times 100$$

Total Assets

As this ratio measures the earning power of the invested capital, the higher the ratio the better for the firm.

3. Leverage Ratios

Leverage ratios measure the relationship between the funds provided by the owners (shareholders) of a firm and funds provided by the creditors of the firm. They also measure the ability of the firm to service the

charges accruing from the use of outsiders' funds (creditors) by its shareholders equity.

- i. **Debt-to-Equity:** This ratio measures the amount of the total funds provided by creditors in relation to the firm's financing provided by the shareholders.

Debt to equity is given by

$$\frac{\text{Total Debt} \times 100}{\text{Shareholders' equity}}$$

Generally, creditors would like this ratio to be low, because the lower the ratio, the higher the level of the firm's financing that is being provided by shareholders, and the larger cushion (margin of protection) in the event of shrinking asset values or outright losses. Preference stocks are sometimes included as debt rather than equity when leverage ratios are calculated.

- ii. **Debt – to-Total Assets:** This ratio measures the amount of the total funds provided by creditors in relation to the total assets of the firm. Debt-to-total asset is given by

$$\frac{\text{Total Debt} \times 100}{\text{Total Assets}}$$

Generally creditors would also prefer low ratio for all debt's ratios, because the lower the ratio, the greater the cushion against the creditors' losses in the event of liquidation.

2.5.4 Investment Ratios

The financial statements of public liabilities companies are used by investors and their advisers to make analysis for investment decision like buying more shares or holding on or selling out. Calculating ratio assists shareholders when analysing a potential investment in the stock of an enterprise. The following are investment ratios:

- i. **Earnings per Share:** This is the ratio that is used to determine the return accruing to each share. It is calculated by dividing the profit after taxes by the total number of common stocks outstanding. Earnings per share (EPS) ratio is given by:

$$\text{EPS} = \frac{\text{Profit after taxes}}{\text{Number of common stocks outstanding}}$$

This ratio simply reveals the profitability of a firm on per share basis, it does not reflect how much is paid as dividend and how much is retained in the business. But as a profitability index, it is a valuable and widely used ratio.

Solution**Gross Profit Margin**

$$2008 = \frac{858000}{3680000} (3,680- 2,822) = 23.3\%$$

$$2007 = \frac{722000}{2888000} (2,888-2166) = 25\%$$

Net Profit Margin

$$2008 = \frac{164000}{3680000} = 4.5\%$$

$$2007 = \frac{116000}{2888000} = 4.0\%$$

ii. Return on Capital Employed (ROCE)

This ratio relates profit only to long term funds made up of equity shares capital, reserves and profits) preferences capital and debenture or loan stock.

$$\text{ROCE} = \frac{\text{Net profit before interest on long term loan}}{\text{Total long term funds}}$$

$$2008 = \frac{164000+16000}{1010000} = \frac{180000}{1010,000} = 17.8\%$$

$$2007 = \frac{116000+20000}{736000} = \frac{136000}{736000} = 18.5\%$$

This ratio is used in determining rate of returns on capital employed with a view to ensure efficient use of resources.

iii. Return on Equity

This is the ratio of net profit after tax to the total equity funds and it shows the efficiency with which the equity funds are employed.

$$2008 = \frac{164000 - 3600}{850000} = \frac{128000}{850000} = 15.1\%$$

$$2007 = \frac{116000 - 24000}{536000} = \frac{92000}{536000} = 17.2\%$$

iv. Quick Asset Ratio (Acid Test)

This is the ratio of current assets less inventories to current liabilities. The ratio indicates the capacity of the company to generate sufficient cash to discharge is short – term liabilities as they fall due.

$$= \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

$$2008 = \frac{574000 - 180000 - 134000}{290000} = \frac{260,000}{290,000} = 0.91$$

$$2007 = \frac{452,000 - 140,000 - 92000}{236,000} = \frac{220000}{236000} = 0.93:1$$

You met the Managing Director and Financial Controller of Abubakar Nigeria Plc to discuss the figures, and they explained that the reduction in trading profit was due to various adverse economic, infrastructural and socio – political factors prevalent in 2008.

You are required to:

1. Compute the following ratios for 2007 and 2008:
 - i. Gross profit margin
 - ii. Return on capital employed
 - ii. Net profit margin
 - iv. Current ratio
 - v. Liquid ratio
 - vi. Debtors collection period
 - vii. Proprietary ratio
 - viii. Earnings per share
 - ix. Dividend per share
 - x. Price earnings ratio
2. Based on the ratio computed in (a) above comment on the company's profitability and liquidity position.
3. Indicate the measures the company should take to improve the collection of debts and cash flow under the central and accounting information you would require for this purpose.

7.0 REFERENCES/FURTHER READING

Okwuosa, I. (2005). *Advanced Financial Accounting Manual*. Lagos: Arnold Consulting Ltd.

Olowe, R. A. (1997). *Financial Management: Concepts, Analysis and Capital Investments*. Lagos: Briefly Jones Nig Limited.

Omolehinwa, A. (2001). *Work Out Corporate Finance*. (2nd ed.). Lagos: Panaf Publishing Inc.

increasing total asset turnover is the same thing as decreasing capital intensity.

4.0 CONCLUSION

Financial planning is not just a mechanical activity; otherwise, it will focus on wrong things. In actual sense, plans are formulated in terms of growth target. It is true that financial planning models may not ask the right questions because it relies on accounting relationships rather than on financing relationships. However, it must be very clear to note that financial planning is an interactive process i.e. plans are created, examined and modified.

5.0 SUMMARY

In this unit, we have discussed that financial planning forces the firm to think about the future, also we discussed features of planning process, what financial planning can accomplish and the relationship between growth and financing needs.

SELF-ASSESSMENT EXERCISE

- i. What are the determinants of growth?
- ii. What are the two dimensions of the financial planning process?

6.0 TUTOR-MARKED ASSIGNMENT

1. What is financial planning?
2. Why should firm draw up financial plan?
3. What are the basic components of a financial plan?
4. How is a firm's sustainable growth related to its accounting return on equity (ROE)?

7.0 REFERENCES/FURTHER READING

Ross, S.A. *et al.* (2006). *Fundamentals of Corporate Finance*. USA: McGraw – Hill Inc.

Damodaran, A. (1997). *Corporate Finance: Theory and Practice*. USA: John Wiley and Sons Inc.

3.2 Pro forma Balance Sheet

In preparing a pro forma balance sheet, there are several items for which using a percentage of sales are not appropriate, for example:

- Cash
- Capital assets
- Borrowings both short and long term
- Common and Preferred stock
- Retained earning

A better approach to prepare a balance sheet forecast is to use what is referred to as a judgmental approach. What this involves is assessing how to best estimate each item on the balance sheet using a combination of methods for estimating. In preparing the balance sheet, there will need to be a 'plug' amount. This is an amount required to balance the balance sheet using the basic accounting equation, that is, assets = liabilities + shareholders equity.

If more assets are required to balance your statement then the plug figure is excess cash. If more liabilities are needed, then the plug figure is called external financing. We will extend our example of Ilwenoc to preparing a pro forma sheet for 2002 using the following assumptions:

- no capital investment will be made in 2002
- the amortisation of capital assets for 2002 is projected to be 500
- a new issue of shares will produce net proceeds of N1,000 in 2002
- sales will increase by 12% in 2002 bringing a corresponding increase in accounts receivable
- net income in 2002 is forecast to be N954
- the dividend payout rate is estimated to be 5% of net income.

The process for solving this problem is:

- a. Calculate the values of the assets and liabilities where you have the data to do it.
- b. Determine the value of the line of credit (LOC) based upon the balance sheet equation.

The calculations are as follows:

$$\text{Debtors} = 1.12 \times 1,500 = 1,680$$

$$\text{Fixed Assets} = 2001 \text{ balance} + \text{capital expenditure in 2002} - \text{amortization in 2002} = 7,500 + 0 - 500 = 7,500$$

$$\text{Shares} = \text{shares at 2001} + \text{net proceeds of new shares} = 1,000 = 2,000$$

$$\text{Dividend} = \text{net income} \times \text{dividend rate} = 954 \times 0.5 = 477$$

$$\begin{aligned} \text{Retained Earnings for 2002} &= \text{retained earnings for 2011} \\ &+ \text{net income for 2002} - \text{dividend} = 5,500 + 954 (\text{net income}) \end{aligned}$$

incurring large transactions costs or loss of flexibility. There are some cautions to the use of internal equity for funding projects. Firms have to know that internal equity has the same cost as external equity before factoring in the transactions cost differences. Thus, the cost of equity, computed using the capital asset, applies as much as to internal as it does to external equity. This implies that the projects taken with the internal equity should pass and earn a return on equity for investor that is greater than the cost of equity.

Secondly, internal equity is clearly limited to the cash flows generated by the firm for its stock holders. Even if the firm does not pay dividends, the cash flows may not be sufficient to fund the firm's project. Depending entirely on equity can therefore result in project delays or their possible loss to competitors.

Thirdly, managers should not make the mistake of thinking that just because they use internal equity for financing projects that the stock price does not matter. In reality, stockholders in firms whose stock prices have dropped are much less likely to trust their managers to reinvest their cash flows for them than are stockholders in firms with rising stock prices.

4.0 CONCLUSION

We have discussed that firms have a number of options when it comes to financing. In this unit, we have differentiated between debt and equity, pointing out that any financing approach that results in fixed cash flows has prior claims in the case of default. That also within the broad category of debt, firms have to make a number of ranging long versus short-term debt decisions.

5.0 SUMMARY

A company's reasonable, proportional use of debt and equity to support its assets is a key indicator of balance sheet strength. A healthy capital structure that reflects a low level of debt and a corresponding high level of equity is a very positive sign of investment quality. We also examine that there is a limit to which a firm can use debt financing to generate tax shields because firms do not use great amount of debt but they pay substantial taxes.

SELF-ASSESSMENT EXERCISE

What are the important factors in making capital structure decisions?

6.0 TUTOR-MARKED ASSIGNMENT

1. Why should financial managers choose the capital structure that maximises the value of the firm?
2. What is an optimal capital structure?

7.0 REFERENCES / FURTHER READING

Damodaran, A. (1997). *Corporate Finance: Theory and Practice*. USA: John Wiley & Sons Inc.

Richard, L. (2006). *Investopedia News and Articles*. USA: Coupon Mountain.

Ross, S.A. et al. (2006). *Fundamentals of Corporate Finance*. USA: McGraw – Hill Inc.

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and the cost of equity to determine a company's cost of capital. However, a rate of return larger than the cost of capital is usually required.

- A. Cost of Equity:** The cost of equity is more challenging to calculate as equity does not pay a set return to its investors. Similar to the cost of debt, the cost of equity is broadly defined as the risk weighted projected return required by investors, where the return is largely unknown. The cost of equity is therefore inferred by comparing the investment to other investments (comparable) with similar risk profiles to determine the "market" cost of equity. It is commonly equated using the CAPM formula (below), although articles such as Stutz (1995) question the validity of using a local CAPM versus an international CAMP. Also, considering whether markets are fully integrated or segmented (If fully integrated, there would be no need for a local CAPM).

Once cost of debt and cost of equity have been determined, their blend, the weighted – average cost of capital (WACC), can be calculated. This WACC can then be used as a discount rate for a project's projected cash flows.

- B. Cost of Debt:** The cost of debt is relatively simple to calculate, as it is composed of the rate of interest paid. In practice, the interest rate paid by the company can be modeled as the risk – free rate plus a risk component (risk premium), which itself incorporates a probable rate of default (and amount of recovery given default). For companies with similar risk or credit ratings, the interest rate is largely exogenous (not linked to the company's activities).

This can be computed by taking the rate on a risk free bond whose duration matches the term structure of the corporate debt, then, adding a default premium. This default premium will rise as the amount of debt increases (since, all other things being equal, the risk rises as the amount of debt rises). Since in most cases debt expense is a deductible expense, the cost of debt is computed as an after tax cost to make it comparable with the cost of equity (earnings are after – tax as well). Thus, for profitable firms, debt is discounted by the tax rate. The formula can be written as $(R_f + \text{credit risk rate}) (1 - T)$, where T is the corporate tax rate and R_f is the risk free rate.

Cost of Equity = Risk free rate of return + Premium expected for risk

Cost of Equity = Risk free rate of return + Beta x (Market rate of return – risk free rate of return) where Beta = sensitivity to movements in the relevant market:

$$E_s = R_f + B_s (R_m - R_f)$$

major policy changes, overthrow of governments, economic collapses and war. Countries such as the United States and Canada are seen as having very low country-specific risk because of their relatively stable nature. Other countries, such as Russia, are thought to pose a greater risk to investors. The higher the country-specific risk, the greater the compensation investors will require.

4.0 CONCLUSION

This unit has discussed to an extent the various market security risks that are associated with cost of capital. Some of the risks discussed will be able to help the learner understand the precaution a person should take before investing in a project.

5.0 SUMMARY

This unit has explored the subject of capital market history. Such history is useful because it tells us what to expect in the way of returns from risky assets. We summed up our study of market history with two keys lessons:

- Risky assets, on average, earn a risk premium. There is a reward for bearing risk.
- The greater the potential reward from a risky investment, the greater is the risk.

6.0 TUTOR-MARKED ASSIGNMENT

1. What are the reasons why firms find themselves with idle cash?
2. What are the various risk associated with cost of capital you know?
3. Discuss any three market security risks you know.

7.0 REFERENCES/FURTHER READING

Damodaram, A. (1997). *Corporate Finance: Theory and Practice*. USA: John Wiley and Sons Inc.

Ross, S.A. *et al.* (2006). *Fundamentals of Corporate Finance*. USA: McGraw – Hill Inc.

that is paid out as dividends could well have been used to invest in some of these projects, lending to a much higher return for stockholders and higher stock prices for the firm.

Consequences of High Payout

When a firm pays out more in dividends than it has available in free cash flow to equity, it is creating a cash shortfall. If this firm also has good projects available currently that are not being taken because of capital rationing constraints, it can be argued that the firm is paying a hefty price for its dividend policy. Even if the projects are passed up for other reasons. It can be argued that the cash this firm is paying out as dividends would earn much better returns for it if left to accumulate in the firm.

Dividend payments also create a cash deficit that now has to be met by issuing new stock that carries a potentially large issuance cost, which reduces firm value. On the other hand, if the firm issues new debt, it might become overleveraged, and this may reduce value.

Stockholder Reaction

Rationally, the stockholders' best option in this case is to insist that the firm pay out less in dividends and take on better projects. This may not happen, however, if the firm has paid high dividends for an extended period of time and has acquired stockholders who value high dividends even more than they value the firm's long-term health. Even so, stockholders may be much more amenable to cutting dividends and reinvesting the cash in the firm that has a ready supply of good projects at hand.

Management Response

The managers of firms that have good projects, while paying out too much in dividends, have to figure out a way to cut dividends and at the same time differentiate themselves from those firms that are cutting dividends owing to declining earnings. The initial suspicion with which markets view dividend cuts can be overcome in part by providing markets information on project quality at the time of the dividend cut. If the dividends have been paid for a long time, however, the firm may have acquired stockholders who like the high dividends and may not be particularly interested in the projects that the firm has available. If this is the case, the initial reaction to the dividend cut, no matter how carefully packaged, will be negative. However, as disgruntled stockholders sell their holdings, the firm will acquire new stockholders who may be more willing to accept the lower dividends and higher investment policy.

methods for creating organisational growth within a small business are discussed below.

1. **Joint Venture/Alliance:** This strategy is particularly effective for smaller firms with limited resources. Such partnerships can help small business secure the resources they need to grapple with rapid changes in demand, supply, competition, and other factors. Forming joint ventures or alliances gives all companies involved the flexibility to move on to different projects upon completion of the first, or restructure agreements to continue working together. Subcontracting, which allows firms to concentrate on those aspects of their business that they do best, is sometimes defined as a type of alliance arrangement (albeit one in which the parties involved generally wield differing levels of power). Joint ventures and other business alliances can inject partners with new ideas, access to new technologies, new approaches, and new markets, all of which can help the involved businesses to grow. Indeed, establishing joint ventures with overseas firms has been hailed as one of the most potentially rewarding ways for companies to expand their operations. Finally, some firms realise growth by acquiring other companies.
2. **Licensing:** A firm may wish to expand and grow by licensing its most advanced technology. This course of action is often recommended to firms with their own proprietary technologies because competitors will likely copy whatever a company develops at some point. Licensing is one method that can be used to maximise the benefit that a firm can gain from its technology. It is also a way to gain the resource to fund future research and development efforts.
3. **Sell Off Old Winners:** Some organisations engaged in a concerted effort to divest themselves of mature "cash cow" operations to focus on new and innovative lines of products or services. This option may sound contradictory, but analysts note that businesses can command top prices for such tried and true assets. An addendum to this line of thinking is the divestment of older technology or products. Emerging markets in Latin America and Eastern Europe, for instance, have been favourite places for companies to sell products or technology that no longer attract high levels of interest in the United States. These markets may not yet be able to afford large quantities of state-of-the-art goods, but they can still benefit from older models.
4. **New Markets:** Some businesses are able to secure significant organisational growth by tapping into new markets. Creating additional demand for a firm's product or service, especially in a market where competition has yet to fully developed, can spur phenomenal growth for a small company, although the

Are leaders in your company willing to sacrifice for the growth of the company and others?

True leaders sacrifice. They do it for their families, their companies, and fellow co-workers. If you want to know true leaders in your organisation, find those that sacrifice something for a team member. Building a better company means finding people willing to put their own interests on hold for a time in order to advance the interests of those around them.

Developing a company means much more than just having a plan and going with it. It means having a team that is both willing to grow and given the opportunity to grow. How much you grow your company is determined by how willing you are to do what it takes to make growth happen.

4.0 CONCLUSION

Organisational growth has the potential to provide small businesses with a lot of benefits, including things like greater efficiencies from economies of scale, increased power, a greater ability to withstand market fluctuations, an increased survival rate, greater profits, and increased prestige for organisational members. However, organisational growth is what every organisation wishes to achieve and this unit has discussed to an extent how that can be achieved.

5.0 SUMMARY

In this unit, we have been able to explain organisational growth using, its meaning, how it can be achieved, problems faced when trying to achieve growth and the various steps that can be taken when trying to achieve growth.

6.0 TUTOR-MARKED ASSIGNMENT

1. List the various steps to organisational growth.
2. How can organisational growth be achieved?
3. What challenge can be faced in trying to achieve organisational growth?

7.0 REFERENCES/FURTHER READING

John Maxwell. *Developing the Leaders around You*.

Lipton, M. (2003). *Guiding Growth: How Vision Keeps Companies on Course*. Harvard Business School Press.

UNIT 5 INTERNATIONAL FINANCE

CONTENTS

- 1.0 Introduction
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1.0 INTRODUCTION

The principles of corporate finance do not change just because a project is a 'foreign project', or because the financing of such project is in a different currency. A good project is always one greater than the hurdle rate. Using debt makes sense only if the firm has excess debt capacity, and dividends should be paid only if there are surplus cash flows. Certain issues relating to investment financing, and dividend decisions are however specific to non-domestic projects.

2.0 OBJECTIVES

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

- list the determinants of changes in currency rates
- explain how these determinants can be used in forecasting expected cash flows in another currency analyse the difference between investment in foreign projects done in local or foreign currency
- highlight risks associated with non-domestic projects.

3.0 MAIN CONTENT

3.1 Why Currency Rates Move?

One source of risk unique to international projects is exchange-rate risk. A company may find its cash flows depleted by movements in exchange rates over time.

(e.g., the existing government is overthrown) to more limited changes (e.g., the basic laws and regulations are rewritten as a consequence of a political shift). The effects on the firm can also extend from expropriation, whereby the firm's assets are seized with no compensation, to a reduction in expected cash flows as a result of changing laws.

It is argued that the difference between the more stable economies, such as the United States, and less stable ones, such as some of the emerging markets like Brazil and Indonesia, is merely one of degree. Although the existence of political risk cannot be disputed, the measurement of political risk is still extremely subjective.

Another risk firms face when they venture out of their domestic markets is the risk of operating in unfamiliar terrain, with different regulations and cultures. If ignored, these differences can end up costing the firm.

Managing Exchange Rate and Other Risks

As the preceding section illustrates, exchange rate changes affect not only current income but also the value of the firm. In addition, a firm may be exposed to political and regulatory risks as it takes on projects in other countries. The follow up questions then become:

- should firms try to manage or minimise their exposure to exchange rate, political, and other risks?
- if they decide to do so, what products are available to help them hedge these risks?

Any time a firm enters into a transaction that exposes it to cash flows in a foreign currency, it is exposed to exchange-rate risk. If the firm ventures into other countries, it creates additional political and regulatory risks for itself. The manager can leave the firm exposed to these risks, or the manager can hedge the risks, using a variety of financial instruments. This choice cannot be made without considering the following factors.

1. **Stockholder Composition:** For stockholders to be able to diversify away the foreign-exchange risk that flows through to firms, they must be internationally diversified. Thus, an investor who holds Siemens and GE in the same portfolio may not be affected much by movements in the \$/ DM exchange rate, because of offsetting change effects on his or her investments. If a firm's stockholders fit this profile, hedging exchange-rate risk becomes much less of a priority. If, on the other hand, the stockholders in a firm are not internationally diversified, a much better argument can be made for diversifying exchange-rate risk.

2. **Diversification across Countries:** Some companies accomplish a diversification of a different kind, because they have economic exposures in many currencies. To illustrate, Citibank, with operations in more than 90 countries, is less likely to be concerned about hedging the exchange rate risk than, say, Wal-Mart, whose only international investments are in Mexico.
3. **Cost of Hedging Risk:** Hedging foreign exchange risk exposure is cheaper in some currencies than in others and for shorter periods than for longer ones. Other things remaining equal, the greater the cost of hedging risk, the less likely firms will be to hedge. In terms of the types of exposure described above, firms are much more inclined to hedge translation and other short – term exchange rate risk exposure, because of the low cost of hedging. They are less inclined to hedge long-term exchange rate risk exposure and political risk, because the hedges are more difficult and much more expensive to acquire.

In summary, firms with limited foreign operations primarily domestic investors and short –term transactions exposures are likely to gain the most by hedging. Firms with far-flung foreign operations, internationally diversified investors, and long –term exchange rate risk exposures or political risk exposure should be much more cautious about hedging that risk.

In closing, it is worth pointing out that firms will always be exposed to the expected changes in exchange rates; it is only the unexpected component of the changes that is being hedged away. To illustrate, if the Home Depot opens a store in Mexico, and the expected annual inflation rate is 40 per cent higher in Mexico than in the United States, the firm should expect the peso to depreciate about 40 per cent a year. The actual exchange rate change may be very different for a number of reasons, however; among other factors, there may be political upheaval, and the actual inflation rate differential may turn out to be much higher or lower than the anticipated 40 per cent. It is this component of the exchange rate change that can be hedged using forward, futures, or options contracts.

3.3 Investment Analysis of Foreign Projects

Regardless of whether the project is domestic or foreign, the decision of whether or not to take a new project remains grounded in the expected cash flows and hurdle rates for that project. That said, there are unique issues that are associated with analysing projects with cash flows in currencies other than the firm's domestic currency and that are based in a different country.