COURSE TITLE: INTRODUCTION TO FINANCE 1

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THE FIRM AND ITS FINANCIAL OBJECTIVES

A firm is organization that provides goods and services. There are two major organizational types namely business organization and governmental organization. While business organizations are private entities providing goods and services, governmental organizations provide public services.

Background

Finance can be referred to as the art and science of the management of money. Finance is the study of concepts, applications, and systems that affect the value (or wealth) of individuals, companies, and countries over the short and long term. It is the management of the flows of money through an organization (whether it is a private or governmental organization) and claims against money. Finance is very vital to the management of any organization. The functional activities of companies such as marketing, production, purchasing etc. require the use of money. The activities of government organization also require the use of money.

Financial management is an applied field of management. It borrows knowledge from the various fields of management such as marketing, economics etc. in the management of money. Today, finance can also be applied to other fields and to the problem of money management. We refer to persons responsible for finance function as financial managers.

Types of finance

Finance is one of the important and integral parts of business concerns; hence it plays major roles in every part of the business activities. It is used in all areas of the activities of any organization under different names.

Finance can be classified into two major parts: Private and Public

Fig. 1.1 – Types of Finance

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Private Finance includes the individual, firms, business or corporate financial activities to meet the requirements.

Public finance concerns revenue and disbursement of government such as Federal, State and Local government financial matters.

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Firm and its financial objectives

Firms/organizations can be classified into two broad categories which are: business organization and governmental organization. Business organizations engage in economic activities to make profit while governmental organization includes central, state, local governments and nationalised industries which provide public services at those levels. Governmental organizations are run in public interest and their activities do not necessarily result in profit. Business organization on the other hand takes three forms: sole proprietorship, partnership and companies.

- Sole proprietorship: this is a business organization that is owned by one person. The owner of the business has all rights to the business assets and liabilities. The single owner receives all profits from the business and also suffers all losses incurred by the business. It is the most common form of business and it is easy to set up.

Characteristics of sole proprietorship

- o It is easy to establish and form.
- o No financial security is required as a proof of business ownership and a sole proprietor can issue debt securities.
- o The liabilities of a sole proprietor are unlimited.
- o It's the easiest means of maintaining control over an organization.
- o The business may not have perpetual existence.

- **Partnership:** a partnership is a business firm carried on by two or more persons with a view of making profit. The maximum number of partners in a partnership business is twenty excluding solicitors, accountants and surveyors. In most cases, the activities of partners in the business are regulated by partnership deed. Partnership deed is a written agreement stating the responsibilities of each partner, profit and loss sharing ratio among partners, interest on capital, interest on drawing etc. There are two broad types of partnership:

• General partnership: it is the most common form of partnership business and all partners are liable for the debt of the partnership.

• Limited partnership: this is a partnership in which the liabilities of some partners are limited to the amount stated in the partnership agreement. In this type of partnership, there will be one or two general partners.

Characteristics of Partnership Business

- o No financial security is required as evidence of ownership of the business.
- o The liabilities of all partners in the business are unlimited except the limited

partner.

- The business may not have a perpetual existence.
  Profit and loss are shared among partners.

- **Limited Companies:** a limited company is an artificial legal entity incorporated by registration under the law. A company is a person distinct from the persons who have proprietary interest in it or who are the owners of the business. It can sue and be sued in its corporate name. It has the ability to own properties. In Nigeria the relevant law that regulates limited companies is the Companies and Allied Matters Act 1990 (CAMA) as amended. In order to form a company in Nigeria, CAMA requires the promoters to file memorandum and articles of association and also form a board of directors consisting of at least two directors. The memorandum and articles of association both represent the constitution of the company.

Types of company: there are majorly three types of companies:

- Company limited by shares: this is a company that has the liability of its members limited by the memorandum to the amount, if any that is unpaid on the shares respectively held by them.
- Company limited by guarantee: this is a company that has the liability of its members limited by memorandum to such amount as the members may respectively thereby undertake to contribute to the assets of the company in the event of its being wound up.
- Unlimited company: this is the type of company where the liability of its members does not have any limit.

Characteristics of limited companies

- Legal entity: the company is distinct from its owners.
- Limited liability: the liability of the owners is limited to an unpaid amount on the shares they have purchased.
- Perpetual existence: the death of a shareholder does not affect the existence of the company.
- Shares represent ownership in the company: the shareholders are owners of the business and they have a voting right in the company.
- Transferability of shares: ownership in a company can be transfer from one person to another easily.
- Directors of the company are appointed at annual general meetings.

Objectives of the firm

The starting point for developing a good financial management for any organization is the definition of achievable objectives. Clearly defined and understood objectives are the keys to moving the firm to a future desired position. Business firms are profit seekers; thus, their objectives need to be stated in monetary terms. The following are the frequently encountered financial objectives of the firm:

I. Profit maximization
II. Shareholders' wealth maximization

PROFIT MAXIMIZATION

Profit maximization is the main objective of a business enterprise. Most businesses believe as long as they are increasing revenue while keeping down cost, they are achieving this objective. Maximization of profit is an easily understood and measurable rational objective for any business since it focuses the firm's efforts toward making money. One can ask whose profits the firm is trying to maximize. Since ordinary shareholders are the suppliers of risk funds, the firm is actually trying to maximize profit for the ordinary shareholders. Profit maximization consists of the following important features:

1. Profit maximization is also called "cashing per share" maximization. It leads to the maximization of the business operations for profit maximization.
2. Ultimate aim of the business concern is to profit hence; it considers all the possible ways to increase the profitability of the concern.
3. Profit is the parameter of measuring the efficiency of the business concern. So, it shows the entire position of the business concern.
4. Profit maximization objective helps to reduce the risk of the business.

Arguments for Profit Maximization

The following important points are in support of the profit maximization objective of the business concern:

(i) Main aim is the earning of profit.
(ii) Profit is the parameter of the business operation.
(iii) Profit reduces risk of the business concern.
(iv) Profit is the main source of finance.
(v) Profitability meets the social needs also.

Arguments against Profit Maximization

The following important points are against the objective of profit maximization:

(i) Profit maximization leads to exploiting workers and consumers.
(ii) Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.
(iii) Profit maximization objective leads to inequalities among the stakeholders such as customers, suppliers, public shareholders, etc.

Drawbacks of Profit Maximization Profit Maximization Objective

Profit maximization objective has been criticized on the following grounds:

- There are many interest groups in modern day organization compared with owner-managed organization that was in existence in ancient days. The interest groups such as customers and the general public have varying objectives which have to be reconciled with the financial objectives of a firm.

- The definition of profit which is the major objective of the firm is vague. The definition of profit is not clear. Is the firm maximizing short- or long-term profit? Are they maximizing profit before tax or profit after tax? Operating profit or gross profit? For instance, if an organization is seeking profit without maintenance or planning for replacement of its machinery, it is pursuing short term profit. In the long term such firms may not survive. Profit could also be earnings per share or return on capital employed.
- It ignores timing of returns: money received today has a higher value than money to be received tomorrow. This is because N1 today can be invested to yield more than N1 tomorrow, N1 million profit this year is different from N1 million next year.
- It ignores risk or uncertainty of future earnings: the future profits might be risky
- It does not consider the qualitative aspects of future activities: some non-financial objectives such as growth and diversification might result in short term profits but will ensure a firm's stability in the long term.
- Profits do not necessarily translate into cash flows for the firm or shareholders.

MAXIMIZATION OF SHAREHOLDER'S WEALTH

The theory of company finance is based on the assumption that the objective of the firm is to create value (or wealth) for the shareholders. This objective is considered more credible since all residual earnings of a business belong to the legal owners of the company, i.e. ordinary shareholders and retained earnings are undistributed wealth of these equity shareholders. Thus, if the objective of the firm is to maximize its value, any extra wealth created will belong to the equity (ordinary) shareholders. Thus, maximizing the value of a firm means also maximizing the wealth of shareholders.

The wealth of the shareholders will be maximized if the market price of a company's shares goes up. Market price of a company's shares represents the value placed on the company by market participants. This is a reflection of the company's investment, financing and dividend decisions. If a firm embarks on an investment decision that yields a positive net present value, the amount of positive net present value will increase the wealth of the shareholders. The increase in wealth of the shareholders will also make the market price of the company's shares to go up if it is quoted on the stock Exchange.

Arguments for Wealth Maximization

(i) Wealth maximization is superior to profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.

(ii) Wealth maximization considers the comparison of the value to cost associated with the business concern i.e. it considers timing of returns as the net present value of an investment is obtained by discounting the present value of cash flows at the opportunity cost of capital.

(iii) Wealth maximization considers both time and risk of the business concern.
(iv) Wealth maximization provides efficient allocation of resources
(v) It ensures the economic interest of the society.
(vi) It balances short- and long-term benefits, in a way that profit maximization objective cannot.

Arguments against Wealth Maximization

(i) Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.
(ii) Wealth maximization is nothing. It is also profit maximization in an indirect way.
(iii) Wealth maximization creates ownership-management controversy.
(iv) Management alone enjoys certain benefits.
(v) The ultimate aim of the wealth maximization objectives is to maximize the profit.
(vi) Wealth maximization can be activated only with the help of the profitable position of the business concern.

SHAREHOLDER'S WEALTH MAXIMIZATION AND SOCIAL RESPONSIBILITY

The shareholders' wealth maximization objective provides a guide for efficient allocation of society's economic resources. Any other objective will lead to sub-optimal allocation of resources that will have implication on the growth of an economy. However, pursuing wealth maximization objective does not necessarily imply fulfillment of social responsibility of a firm. The social responsibilities of the firm include such things as protecting consumers (e.g. supply of quality goods at low price), maintaining sound industrial relations, paying fair remuneration to employees, maintaining fair recruitment practices and safe working condition, supporting education and sports, supporting the government in the provision of clean water etc. Some social actions are compatible with the objective of shareholders' wealth maximization e.g. capital investment for the welfare of customers and employees while some others (e.g. investment in education) conflicts with the objective of shareholders' wealth maximization (it might reduce shareholders' wealth). Since shareholders' wealth maximization objective has implication on the efficient allocation of society's economic resources, there is a tradeoff between social goals and economic efficiency.

THE FINANCE FUNCTIONS

The finance function is an integral part of financial management which involves the acquisition and utilisation of funds necessary for efficient operations of the business organisation. It is not possible to substitute or eliminate this function as it starts at the setting up of the business organisation and remains at all times during the life of the enterprise. Finance is required everywhere, be it production, marketing, human resource development, public sector, non-profit making organization or in undertaking research activity. Therefore, it becomes important to understanding the universality and importance of finance.

Finance function is the most important function of a business. Finance is closely connected with production, marketing and other business activities. In the absence of finance, all these activities come to a halt. In fact, only with finance, can a business activity be commenced, continued and expanded. Finance is required everywhere, be it production, marketing, human resource development, public sector, non-profit making organization or in undertaking research activity. Therefore, it becomes important to understanding the universality and importance of finance.

All decisions mostly involve finance. These decisions are referred to as financial decisions in an organization. The role of the finance manager in any financial decision is very vital. We can classify the finance functions or financial decisions into three major groups:

- Investment Decision or Long-term Asset mix decision
- Finance Decision or Capital mix decision
- Dividend Decision or Profit allocation decision

➢

Investment Decision

Investment decisions relate to selection of assets in which funds are to be invested by the firm. Investment alternatives are numerous and resources are scarce and limited. Therefore, the available resources have to be rationed and discretely used in order to maximise organizational objectives. Investment decisions allocate and ration the resources among the competing investment alternatives or opportunities. The effort is to find out the projects, which are acceptable and the ones that will yield the best results.

Investment decisions relate to the total amount of assets to be held and their composition in the form of fixed and current assets. Both factors influence the risk the organisation is exposed to and the most important aspect is how the investors perceive the risk. Investment decisions result in purchase of assets. Assets can be classified under two broad categories:

- o Long-term investment decisions – Long-term assets
- o Short-term investment decisions – Short-term assets

Long-term Investment Decisions: The long-term capital decisions are referred to as capital budgeting decisions, which relate to fixed assets. The fixed assets are long term in nature. Basically, fixed assets create earnings to the firm. They give benefit in future. It is difficult to measure the benefits as future is uncertain. The investment decision is important not only for setting up new units but also for expansion of existing units. Decisions related to them are, generally, irreversible. Often, reversal of decisions results in substantial loss. When a brand new car is sold, even after a day of its purchase, buyer treats the vehicle as a second-hand car. The transaction, invariably, results in heavy loss for a short period of owning. So, the finance manager has to evaluate the profitability of every investment proposal, carefully, before funds are committed to them.

Short-term Investment Decisions: The short-term investment decisions are, generally, referred to as working capital management. The finance manager has to allocate among cash and cash equivalents, receivables and inventories. Though these current assets do not, directly contribute to earnings, their existence is necessary for proper, efficient and optimum utilisation of fixed assets.

➢ Finance Decision

Once investment decision is made, the next step is how to raise finance for the concerned investment. Finance decision is concerned with the mix or composition of the sources of raising the funds required by the firm. In other words, it is related to the pattern of financing. In finance decision, the finance manager is required to determine the proportion of equity and debt, which is known as capital structure. There are two main sources of funds, shareholders' funds (variable in the form of dividend) and borrowed funds (fixed interest bearing).

These sources have their own peculiar characteristics. The key distinction lies in the fixed commitment. Interest is to be paid on borrowed funds irrespective of the profitability of the firm and this permanent obligation is not applicable to funds raised from the shareholders. The borrowed funds are relatively cheaper compared to shareholders' funds because they have tax shield in most cases. However, they carry risk. This risk is known as financial risk i.e. Risk of insolvency due to non-payment of interest or non-repayment of borrowed capital.

On the other hand, the shareholders' funds are permanent source to the firm. The shareholders' funds could be from equity shareholders or preference shareholders. Equity share capital is not repayable and does not have fixed commitment in the form of dividend. However, preference share capital has a fixed commitment, in the form of dividend and could be redeemable. Barring a few exceptions, every firm tries to employ both borrowed funds and shareholders' funds to finance its activities. The employment of these funds, in combination, is known as financial leverage. Financial leverage provides profitability, but carries risk. Without risk, there is no return. This is the case in every walk of life!

When the return on capital employed (equity and borrowed funds) is greater than the rate of interest paid on the debt, shareholders' return gets magnified or increased. In period of inflation, this would be advantageous while it is a disadvantage or curse in times of recession. The finance manager follows that combination of raising funds which is optimal mix of debt and equity. The optimal mix minimizes the risk and maximizes the wealth of shareholders.

➢ **Dividend Decision**

Dividend decision is concerned with the amount of profits to be distributed and retained

in the firm. The term 'dividend' relates to the portion of profit, which is distributed to shareholders of the company. It is a reward or compensation to them for their investment made in the firm. The dividend can be declared from the current profits or accumulated profits. Which course should be followed – dividend or retention?
Normally, companies distribute certain amount in the form of dividend, in a stable manner, to meet the expectations of shareholders and the balance is retained within the organisation for expansion. If dividend is not distributed, there would be great dissatisfaction by the shareholders. Non-declaration of dividend affects the market price of equity shares severely. One significant element in the dividend decision is, therefore, the dividend payout ratio i.e. what proportion of dividend is to be paid to the shareholders.
The dividend decision depends on the preference of the equity shareholders and investment opportunities available within the firm. A higher rate of dividend, beyond the market expectations, increases the market price of shares. However, it leaves a small amount in the form of retained earnings for expansion. The business that reinvests less will tend to grow slower. The other alternative is to raise funds in the market for expansion. It is not a desirable decision to retain all the profits for expansion, without distributing any amount in the form of dividend. There is no ready-made answer to the question on how much is to be distributed and what portion is to be retained. Retention of profit is related to:

- Reinvestment opportunities available to the firm.
- Alternative rate of return available to equity shareholders, if they invest themselves

Fig. 2.1 – Financial Management Decisions

INTER-RELATIONSHIP OF FINANCE FUNCTIONS OR DECISIONS

All the major functions or decisions – Investment function, Finance function and Dividend function, are inter-related and inter-connected. They are inter-related because the goal of all the functions is one and the same. Their ultimate objective is only one – achievement of maximization of shareholders' wealth or maximizing the market value of the shares. However, funds have economic cost. So, an efficient financial manager takes the optimal decision by considering the implications or impact of all the decisions, together, on the market value of the company's shares. The decision has to be taken considering all the angles, simultaneously. No function is superior: All the functions are important. Importance of the function depends on the situation of the firm. If a firm has adequate investment opportunities but experiences difficulty to raise funds, then the finance function is superior to the firm, at that juncture. It does not mean that investment decision is less important compared to finance decision, always.

Fig. 2.2: Goals of Finance

ORGANISATION OF THE FINANCE FUNCTION

The responsibilities for financial management are spread throughout the organisation in the sense that financial management is, to an extent, an integral part of the job for the .managers involved in planning, allocation of resources and control. For instance, the production manager (engineer) shapes the investment policy (proposal of a new plant), the marketing manager/analyst provides inputs in forecasting and planning, the purchase manager influences the level of investment in inventories and the sales manager has a say in the determination of receivables policy. Nevertheless, financial management is highly specialized in nature and is handled by specialists. Financial decisions are of crucial importance. It is, therefore, essential to set up an efficient organisation for financial management functions.

Since finance is a major/critical functional area, the ultimate responsibility for carrying out financial management functions lies with the top management, that is, board of directors/managing director/chief executive or the cornerstone of the board. However, the exact nature of the organisation of the financial management function differs from firm to firm depending upon factors such as size of the firm, nature of its business, type of financing operations, ability of financial officers and the financial philosophy, and so on.

Similarly, the designation of the chief executive of the finance department also differs widely in case of different firms. In some cases, they are known as finance managers while in others as vice-president (finance), director (finance), and financial controller and so on. S/He reports directly to the top management. Various sections within the financial management area are headed by managers such as controller and treasurer.

Figure 2.3: Finance in the Organization structure of a firm

- The board of directors constitutes the source of ultimate authority in the company. The board of directors represents the shareholders and are responsible for the successful management of a company.
- The chairman is the head of the board of directors. He chairs the board of directors' meetings.
- The Managing Director is the Chief Executive Officer to whom the other directors report. Sometimes in some companies in Nigeria, the Chairman can be the Chief

executive officer.

- The Finance Director is one of the key executives and is the chief financial officer (CFO), responsible for the formulation of major financial policies in the firm. The finance director also interacts with other executive directors to present the financial implications of major decisions in other areas. He specifies the duties of other financial officers who report to him, and is held accountable for the treasurer's and controller's activities.
  Specific finance functions are typically divided between the treasurer and the controller.

- The Treasurer
  The treasurer is one of the top financial officers. He is responsible for the following:

  - Banking relationships.
  - Cash Management- reports on the daily cash position of the firm and its working capital
  - Money market and capital market
  - Foreign exchange management
  - Dividend disbursement
  - Credit management, insurance and pension's management.

- The Controller
  The controller is another top financial officer of a company. He is responsible for the following

  - The recording and reporting of financial information
  - Preparation of budgets and financial statement
  - Payroll, taxes and internal auditing.

In a small company, the same person can perform the role of the treasurer and controller under the title of treasurer, controller or finance director.

FINANCIAL MANAGEMENT AS A TOOL FOR PLANNING AND CONTROL

Introduction

Financial management involves planning, controlling and monitoring financial resources to achieve organisational objectives. Faced with accelerating rate of change in the technical, political, social and economic forces, the management of organisations has become more difficult requiring greater skills in planning, analysis and control.

Background

Financial planning involves analysing the financial flows of a company, forecasting the consequences of various investment, financing and dividend decisions and weighing the effects of various alternatives. The idea is to determine where the firm has been, where it is now and where it is heading – not only the most likely course of events, but deviation from the most likely outcome. The advantage of financial planning is that it forces management to take account of possible deviation from the company's anticipated path. The aims in financial planning should be to match the needs of the company with those of the investors with a sensible gearing of shortterm and long-term fixed interest securities and eliminate waste resulting from complexity of operation (e.g. by providing policies and procedures which make possible a closer coordination between various functions of the business enterprise). A firm which does not perform financial planning, depends upon past experience for the establishment of its objectives, policies and procedures. It may be summarized that financial planning should

- Determine the financial resources required in meeting the company's operating program.
- Forecast the extent to which these requirements will be met by internal generation of funds and to what extent they will be met from external sources.
- Develop the best plans to obtain the required external funds.
- Establish and maintain a system of financial control governing the allocation and use of funds.
- Formulate programs to provide the most effective cost - volume - profit relationship.
- Analyse the financial results of operation.
- Report the facts to the top management and make recommendations on future operations of the firm.

Steps in Financial Planning

Financial planning involves the following steps:

Establishing objectives - The financial objective of any business enterprise is to employ capital in whatever proportion necessary and to increase the productivity of the remaining factors of production over the long run. Although the extent to which the capital is employed varies from firm to firm, the overall objective is identical in all firms. Business enterprise operates in a dynamic society, and in order to take advantage of changing economic conditions, financial planners should establish both short-term and long-term objectives. The long-term goal of any firm is to use capital in the correct proportion. The managers of an organisation know it very well that in today's world, innovation and adaptation is crucial to be successful in the dynamic market. The impact of innovation on key value drivers also has to be examined to remain in the forefront in the industry. While establishing the objectives, the innovation and the value-driver should be clearly stated. Constant innovation and adaptation of key business processes is assuming increasing importance in establishing the objectives of a company.

Policy Formulation - Financial policies are guides to all actions, which deal with procuring, administering and disbursing the funds of business firms. The policies may be classified into several broad categories:

- Policies governing the amount of capital required for firms to achieve their financial objective.
- Policies which determine the control by the parties who furnish the capital.
- Policies which act as a guide in the use of debt or equity capital.
- Policies which guide management in the selection of sources of funds.
- Policies which govern credit and collection activities of the enterprise.

Forecasting - A fundamental requisite of financial planning is the collection of facts. However, where financial plans concern the future, "facts" are not available. Therefore, financial management is required to forecast the future in order to predict the variability of factors influencing the type of policies formulated.

Formulation of Procedures - Financial policies are broad guides which, to be executed properly, must be translated into detailed procedures. This helps the financial manager to put planned activities into practice. The objective setting and forecasting may be done by considering some facts and figures. But formulation of procedure is the backbone of procurement, operation, distribution, logistics and collection from debtors. It is a complex flowchart involving all possible options.

Characteristics of Financial Planning

A good financial plan is characterized by the following:

i. **Simplicity of purpose** - The planning schedule should be organized and should be as simple as possible so that the understanding of it becomes easier.
ii. **Intensive use** - A wasteful use of capital is almost as bad as inadequate capital. A financial plan should be such that it will provide for an intensive use of funds. Funds should not remain idle, nor should there be any paucity of funds. Moreover, they should be made available for the optimal utilization of projects.
iii. **Financial contingency** - Planning, as it is commonly practiced today, tends to build in rigidities, which work against a quick and effective response to the unexpected event. Contingency planning or a strategy for financial mobility should be brought into the open for a careful review. Every business has objectives that guide policy in their most basic form and include survival, profitability and growth. Growth objectives that are central to a philosophy of successful management may be expressed in a variety of ways – sales, profits, market share, geographical coverage and product line. However, they are all contingent on a continuous flow of funds which make it possible for the management to implement decisions. Financial contingency planning is a strategy, which a firm adopts in situations of adversity.
iv. **Objectivity** - The figures and reports to be used for a financial plan should be free from partiality, prejudice and personal bias. A lapse from objectivity is undesirable as it may mislead and make it difficult if not impossible for a firm to

prepare a fact-finding plan.

v. **Comparisons** - Figures and reports should be expressed in terms of standards of performance. Financial executives often take decisions based upon their personal judgments. These decisions are subjective. Subjectivity can be eliminated if standards of performance, including those of past performance are clearly highlighted and properly documented.

vi. **Flexibility** - The financial plan should be such that it can be made flexible, so that it can be modified or changed, if it is necessary to do so. Such flexibilities include making provisions for valuable or convertible securities, avoiding restrictive or binding provisions in debentures and preferred stock and introducing flexible sinking fund position in debenture financing. The environment of a firm may change from time to time. It is therefore advisable to have a more versatile plan than a routine one.

vii. **Profitability** - A financial plan should maintain the required proportion between fixed charge obligations and the liabilities in such a manner that the profitability of the organization is not adversely affected. The most crucial factor in financial planning is the forecasting of sales which almost invariably represents the primary source of income and cash receipts. Besides, the operation of the business is geared to the anticipated volume of sales. The management should recognize the likely margins of error inherent in forecasts, and this recognition would enable the management to avoid the hazards involved in attaching a false accuracy to forecast data based on tenuous assumptions.

viii. **Maneuverability** - Maneuverability is the direct result of a management's adherence to the financial structure which is acceptable to the business community i.e. creditors, shareholders, bankers, etc. It is necessary to choose a financial plan, which may control the crisis that may develop from time to time. It is well known that any financial plan should aim at a proper balance between debt and equity. This is essential to ensure that the stake of the entrepreneur in an industry or a concern is substantial, so that his handling of the affairs, financial and others may be in its best interest.

ix. **Risks** - There are different types of risks but the financial manager is more concerned about the financial risk which is created by a high debt-equity ratio than about any other risk. If earnings are high, the financial risk may not have much of an impact. In other words, if the economic risks of the business activities are reduced to a minimum, a firm may not be exposed to financial risks. Its refinancing should be planned in such a manner that the impact of risk is not seriously felt.

Planning is essential for any business operations so that the capital requirement may be assessed as accurately as possible. A plan should be such that it should serve a practical purpose. It should be realistic and capable of being put to intensive use. But a proper balance between fixed and working capital should be maintained.

Limitation of Financial Planning

Plans are decisions and decisions require facts. Since facts about the future are non-existent, assumptions concerning the future must be substituted. Since future conditions cannot be forecasted accurately, the adaptability of plan is seriously limited. This is true for plans which cover several years in advance, since reliability of forecasting decreases with time. On the other hand, plans which cover a relatively short period, such as interest rates, and general business conditions can be predicted with a good degree of accuracy.

One way to offset the limitations imposed by management's inability to forecast future condition is to improve their forecasting techniques. Another way to overcome this limitation is to revise plans periodically. The development of variable plans, which take into account changing conditions, will go a long way in eliminating this limitation. Variable budgets are examples of variable plans. Another serious difficulty in planning is the reluctance or inability of the management to change a plan once it has been made. There are several reasons for this. First, plans relating to capital expenditure often involve colossal expenditure and commitments for funds are made months in advance and cannot be readily changed. Second, in addition to advance arrangements regarding capital, management often makes commitments for raw material and equipment prior to the time when the plan is to be initiated. Third, management personnel may resist change, which creates rigidity. Financial planning is limited when there is lack of coordination among the personnel. Financial planning affects each function in the organization, and to be effective, each function should be coordinated in order to ensure consistency in action.

Financial Controls

Financial controls are the procedures, policies, and means by which an organization monitors and controls the direction, allocation, and usage of its financial resources. Financial controls are at the very core of resource management and operational efficiency in any organization.

Required Processes

The implementation of effective financial control policies should be done after a thorough analysis of the existing policies and future outlook of a company. In addition, it is important to ensure the following four processes are completed before implementing financial control in a business:

1. **Detecting overlaps and anomalies** - Financial budgets, financial reports, income statements, statement of financial position, etc. present the overall performance and/or operational picture of a business. Hence, while formulating financial control policies, it is very important to detect any overlaps and/or anomalies arising out of the data available. It helps in detecting any existing loopholes in the current management framework and eliminating them.
2. **Timely updating** - Financial control is the essence of resource management and, hence, the overall operational efficiency and profitability of a business. Timely updates of all available data are very important. In addition, updating all management practices and policies concerning the existing financial control methods is also equally important.
3. **Analysing all possible operational scenarios** - Before implementing a fixed

financial control strategy in an organization, it is important to thoroughly evaluate all possible operational scenarios. Viewing the policies from the perspectives of different operational scenarios – such as profitability, expenditures, safety and scale of production or volume – can provide the necessary information. Also, it helps establish an effective financial control policy that covers all operational aspects of the organization.

4. **Forecasting and making projections** - While implementing a financial control policy, forecasting and making projections are very important steps. They provide an insight into the future goals and objectives of the business. In addition, they can help establish a financial control policy in accordance with the business objectives and act as a catalyst in achieving such goals.

Importance of Financial Controls

a. **Cash flow maintenance** - Efficient financial control measures contribute significantly to the cash flow maintenance of an organization. When an effective control mechanism is in place, the overall cash inflows and outflows are monitored and planned, which results in efficient operations.
b. **Resource management** - The financial resources of an organization are at the very core of any organization's operational efficiency. Financial resources make available all other resources needed for operating a business. Hence, financial resource management is crucial in order to manage all other resources. Effective financial control measures hence, are crucial to ensure resource management in an organization.
c. **Operational efficiency** - An effective financial control mechanism ensures overall operational efficiency in an organization.
d. **Profitability** - Ensuring an organization's overall operational efficiency leads to the smooth functioning of every organizational department. This in turn, increases productivity which comes with a direct, positive relationship with profitability. Hence, establishing effective financial control measures ensures improved profitability of any business.
e. **Fraud prevention** - Financial control serves as a preventative measure against fraudulent activities in an organization. It can help prevent undesirable activities such as employee fraud, online theft, and many others by monitoring the inflow and outflow of financial resources.

Examples of Financial Controls

Financial controls are instituted in several areas of an organisation's operations. Some of these are:

1. **Overall financial management and implementation**

- Placing certain qualification restrictions and employing only certified, qualified financial managers and staff working with the formulation and implementation of financial management policies.

- Establishing an efficient, direct chain of communication among the accounting staff, financial managers, and senior-level managers, including the Chief Finance Officer (CFO).
- Periodic training sessions and information sessions among accounting staff, etc. to ensure being updated with the changing laws and evolving business environment concerning business finance.
- Periodic, thorough financial analysis and evaluation of financial ratios and statements wherever fluctuations are significant.
- Delegation of financial duties in a segregated and hierarchical fashion in order to establish a chain of operation and efficiency via specialization.

2. Cash inflows

- Stringent credit reporting policy for all customers before entering into a creditor-debtor relationship with them.
- Periodic reconciliation of bank statements to the general ledger in addition to annual reporting for more efficient financial control.
- Establishing a periodic review policy with all existing customers that the business establishes a creditor-debtor relationship with. This ensures the ongoing creditworthiness of customers and eliminates the probability of bad debts.
- Support files and backups for all financial data in a separate secured database with access only permitted to senior management staff.

3. Cash outflows

1. Automatic/subscription payments to be monitored and requiring proper authorization in order to control extravagant business expenditure
2. Maintaining a vendor database with detailed purchase records with restricted access in order to monitor cash outflow efficiently
3. Periodic reconciliation of bank statements to the general ledger
4. Clear and precise expense reimbursement policy to be maintained, including detailed expense reports and receipt verifications in order to curb extravagant business expenses and employee fraud

NATURE AND RISKS OF FINANCE

Introduction

Risk is the variability that is likely to be associated with the future returns from a project. Strictly, risk is a situation where the future outcomes is unknown, but the likelihood of various possible future outcomes may be assessed with some degree of confidence, probably based on knowledge of past or existing events in other words, probabilities of possible outcomes can be estimated.

Background

To function properly in business, an investor should consider the risk taken especially in the sourcing and usage of funds. If the investor believes that there is some chance, however small, that in the long run he may earn an extra return (profit), he would invest extra effort than he normally would to obtain return on a riskless investment. He will not invest unless he can expect a higher return if the investment does succeed. Though in the course of event, he will not necessarily expect this higher return to become available at once. This allowance for risk, in greater or less degree, is made whenever the yield of the investment is anywhere dependent on the satisfactory result of the undertaking of work for which the full fruits are reaped only after a delay. It is pertinent to note that there can never be a certainty that the fruits, when reaped would be commensurate with the cost of resources (labour, capital etc) expended in the production/marketing. Hence, there is always some chance that part or all of the resources employed may prove to have been wasted.

Classification of Risk

Generally, risk can be classified into two categories named systematic and unsystematic risks.

- Systematic Risk: this is a risk that is caused by external but uncontrollable factor. It is that risk that is common to all investments. It is not within the control of the investor. So, it cannot be reduced or eliminated through portfolio diversification. Therefore, it is alternatively called non-diversifiable risk. It is caused by events such as inflation, economic problems, political problems, war etc. The market pays the investor a premium for the risk.
- Unsystematic Risk: this is unique to a particular security or business. This is the reason why it is called specific risk. It is, therefore, within the control of the management. So, it can be eliminated or reduced through portfolio diversification. In other words, it is a diversifiable risk. It can be caused by such events as the quality of management, location, dependency on limited capital, nature of the products etc.

Forms of Risks

The risk that threatens the complete or partial loss of the postponed fruits of effort can take four main forms:

1. Physical risks
2. Technical risks
3. Economic risks
4. Political risks

1. Physical Risks and Finance

These are risks that some accident may destroy or spoil some physical goods created by the work financed. Examples include a stock of food going bad or being eaten up by insects or animals, a house (premises) destroyed by fire, a ship wrecked or sunk and dangers from fire, flood, storm, theft etc. These have always threatened and still threaten the benefit of the fruits of investment in business enterprise.

2. Technical Risks and Finance

These are risks arising from the fact that the producer's skill or that of the subordinates may not be up to the expected level for the plan, hence it may fall short of achieving the intention. If at all it is achieved, it may fall below the standard; i.e. the end -product, at disposal may consume, in its construction, more resources than permitted in making the plans. For example, a farm entrepreneur in a new environment may try to grow crops unsuited to the soil or climate. A new technical process, successful in the laboratory or in small-scale plant may encounter unforeseen difficulties when tried in large-scale production. Wherever experience of the exact process is lacking, whether because the process itself is only newly developed or because of the lack of experience of the people using it, a high degree of technical risk is always present. This is one of the reasons the early stage of enterprise venturing into new areas of producing goods/services, using newly processes are nearly always less satisfactory than anticipated. Experience (know-how) gained by the organization of its particular technical process often constitutes its most valuable possession.

Thus, unforeseen technical risk in finance renders the whole period of intensive work completely wasteful except for the obtaining of valuable experience.

3. Economic Risks and Finance

This category of risks is usually the greatest and closely related to finance. They remain; even though the physical object created suffer no unexpected damage. It is found possible to construct these physical objects with the resources assumed to be available. There are four main kinds of this risk:

i. The risk of an inadequate supply of the resources (raw materials) needed to make the product planned so that it costs more to make than had been expected or even cannot be made at all.
ii. The risk of fall in demand for the product once it has been made.
iii. The risk of a failure of the demand for a product is increased when that product is itself highly durable. iv. The risk that potential purchasers may be prevented from buying by a shortage of finance.

4. Political Risks and Finance

These are risks of losses as a result of the unforeseen intervention by governments. These risks may particularly affect the enterprise operating in or exporting to, a foreign country, where government laws and policies are unstable or discriminatory. This may have untold frustration in the quest for achievement of the expected return on capital investment. Example includes Rent Act, which can affect the status of workers who are tenants if it is not favourable; corporate tax can affect the profit margin of an enterprise and this may in turn have effect on the finances of the organization.

Despite the above classifications of risks, an investor is subject to a variety of other risks which include:

- **Interest Rate Risk:** this risk stems from the variability in the level of interest rates. As rates change, bond with fixed coupon payments experience price changes. Specifically, the higher the interest rates, the lower the price of bonds and vice versa.
- **Default Risk:** this is the probability of failure by the debtor to meet interest and/or principal obligations as and when due.
- **Exchange Risk:** this is the variability of a firm's value that is due to uncertain exchange rates.
- **Price Level Risk:** this arises from changes in the inflation rate which produce uncertainty about the real income from an investment and consequently, about its present or market values as well as its future value.
- **Finance Risk:** it is the risk resulting from leverage i.e. the degree of the firm's assets financed by debt. The higher the percentage of a firm's assets financed by debt, the greater the finance risk and hence the probability of liquidation.
- **Liquidity risk:** this result from inefficient disbursement of a firm's cash flows. A good example is using short-term funds to finance a project with medium or long-term maturity.
- **Market Risk:** this is due to the impact of market conditions on the operation of a firm or on the value of its securities. The higher the correlations between the rates of return on a given security and those on an index representative of the market, the greater the market risks.
- **Operating risk:** this relates to the fixed charges in the firm's operation. The higher the fixed costs, the higher the operating leverage and the operating risk. The reason is that a firm with high operating leverage would require higher sales level in order to reach breakeven points.
- **Business Risk:** it is the uncertainty of income flows caused by the nature of the firm's business. In order words, it is inherent in the operations of a firm or industry. Business risk is divided into two categories: internal and external business risks. o Internal Business risk: it is associated with operating conditions that can be managed within the firm and is reflected in the operating efficiency of the firm. o External business risk: it is associated with operating condition imposed on the firm by circumstances beyond its control such as the political, social and economic environment in which it operates.
- **Portfolio Risk:** it is measured as the standard deviation of the expected return on securities in a portfolio.

Management of Risks

Once risks have been identified and assessed, all techniques to manage the risk fall into one or more of these four major categories:

- Avoidance (eliminate, withdraw from or not become involved)
- Reduction (optimize – mitigate)
- Sharing (transfer – outsource or insure)
- Retention (accept and budget)

i. **Risk avoidance** - This includes not performing an activity that could present risk. Refusing to purchase a property or business to avoid legal liability is one such example. Avoiding airplane flights for fear of hijacking. Avoidance may seem like the answer to all risks, but avoiding risks also means losing out on the potential gain that accepting (retaining) the risk may have allowed. Not entering a business to avoid the risk of loss also avoids the possibility of earning profits.

ii. **Risk reduction** - Risk reduction or "optimization" involves reducing the severity of the loss or the likelihood of the loss from occurring. For example, sprinklers are designed to put out a fire to reduce the risk of loss by fire. This method may cause a greater loss by water damage and therefore may not be suitable. Halon fire suppression systems may mitigate that risk, but the cost may be prohibitive as a strategy. Acknowledging that risks can be positive or negative, optimizing risks means finding a balance between negative risk and the benefit of the operation or activity; and between risk reduction and effort applied. Modern software development methodologies reduce risk by developing and delivering software incrementally.

iii. **Risk sharing** – It is defined as "sharing with another party the burden of loss or the benefit of gain, from a risk, and the measures to reduce a risk." Risk transfer is often used in place of risk sharing in the mistaken belief that you can transfer a risk to a third party through insurance or outsourcing. In practice if the insurance company or contractor go bankrupt or end up in court, the original risk is likely to still revert to the first party. As such, in the terminology of practitioners and scholars alike, the purchase of an insurance contract is often described as a "transfer of risk."

   However, technically speaking, the buyer of the contract generally retains legal responsibility for the losses "transferred", meaning that insurance may be described more accurately as a post-event compensatory mechanism. For example, a personal injuries insurance policy does not transfer the risk of a car accident to the insurance company. The risk still lies with the policy holder namely the person who has been in the accident. The insurance policy simply provides that if an accident (the event) occurs involving the policy holder then some compensation may be payable to the policy holder that is commensurate with the suffering/damage.

iv. **Risk retention** - Risk retention involves accepting the loss, or benefit of gain, from a risk when the incident occurs. Risk retention is a viable strategy for small risks where the cost of insuring against the risk would be greater over time than the total losses sustained. All risks that are not avoided or transferred are retained by default. This includes risks that are so large or catastrophic that either they cannot be insured against or the premiums would be infeasible. War is an example since most property and risks are not insured against war, so the loss attributed to war is retained by the insured. Also, any amounts of potential loss (risk) over the amount insured is retained risk. This may also be acceptable if the chance of a very large loss is small or if the cost to insure for greater coverage amounts is so great that it would hinder the goals of the organization too much.

FINANCING BUSINESS

Introduction

Financing is the process of providing funds for business activities, making purchases, or investing. Financial institutions, such as banks, are in the business of providing capital to businesses, consumers, and investors to help them achieve their goals. The use of financing is vital in any economic system, as it allows companies to purchase products out of their immediate reach. As a business develops, it requires varying amounts of finance depending on the stage of development the business is at.
Background

In order to carry on business activities a business, a firm needs to raise funds from various sources. A firm should realistically evaluate its creditworthiness and investment profile so as to assess the finance option that best suits the needs of the business. The basic things that a firm should consider when assessing the finance option are:

i. Development stage of the business in its financial life cycle such as start-up, developing, or mature stage.
ii. Appeal of the business and its operations in the eyes of investors.
iii. Capital requirement for the business.
iv. Whether personal finance can cover the needs of the business.
v. Whether internal finance can fill the gap between what the business has and what it needs.

Development stages of a business

i. Start-up business: business in this stage face great challenge in obtaining finance due to lack of financial performance history and credit ratings.
ii. Growing business: business in this stage has lesser difficulty in obtaining finance as it has more finance option to select from due to its credit worthiness and operating history.
iii. Aging business: businesses in this stage are usually liquid because they don’t engage in new investment but rather, they are searching for the best way to sell out.

Sources of finance

Fundamentally, sources of finance can be classified into debt financing and equity financing.

Debt financing - debt finance is the money borrowed which is to be repaid over a stated period of time. Debt finance can be short term debt finance or long-term debt finance. It is short term if repayment period is less than one year and it is long term if it has a repayment period that is more than one year. Lenders do not have ownership interest in the business and the obligation of the borrower is pay interest on the loan and repayment of the lump sum at due date. Debt finance can be secured or unsecured. A secured debt is a debt in which the borrower grants interest in an asset (collateral) to the lender. The lender can have a floating charge or a fixed charge on the asset of the firm. In the event of default by the borrower, the lender can use the collateral of the loan to recoup fund by seizing and liquidating it.

Advantages of Debt Financing

The advantages of financing a business through debt include the following:

i. The lending institution has no control over how the company is run and it has no ownership interest.
ii. Once the credit facility is repaid, relationship with the lender ends. This is especially important as the business becomes more valuable.
iii. The interest paid on debt financing is tax deductible as a business expense.
iv. The monthly payment, as well as the breakdown of the payments, is a known expense that can be accurately included in the company's forecasting models.

Disadvantages of Debt Financing

However, debt financing for a business does come with some downsides which include:
i. Adding a debt payment to the monthly expenses assumes that the company will always have the capital inflow to meet all business expenses, including the debt payment. For small or early-stage companies that is often far from certain.
ii. Small business lending can be slowed substantially during recessions. In tougher times for the economy, it can be difficult to receive debt financing unless the borrowing company is overwhelmingly qualified.

Equity financing - equity finance is contributed by owners of the business. The contributors have ownership in the business. They exchange cash or other asset for share of ownership. The control exercised by equity owners depends on their share in the firm. The contributors of equity finance share the risk and reward of ownership. Equity owners have claim on asset and earnings of the firm after all other fixed obligations have been settled. No specific amount is paid as interest on equity finance and there is no repayment obligation unlike debt finance that has a repayment period and also attracts fixed interest. The firm can persuade the equity holders in the deferment of obligation due to them. Raising new finance by issuing equity will result in dilution of ownership and there may be loss of control over the firm.

Advantages of Equity Financing

Funding a business through investors has several advantages, including the following:

i. The company does not have to pay back the money. In the unlikely event of the company going bankrupt, the investor or investors are not creditors. They are partial owners in the company and because of that, their money is lost along with the company.
ii. Monthly payments are not necessary, so there is often more liquid cash on hand for operating expenses.
iii. Investors understand that it takes time to build a business. This removes the pressure of having to ensure that the company's products or business thrive within a short amount of time.

Disadvantages of Equity Financing

Similarly, there are a number of disadvantages that come with equity financing, including the following:

i. Equity financing involves giving up ownership of a portion of the company. The larger and riskier the investment, the more of a stake the investor will want. Unless a deal is later constructed to buy the investor's stake, that partner will take the agreed percentage of the business' profits indefinitely.
ii. Decision making requires stakeholders' consultation thereby curtailing the influence of the original promoter(s) of the business.

Forms of equity finance: the form of equity finance depends on the type of business organization.

- Sole proprietorship: this is a business organization owned by one person. The equity finance is the capital contributed by the sole owner of the business which can be in cash or asset. The capital will be increased by additional capital introduced by the owner and profit retained in the business while it will be reduced by drawings made by the owner.
- Partnership business: this is a business carried on by two or more people. The equity finance is the capital contributed by the partners according to partnership agreement which can be in the form of cash or asset. Equity can be increased by undistributed profit and it can be reduced by drawings. Additional equity can be injected into the business by existing partners. If new equity is to be introduced by a new partner, the partnership business will be dissolved and a new partnership will be formed. Sole proprietorship and partnership offer limited equity when compared to a limited company that can offer its share to the public and where shares can be easily transferred.
- Limited company: equity finance is represented by shares. Shares divide the capital of the firm into smaller units with a par value. The par value can be the nominal value of the face value. There are two types of equity finance in limited companies which are ordinary shares and preference shares. Ordinary shares: ordinary share is a unit in the capital of a company. It is raised by owners of the company. It has a nominal value of a face value. The authorised share that can be raised by a company is stated in its memorandum and articles of Association of the company. Ordinary shareholders have voting rights in a company and the

extent of their voting rights depends on the number of ordinary shares owned. Ordinary shareholders have residual claims over the income and asset of the company. Preference shares are finance contributed by the investing public. Preference shareholders do not have ownership in the company and thus they do not have a voting right in the company. Preferences shares attract fixed dividend which is settled before ordinary shareholders' dividend. The dividend of preference shareholders can only be paid when the company has sufficient undistributed profit. However, where the preference share is cumulative preference shares, the company will pay any unpaid cumulative preference dividend at a later year when it has sufficient undistributed profit. The dividend is calculated as a percentage of the nominal value of the share. Preference shares are part of the shareholders' funds in a company. There are the various types of preference shares viz:

i. Redeemable preference shares
ii. Irredeemable preference shares
iii. Cumulative preference shares
iv. Participating preference shares
v. Convertible preference shares

Debt Vs Equity

The choice of the two sources of capital depends on a number of considerations such as cost and repayment, business control, flexibility and profitability. Debt carries mandatory interest payment and repayment of principal at maturity. These are burdens which many firms may not be able to shoulder in times of adverse economic development and low profitability.

Debt is however said to enhance profitability as the interest on it is tax deductible thereby leaving more profit for sharing. Rationality demands that equity is relied on as its cost is variable and principal irredeemable. Flexibility in financing favours debt as it could be retired (redeemed) at maturity thus freeing the firm from its (debt) conditions. Equity is perpetual and therefore carries endless demands for dividends although its payment is not as rigid as that of interest on debt. Reliance on equity unarguably engenders increased share flotation which characteristically brings in more co-owners thus diluting the company's ownership.

The arguments above tend to favour the use of debt rather than equity thus underscoring the idea that debt financing is virtuous as it not only complements equity but maximizes the wealth of investors. However, this assertion is not a settled issue. It is contested on the grounds that debt financing threatens the solvency of the firm resulting in financial risk. The contest has given rise to conflicting theories of capital structure namely: the net income thesis, the net operating income thesis and the traditional thesis. While the first favours the use of debt financing, the second is against it. The traditional thesis strikes a balance between them indicating that though debt finance may be good, there is a limit beyond its advantage turns into disadvantage.

Classification of source of finance by maturity

Short term financing: short term finance is used in financing short term working capital and they are payable with one year. Examples of short-term financing include trade credit, bank overdrafts, short term loans, commercial papers, banker's acceptance, asset-based financing.

The first problem in dealing with the short-term sources is how to determine the amount of finance which the firm should use. This can be tackled appropriately by applying the matching principle which involves matching temporary needs for funds with short-term sources of financing and permanent needs with long-term sources.
The next problem concerns the question of what specific sources of short-term financing to select. In this case, there are four major considerations in selecting a source of short-term finance. They are:

a. The burden or cost implications of credit;
b. The availability of credit properly packaged as to the amount needed and for the period of time when financing is required;
c. The influence of the use of a particular credit source on the cost and availability of other sources; and
d. Ability to provide the necessary requirements to secure the credit.

The following are the sources of short-term finance:

i. Internal sources of fund through cash flow management: Firms should manage the inflow and outflow of cash efficiently because it is essential to liquidity and profitability. Cash flows can be managed by speeding up payment from trade debtors, inventory management, controlling expenses and delaying payments.
ii. Trade credits: this is another short means of finance. The company buys goods, raw materials and other supplies on credit without any formal agreement for the liability. It is an unsecured form of short-term finance since no collateral is pledged to the seller. It represents an interest free source of short-term finance.
iii. Bank overdraft: it is a short-term finance provided by banks for a period not exceeding one year. It attracts interest and the borrower must maintain a current account with the bank. Bank overdraft is used to finance working capital or other transactions with duration less than a year. This arrangement allows the borrower to draw more than he has in his account which is subject to a limit determined by the bank. Interest is charged on the overdrawn amount. Bank overdraft can be secured or unsecured. This type of finance is payable on demand.
iv. Short term loan: this involves a formal agreement between a lender and a borrower. The lender agrees to lend the borrower a specific amount of money which is repayable at a specific date and it attracts interest. This type of finance is not repayable on demand and interest is charged on the lump sum amount borrowed.
v. Commercial Papers: these are unsecured short-term promissory notes issued by companies directly to the investing public through an issuing house. The tenor ranges between 30 and 180 days and they are issued at a discount to

the face value. The face value will be paid to investor at maturity.

Medium term financing: the maturity of this type of finance ranges between one year and five years. The following are examples of medium-term finance.

i. Term loan: this is a loan between a lender and a company with maturity that extends beyond one year and runs up to five years usually at a fixed rate of interest. In some cases, the interest rate on the loan may be variable. Term loan can be secured or unsecured depending on the creditworthiness of the company. The repayment of term loan is at a specific agreed date, usually by fixed equal installment.
ii. Finance lease: a lease is a contract between the owner of an asset (lessor) and the user of the asset (lessee) granting the user or lessee the exclusive right to use the asset, for an agreed period in return for the payment of rent. Finance lease agreements in most cases cover the useful economic life of the asset. The lessee is responsible for the upkeep, insurance, servicing and maintenance of the asset. Types of finance lease include: sale and leaseback, direct leasing and leverage leasing.
iii. Hire purchase: hire purchase agreement is a credit sale agreement by which the owner of the asset or supplier grants the purchaser the right to take possession of the asset but ownership will not pass until all the hire purchase payments or installment have been made. The purchaser will pay the hire purchase payment over an agreed period. The hire purchase payments consist partly of capital payments towards the purchase of the asset and partly of interest charges. The owner of the asset takes full possession of the asset when there is default in installment payment and the amount paid by the purchaser will be lost.
iv. Loan/lease syndication: it's a situation where two or more participating banks pool their funds together to provide lending/lease to a single borrower. The lending/lease will be coordinated by a lead bank.

Long term financing: Long term financing options can also be referred to as capital market financing option. It means financing by loan or borrowing for a term of more than one year by way of issuing equity shares, by the form of debt financing, by long term loans, leases or bonds and it is done for usually big projects financing and expansion of company and such long term financing is generally of high amount. The fundamental principle of long-term finances is to finance the strategic capital projects of the company or to expand the business operations of the company. These funds are normally used for investing in projects that are going to generate synergies for the company in the future years.

Sources of Long-Term Financing

Sources of Long-Term Financing

i. **Equity** - It represents the interest-free perpetual capital of the company raised by public or private routes. Either the company may raise funds from the market via Initial Public Offering (IPO) or may opt for a private investor to take a substantial amount of stake in the company. In equity financing, there is a dilution in the ownership and the controlling stake rest with the largest equity holder. The equity holders have no preferential right in the dividend of the company and carry a higher risk across all the buckets. The rate of return expected by the equity shareholders is higher than the debt holders due to the excessive risk they bear in terms of repayment of their invested capital.

ii. **Preference Capital** - Preference shareholders are those who carry preferential rights over equity shareholders in terms of receiving dividends at a fixed rate and getting back invested capital in the company in case the same (company) is wound up. It is a part of the net worth of the company thus increasing the creditworthiness and improving the leverage as compared to the peers.

iii. **Debenture** – This is a loan taken from the public by issuing debenture certificates under the common seal of the company. Debentures can be placed via public or private placement. If a company wants to raise money via NCD from the general public, it takes the debt IPO route where all the public subscribing to it gets allotted certificates and are creditors of the company. If a company wants to raise money privately, it may approach the major debt investors in the market and borrow from them at higher interest rates. They are entitled to a fixed payment of interest as per the agreed-upon terms mentioned in the term sheet. They do not carry voting rights and are secured against the assets of the company. In case of any default in payment of debenture interest, the debenture holders can sell the assets of the company and recover their dues. They can be redeemable, irredeemable, convertible, and non-convertible.

iv. **Term Loans** - They are given generally by banks or financial institutions for more than one year. They have mostly secured loans given by banks against strong collaterals provided by the company in the form of land & building, machinery, and other non-current assets. They are a flexible source of finance provided by the banks to meet the long-term capital needs of the organization. They carry a fixed rate of interest and give the borrower the flexibility to structure the repayment schedule over the tenure of the loan based upon the cash flows of the company. It is faster as compared to the issue of equity or preference shares in the company as there are fewer regulations to abide and less complexity.

v. **Retained Earnings** - These are the profits that are being kept aside by the company over a period of time to meet the future capital needs of the company. These are free reserves of the company which carry nil cost and are available free of cost without any interest repayment burden. It can be safely used for business expansion and growth without taking additional debt burden and diluting further equity in the business to an outside investor. They form part of the net worth and have an impact directly on the equity share valuation.

FINANCIAL INTERMEDIATION

Introduction

Financial intermediation involves the matching of lenders with savings to borrowers who need money by an agent or third party such as a bank or any other financial institution. In other words, the financial institutions facilitate the mainstreaming of funds from those who have more than what they need to those who need more than what they have. Financial institutions act as middle men between the two parties in the financial space. Financial intermediation is a form of indirect financing. There are various forms of financial intermediation, each with its own characteristics.

Background

Financial intermediation is the process by which financial intermediaries provide a linkage between surplus units and deficit units in the economy. Surplus units are firms/individuals who have excess funds above their immediate needs while those who need this fund for immediate investment programmes are referred to as the deficit units. Funds or capital may be raised either internally or externally. Internal means of raising fund may be through contribution made by the shareholders, savings or in other word, ploughing back of profit or issue of new capital from the shareholders. These are usually done without borrowing from external sources. External finance on the other hand is a means of raising fund by borrowing from a third party which could be friends or financial institutions.

Market for loanable funds

This shows the market or institutions where funds can be borrowed by an economic unit to finance its economic activities. This is usually done by the deficit unit. The deficit unit raises it either directly or indirectly through the financial intermediaries from the surplus unit.

The deficit unit comprises those economic units that need funds to pursue their economic activities, which are short of capital or funds for investment purposes. They therefore approach the surplus unit who are in possession of excess capital at their disposal either directly or otherwise in order to achieve their investment objectives.

Direct means of financing the deficit unit is by going directly without any intermediaries to the surplus units, for example, an individual or corporation may borrow fund from his/her friends or relatives for the establishment or growth and expansion of his/their business. Here the lenders belong to the surplus unit through an indirect way, which is usually through an intermediary (i.e. financial institutions). Financial institutions are the monetary group made up of banks, building societies, credit unions etc. Monetary group are mainly commercial banks and merchant banks which grant loans to the deficit unit in return for repayment of lump sum, payment of interest and some other conditions which are referred to as financial instruments. The second group or the non-bank financial institutions includes insurance companies, building societies, Pension funds, Development Banks and other Non-Bank Monetary Institutions.

A unit also exists within an economy which falls in between the deficit and surplus units. This unit is known as the neutral unit. This group has enough funds to meet their financial obligations, without looking either through direct or indirect means to obtain loans from the surplus unit. Having enough money shows they do not belong to the deficit unit. This group also cannot afford to lend to others which means they are not in the surplus unit. It only falls at the middle point of the other two units. It can be categorically said that this type of units are not common and if they exist, will only be few.

The savings/investment process in capitalist economies is organized around financial intermediaries, making them central institutions of economic growth. Financial intermediaries are firms that borrow from consumer/savers and lend to companies that need resources for investment. They also develop the facilities and instruments which make the lending and borrowing between economic units possible. In any economy, it is advisable for the surplus unit to channel their fund to the deficit unit through the financial intermediaries because of the advantages and functions of financial intermediaries.

Financial institutions are institutions that perform the intermediation role of mobilising resources from the surplus unit for the use of the deficit unit for investment purposes. They fall between the ultimate users of funds and ultimate savers of funds. They therefore serve as a link between those units that are in excess of funds and those in need of funds for economic activities since domestic mobilization of resources is of vital importance for the development of any economy. It should be noted that financial intermediaries are neither surplus nor deficit units in any substantial sense, but depend upon the existence of the surplus and deficit units, and on their own ability to match the need for, and availability of finance. They are participants in the financial market, along with industrial and commercial companies, individuals of course and various agencies of government.

Basically, financial intermediaries are the root institutions in the savings-investment process and have the following characteristics:

- Their main category of liabilities (deposits) are specified for a fixed sum which is not related to the performance of a portfolio
- The deposits are typically short-term and of a much shorter term than their assets

- A high proportion of their liabilities are chequeable (can be withdrawn on demand)
- Their liabilities and assets are largely not transferable. There are exceptions such as certificates of deposit and securitisation

Roles of Financial Intermediaries

i. Mobilization of savings
ii. Allocation of funds for investment. The efficient allocation of available domestic resources is of vital importance in the development process.
iii. Financial institutions offer an efficient institutional mechanism through which resources can be mobilised and directed from less essential uses to more productive investments.
iv. They assist in the growth of total financial assets relative to the growth in money as a country develops.
v. They bring about structural change in the system itself.
vi. They assist in aggregation service of collecting funds from scattered sources and making them available to the deficit unit in large size.
vii. They offer great accessibility or ease in the borrowing of funds.
viii. Reduce the risks savers face in earning returns on their savings.
ix. They assist in the area of security transformation through the purchase of primary securities and offering them as their own better securities.

Types of Intermediation

1. **Maturity intermediation** – A bank or financial institution borrows short term funds from the savers and loan the money out for a longer tenor than the deposit tenor. The lender usually wants to be able to have access to his funds in the event of an emergency i.e. he/she is wary of being short of liquidity. This results in the lender having a strong preference for loans with a short time horizon. Conversely, the borrower wishes to have security of his/her funds over the life of the project or investment. Consider the example of investment in new plant and machinery with a life of 15 years. Assume also that funds are required for the full life of the plant but loans are only available with a maturity of 3 years. This would necessitate the borrower having to renew the loan or find alternative lending facilities every 3 years or five times over the life of the project. Banks can fulfill this gap by offering short term deposits and making loans for a longer period. This is called 'maturity transformation/intermediation'
2. **Liquidity intermediation** - Banks or financial institutions provide liquidity to both savers and borrowers by making money available to savers when required while also making funds available as loans to borrowers who have proper documentation at reasonable interest.
3. **Size/Denomination intermediation** – Banks or financial institutions accept deposits in small amounts from many people and give that money to borrowers who require large sums of money. The utility functions of borrowers and lenders differ in a number of ways. Borrowers often require quite large quantities of funds whereas the lender generally will only have smaller amounts of surplus

funds. In other words, the capacity of the lender is less than the size of the investment project. For example, the purchase of a house is likely to require more funds than can be provided by any individual lender. Thus, the bank will collect a number of smaller deposits, parcel them together and lend out a larger sum. This is called 'size transformation/intermediation'

4. **Risk intermediation** – banks or financial institutions take the risk of giving loans to customers who enjoy risk free return in the form in the form of interest on deposits. Lenders will prefer assets with a low risk whereas borrowers will use borrowed funds to engage in risky operations. In order to do this, borrowers are willing to pay a higher charge than that necessary to remunerate lenders where risk is low. It is risky for an individual to give loan to the borrower but financial institutions have the expertise to appraise a borrowing customer so that owners of funds can enjoy risk free return in the form of interest.

Risks of Financial Intermediation

A major objective of financial institution (FI) management is to increase the FI's returns for its owners. This often comes, however, at the cost of increased risk. These risks are:

i. **Interest rate risk** - The risk incurred by an FI when the maturities of its assets and liabilities are mismatched.
ii. **Market risk** - The risk incurred from assets and liabilities in an FI's trading book due to changes in interest rates, exchange rates, and other prices.
iii. **Credit risk** - The risk that promised cash flows from loans and securities held by FIs may not be paid in full.
iv. **Off-balance-sheet risk** - The risk incurred by an FI as the result of activities related to its contingent assets and liabilities held off the balance sheet.
v. **Foreign exchange risk** - The risk that exchange rate changes can affect the value of an FI's assets and liabilities denominated in nondomestic currencies.
vi. **Country or sovereign risk** - The risk that repayments to foreign lenders or investors may be interrupted because of restrictions, intervention, or interference from foreign governments.
vii. **Technology risk** - The risk incurred by an FI when its technological investments do not produce anticipated cost savings.
viii. **Operational risk** - The risk that existing technology, auditing, monitoring, and other support systems may malfunction or break down.
ix. **Liquidity risk** - The risk that a sudden surge in liability withdrawals may require an FI to liquidate assets in a very short period of time and at less than fair market prices.
x. **Insolvency risk** - The risk that an FI may not have enough capital to offset a sudden decline in the value of its assets.

Financial Disintermediation

Disintermediation is the process of removing the middleman or intermediary from future transactions. In finance, disintermediation is the withdrawal of funds from intermediary financial institutions, such as banks and savings and loan associations, to invest them directly. This is a process whereby either:

a. Ultimate borrowers and lenders bypass the normal methods of financial intermediation and find other ways of lending or borrowing funds.

b. Lending and borrowing directly to and from each other, avoiding financial intermediation altogether. For example, if the government squeezes bank lending and company liquidity is high, companies are likely to lend directly to each other in the inter-corporate money market usually by means of commercial papers. This is particularly so in the case of one subsidiary in a group of companies lending to another.

Disintermediation can reduce cost and increase efficiency, but it usually requires more due diligence work. Removing the intermediary may also allow a transaction to go through more quickly. One use of disintermediation involves the securing of additional financial support through a bond issuance. The borrower, in this case, chooses to create a bond issue in lieu of other capital building options, such as a traditional loan. By working directly with interested buyers, the borrower can secure funding without an intermediary.

Risks of Disintermediation

Disintermediation is often associated with an increased burden on the company using the strategy. Since it removes an intermediary from the process, the company may have to dedicate more internal resources to cover the services that were previously handled elsewhere. When associated with issuing bonds, the company will have to dedicate more time and personnel to the management of the funds. In regard to wholesaling, this could include shipping products directly to consumers instead of just supplying retail outlets.

In terms of investing, disintermediation puts a heavier burden on investors, as they are personally responsible for all actions and decisions. This can lead to higher levels of research being necessary on their part, as well as additional time and dedication to complete any transactions. Some investors may find these aspects more challenging, depending on the nature of their investments and personal strategy.

FINANCIAL MARKETS

Introduction

The financial system consists of financial intermediaries, financial markets, financial instruments, rules, conventions and norms that facilitate and regulate the flow of funds through the macro economy. The financial system is controlled by the government through the central bank which supervises the activities of financial intermediaries and monitors adherence to government’s monetary and fiscal policies. The major types of financial intermediaries are the deposit money banks (commercial banks), merchant banks, development banks, finance institutions, insurance companies, mortgage institutions etc. People and organizations wanting to borrow money are brought together with those having surplus funds in the financial markets.

Background

Financial markets are simply the various facilities provided by the financial system for the creation, custodianship and distribution of financial assets and liabilities. Financial asset can either be money or a financial security e.g. bond and shares. The financial market consists of individuals, institutions and instruments which make it possible for the deficit spending unit of an economy to use the surplus funds of the surplus spending unit. A deficit spender is an individual, business or government whose expected expenditure exceeds expected income while the surplus spender has income in excess of expenditure. The market has two major segments, the money market and the capital market.

Functions of Financial Markets

i. Liquidity: Markets help to ensure that buyers and sellers have quick and cheap access to financial instruments. Agents will have the ability to quickly move in and out a financial instrument.
ii. Information: Markets will pool and communicate information about the buyers and sellers of a financial instrument. This is one of the basics of supply and demand.
iii. Risk Sharing: Markets allow individuals to share or pool risk across the entire market. Agents prefer stability and sharing risk is one way to help increase stability.
iv. Efficient intermediation separates the savings and investment functions such that those who save need not be those who invest. The separation therefore allows each function to be better performed.
v. Intermediation encourages savings through the provision in financial markets of various institutions with a variety of financial securities and plans which differ in risk, yield and maturity.
vi. Investment is encouraged through a variety of sources of funds with differing maturities, interest charges and repayments of principal.
vii. The risk of default on loans is reduced through diversifying projects in which borrowed funds are committed.
viii. Funds are efficiently allocated as funds in the market flow to the most productive uses while the unprofitable projects are starved of funds.

Types of Markets

Different financial markets serve different types of customers or different parts of the country. Financial markets also vary depending on the maturity of the securities being traded and the types of assets used to back the securities. For these reasons it is often useful to classify markets along the following dimensions:

i. **Physical asset versus financial asset markets** - Physical asset markets (also called “tangible” or “real” asset markets) are those for products such as wheat, autos, real estate, computers, and machinery while financial asset markets, on the other hand, deal with stocks, bonds, notes, mortgages, and other claims on real assets, as well as with derivative securities whose values are derived from changes in the prices of other assets.

ii. **Spot versus futures markets** - Spot markets are markets in which assets are bought or sold for “on-the-spot” delivery (literally, within a few days). Futures markets are markets in which participants agree today to buy or sell an asset at some future date. For example, a farmer may enter into a futures contract in which he agrees today to sell 5,000 bushels of soybeans six months from now at a price of ₦ 5,000 a bushel. On the other side, an international food producer looking to buy soybeans in the future may enter into a futures contract in which it agrees to buy soybeans six months from now.

iii. **Money versus capital markets** - Money markets are the markets for short-term, highly liquid debt securities. Capital markets are the markets for intermediate or long-term debt and corporate stocks. The Nigerian Stock Exchange is an example of a capital market. There is no hard and fast rule on this, but when describing debt markets, “short term” generally means less than 1 year, “intermediate term” means 1 to 7 years, and “long term” means more than 7 years.

iv. **Primary versus secondary markets** - Primary markets are the markets in which corporations raise new capital. The corporation selling the newly created stock receives the proceeds from the sale in a primary market transaction. Secondary markets are markets in which existing, already outstanding, securities are traded among investors. Secondary markets also exist for mortgages, various other types of loans, and other financial assets. The corporation whose securities are being traded is not involved in a secondary market transaction and, thus, does not receive any funds from such a sale.

v. **Private versus public markets** - Private markets are markets where transactions are negotiated directly between two parties whereas standardized contracts are traded on organized exchanges in public markets. Bank loans and private debt placements with insurance companies are examples of private market transactions. Because these transactions are private, they may be structured in any manner that appeals to the two parties. By contrast, securities that are issued in public markets (for example, common stock and corporate bonds) are ultimately held by a large number of individuals. Public securities must have fairly standardized contractual features, both to appeal to a broad range of investors and also because public investors do not generally have the time and expertise to study unique, non-standardized contracts. Their wide ownership also ensures that public securities are relatively liquid. Private market securities are, therefore, more tailor-made but less liquid, whereas publicly traded securities are more liquid but subject to greater standardization.

The focuses of this module are the money and capital markets in the Nigerian context.

THE MONEY MARKET

Money markets exist to transfer funds from individuals, corporations, and government units with short term excess funds (suppliers of funds) to economic agents who have short-term needs for funds (users of funds). Specifically, in money markets, short-term debt instruments (those with an original maturity of one year or less) are issued by economic agents that require short-term funds and are purchased by economic agents that have excess short-term funds. Once issued, money market instruments trade in active secondary markets.

The need for money markets arises because the immediate cash needs of individuals, corporations, and governments do not necessarily coincide with their receipts of cash. For example, the federal government collects taxes monthly; however, its operating and other expenses occur daily. Similarly, corporations' daily patterns of receipts from sales do not necessarily occur with the same pattern as their daily expenses (e.g., wages and other disbursements). Because excessive holdings of cash balances involve a cost in the form of forgone interest, called opportunity cost, those economic units with excess cash usually keep such balances to the minimum needed to meet their day-to-day transaction requirements.

Consequently, holders of cash invest "excess" cash funds in financial securities that can be quickly and relatively costless converted back to cash when needed with little risk of loss of value over the short investment horizon. Money markets are efficient in performing this service in that they enable large amounts of money to be transferred from suppliers of funds to users of funds for short periods of time both quickly and at low cost to the transacting parties. A money market instrument provides an investment opportunity that generates a higher rate of interest (return) than holding cash (which yields zero interest), but it is also very liquid and (because of its short maturity) has relatively low default risk.

History of the Nigerian Money Market

The history of the Nigerian Money Market is closely linked to the history of the Central Bank of Nigeria which dates back to 1959. Prior to the establishment of CBN, commercial banks in Nigeria had to export their cash surplus to foreign money markets to earn income. The alternative was to hold large cash balances which yielded no income. On the establishment of the CBN, licensed commercial banks were required to hold a minimum amount of specified liquid assets as a proportion of their deposit liabilities. The specified liquid assets included notes, coins, balances at the CBN, balances with other licensed banks, money at call, treasury bills, treasury certificates, bills of exchange and rediscountable promissory notes.

Thus, a market for the specified liquid assets was created for licensed banks to invest surplus funds for short periods so as to earn income and to satisfy liquidity requirements. The market also facilitated trading in government securities.

The basic functions of the Nigerian money market include:

i. Provision of short tenured liquid financial instruments for public and private investment thus covering for financial gaps of short duration. Consequently, the market facilitates expansion of trade, industry and commerce

ii. It facilitates proper implementation of CBN monetary policies. Indeed, without effective, well developed money market, the practice of indirect monetary management will be difficult.
iii. The market facilitates financial mobility from one sector of the economy to another and also from the surplus to deficit economic agents within the economy.
iv. By its nature, the money market provides facilities and instruments for financial liquidity and safety. Accordingly, it encourages savings and therefore, investments
v. The market can also serve as the barometer for interest rate adjustment both for lending and borrowing. This arises from the level of liquidity, mainly in the banking system.

Participants in the Nigerian Money Market

The major participants in the money market are:

i. Central Bank of Nigeria
ii. Nigeria Deposit Insurance Corporation
iii. Deposit Money Banks (Commercial Banks)
iv. Merchant Banks v. Discount Houses
v. Microfinance Banks vii. Insurance Companies
vi. Pension Funds
vii. Other organisations

Features of the Money Market

i. The rate of return in the market generally reflects the rate of inflation in the economy.
ii. The market is available to both small and big fund users.
iii. Transaction costs are very low compared to capital market transactions
iv. Return on investment is very low but is usually sufficient to take care of that part of the investor's capital that could be lost to inflation.

Money Market Instruments

Money market instruments are the medium through which short-term funds are raised in the market. The instruments are generally issued in the primary money market and can be discounted or traded for funds prior to maturity in the secondary money market. The major money market instruments in Nigeria include:

i. **Treasury Bills (TBs)** – These are instruments issued by the CBN to raise short -term funds for the government treasury. The bills have a maturity of 91 days and are usually sold at a discount. Each bill has a face value of N = 100 but they are sold in multiples of N = 1000 as the minimum unit. The first TBs were raised in April 1960 to raise N = 8m for the Federal Government Treasury. The major buyers of TBs are the commercial banks and the CBN.

ii. **Treasury Certificates (TCs)** – They are medium-term securities of one or two-year tenor issued by the CBN to raise funds for the Federal Government treasury. The securities are usually sold to bridge the gap between TB issue and long-term Federal Government Loan Stock issue. Like treasury bills, TCs are sold at a discount although the discount on TCs is usually higher than that on TBs because of their longer tenor. The first sets of TCs were issued in 1968. The major buyers of TCs are the CBN, commercial and merchant banks.

iii. **Bankers' Unit Funds (BUFs)**–BUFs were first issued in 1975nto allow commercial banks, merchant banks and other financial institutions invest their excess funds in Federal Government Development Loan Stocks. Participation in the scheme is in multiples of N = 10,000 and the CBN uses the proceeds to acquire development loan stocks. Participating institutions can withdraw part or all of their investments on demand provided it is made in multiples of N = 10,000. From September 1989, banks stopped buying BUFs due to the liquidity squeeze prevalent during the period and consequent upon which there was no outstanding BUF in the market by the end of 1991.

iv. **Eligible Development Stocks (EDS)** – These are Federal Government Loan Stocks with less than three years to maturity. Although development loan stocks are capital market instruments, those with less than three years to maturity are traded in the money market. The CBN allows banks with holdings of EDS to include the value of such instruments among the banks' liquid assets for the purpose of calculating the banks' statutory liquidity ratios. The traditional holders of EDS are commercial and merchant banks.

v. **Certificates of Deposits (CDs)** – CDs come in two variants – the Negotiable Certificates of Deposit (NCD) and the Non-Negotiable Certificates of Deposits (NNCD). The value on a Negotiable Certificate of Deposits can be transferred by negotiation whereas the value on a Non-Negotiable Certificate of Deposit cannot be transferred and so must be held to maturity and be redeemed by the purchaser. These certificates were first issued in 1975 to enable the transfer of surplus funds between banks especially from commercial to merchant banks. The certificates are generally issued in denominations of N = 50,000 with maturities of three to thirty-six months. NCDs can be discounted. The major holders of CDs are the commercial banks.

vi. **Commercial Papers (CPs)** – Commercial papers are commercial bills issued by reputable business houses through issuing houses which are generally banks. Commercial paper is an unsecured shortterm promissory note issued by a corporation to raise short-term cash, often to finance working capital requirements. Commercial paper is generally held by investors from the time of issue until maturity. Thus, there is no active secondary market for commercial paper. Because commercial paper is not actively traded and because it is also unsecured debt, the credit rating of the issuing company is of particular importance in determining the marketability of a commercial paper issue. CPs generally have maturities ranging between 1 and 270 days but the common maturities are 30,60 and 90 days while interest is normally paid up front.

vii. **Bankers' Acceptances (BAs)** - A banker's acceptance is a time draft payable to a seller of goods, with payment guaranteed by a bank. Many banker's acceptances arise from international trade transactions and the underlying letters of credit (or time drafts) that are used to finance trade in goods that have yet to be shipped from a foreign exporter (seller) to a domestic importer (buyer). Foreign exporters often prefer that banks act as guarantors for payment before sending goods to domestic importers, particularly when the foreign supplier has not previously done business with the domestic importer on a regular basis. Because banker's acceptances are payable to the bearer at maturity, they can and are traded in secondary markets. Maturities on banker's acceptances traded in secondary markets range from 30 to 270 days. Denominations of banker's acceptances are determined by the size of the original transaction (between the domestic importer and the foreign exporter).

Features of Money Market Instruments

i. They are short term in nature i.e. usually less than one-year maturity
ii. Securities are usually cash in nature and where not cash can be traded for cash.
iii. Securities are easily transferable.
iv. Money market instruments can be traded over-the counter (OTC) because the market does not have a permanent or designated place of business like it happens in the capital market.

THE CAPITAL MARKET

A capital market is the segment of the financial market where long-term funds are raised. The tenor of the funds is over two years and the major instruments are ordinary shares, preference shares and bonds/debentures. The process of the transfer of funds is done through instruments, which are documents (or certificates), showing evidence of investments. The market actually performs the function of financial intermediation whereby the savings of some members of the society are harnessed and made available to other members of the society for productive investment. For this process of financial intermediation to take place, the capital market is categorised into two – the primary market and the secondary market.

The Primary Market – This is the new issues market as it is concerned with the issue and sale of new securities. The operators in this market are the issuing houses, stockbrokers, banks, the Central Bank of Nigeria, corporate bodies and governments. Investors pass on their resources to these institutions for investment purposes. Such investments can be in the form of stocks and shares. The Securities and Exchange Commission (SEC) sits at the apex of the primary market in Nigeria, regulating the issues of public companies and all private companies with foreign participation. In summary, the primary market caters for:

i. New issues i.e. when a company not previously quoted on the Exchange issues its securities for the first time

ii. Issues of a company previously quoted on Exchange which may, in the course of time, place another issue in order to raise additional funds. This is considered as a new issue.

The Secondary Market – This is the market for the sale and purchase of existing shares and stocks. The centre of activities in the secondary market is the Stock Exchange which provides a market in which holders of existing quoted shares wishing to sell such shares can make contact with individuals and institutions who are interested in buying them. While the primary market is concerned with the issue of new securities, the secondary market provides facilities for the sale and resale of such securities. The existence of a secondary market allows companies to enjoy a measure of stability and continuity as the stock exchange provides facilities which make it unnecessary for companies to fold up merely because some shareholders have decided to dispose of their shares. The main participants in the market are the stockbrokers who are the dealing members of the stock exchange. Also operating in the market are insurance companies and pension fund managers looking for investment avenues for their funds.

Features of the Capital Market

i. The market is a means of long-term source of investment.
ii. Transaction costs are higher in the capital market than the money market.
iii. Accessibility to the market is limited to governments, multinational corporations and big companies.
iv. Investors' rights are protected as regards security of capital.
v. Different segments are created for medium size and big companies as against what obtains in the money market.

The Nigerian Capital Market

A formal capital market came into existence in Nigeria in 1961 with the establishment of the Lagos Stock Exchange (LSE). The non-profit organisation was intended to offer an avenue for companies and government to raise capital, to encourage Nigerians to participate in the nation's industries and to encourage savings and investment. The exchange started with 19 securities. Some years after the establishment of the Lagos Stock Exchange, the government decided to establish branches outside Lagos. In 1977, the Nigerian Stock Exchange (NSE) took over the activities of the Lagos stock exchange and branches were opened at Kaduna and Port Harcourt.

The Securities and Exchange Commission (SEC)

The SEC which is the apex regulatory institutions of the Nigerian capital market is a federal government agency established by the Securities and exchange commission Act 71 of 1979 (which was re-enacted as Decree 29 of 1988). Since inception, SEC has been playing within the capital market, a role similar to that of the CBN in the money market

Objectives of SEC

1. **Investor protection** – ensuring that issuers of financial instruments provide investors with relevant, timely and adequate information about securities and institutions that are subject of public issues. Furthermore, such protection is pursued to prevent fraudulent practices such as false claims, deceit, price manipulation and unfair use of disclosed price sensitive information that could dent public confidence in the securities business.
2. **Capital market development** – this involves creating general awareness about the market as an important source of investment finance and therefore, a catalyst for rapid socio-economic advancement.

Functions of SEC

a. Determining the price at which securities are to be sold, the amount to be sold as well as the appropriate time to issue the securities either through offer for sale or offer for subscription
b. Registration of securities proposed for offer for sale or subscription
c. Maintaining surveillance over the securities market to ensure orderly, fair and equitable dealings in securities
d. Registering stock exchanges or their branches, registrars, securities dealers and other capital market operators with a view to maintaining proper standards of professionalism in securities business
e. Protect the integrity of the securities market against any abuse arising from the practice of insider trading
f. Acting as the regulatory apex organization for the NSE and its branches to which it would beat liberty to delegate power.
g. Creating the necessary atmosphere for the orderly growth and development of the capital market
h. Reviewing, approving and regulating business combinations
i. Undertaking such other activities as are necessary or expedient for giving full effect to the provisions of the Act.

The Nigerian Stock Exchange (NSE)

The NSE started operations in 1961 as the Lagos Stock Exchange which was a non-profit making organization and as a private company limited by guarantee. Some years after the establishment of the Lagos Stock Exchange, the government decided to establish branches outside Lagos. In 1977, the NSE took over the activities of the Lagos Stock Exchange and branches were opened at Kaduna and Port Harcourt

Functions of NSE

(a) To act as a central meeting place for members to buy and sell existing securities and for granting quotation to new issues through the provision of new or fresh capital raised through the market.
(b) To provide machinery through stocks and shares for mobilizing private and public savings and making these available for productive investment.

(c) To facilitate the purchase and sale of securities, thereby reducing the risk of illiquidity.
(d) To provide opportunities for the continued operation and attraction of foreign capital for Nigeria's development.
(e) To facilitate dealings in government securities.
(f) To prescribe requirements for new listings (listing requirements) and to regulate secondary trading activity and the activity of its dealing members.

Instruments: Instruments traded on the capital market are:

a) Debt instruments
b) Equities (a.k.a. common stock)
c) Preference shares
d) Derivatives

i. **Debt Instruments** - A debt instrument is used by either companies or governments to generate funds for capital intensive projects. It can be obtained through the primary or secondary market. The relationship in this form of instrument is that of borrower-creditor and thus does not imply ownership of the business of the borrower. The contract is for a specific duration and interest is paid at specific periods as stated in the contract agreement (trust deed). The principal sum invested is repaid at the expiration of the contract period. The interest payable may be fixed or flexible depending on the contract agreement while the tenure ranges from 3-25 years. Investment in debt instruments is mostly risk-free and therefore yields lower returns when compared to other instruments traded in the capital market.

Types of Debt Instruments

(a) Sovereign bond- Federal Government debt instrument
(b) State bond – debt instrument issued by a state government
(c) Municipal bond –issued by a local government
(d) Debenture/industrial loan/corporate bond – issued by a corporate body or company

ii. **Equity** - This instrument is used by companies only and can also be obtained either in the primary market or secondary market. Investment in this form of business translates to ownership of the business as the contract stands in perpetuity unless sold to other investors in the secondary market. The investor therefore possesses certain rights and privileges (e.g. right to vote and hold position) in the company. The equity holder receives dividends which may or may not be declared. The risk factor in this type of instrument is high and thus yields a higher return (when successful)

iii. **Preference Shares** - This instrument is issued by corporate bodies and possesses the characteristics of equity in the sense that it is added to equity (or common stock) in the calculation of a company's authorized and paid up capital. Preference shares can also be treated as a debt instrument as they do not confer voting rights on their holders and have a dividend payment that is structured like interest (coupon) paid for bond issues.

Types

(a) Irredeemable and Convertible: Upon maturity of the instrument, the principal sum is converted to equities even though interest (dividends) had earlier been paid.
(b) Irredeemable and Inconvertible: Here, the holder can only sell his holding in the securities market as the contract will always be rolled over upon maturity and cannot be converted to equities
(c) Redeemable: the principal sum is paid at the end of a specified period. In this case, it is treated strictly as a debt instrument

NOTE: Interest may be cumulative, flexible or fixed depending on the agreement in the trust deed (contract)

iv. Derivatives - These are instruments that are derived from other securities which are referred to as underlying assets (i.e. the derivatives are derived from them). The price, riskiness and functions of the derivatives depend on the underlying assets since whatever affects the underlying assets must affect the derivative. The derivative might be an asset, index or even situation. Derivatives are mostly common in developed economies.

Examples of Derivatives

1. Mortgage Backed Securities
2. Asset Backed Securities
3. Futures
4. Options
5. Swaps
6. Rights
7. Exchange Traded Funds or Commodities

The common one in Nigeria is Rights where the holder of an existing security gets the opportunity (right) to acquire additional quantity to his holding in an allocated ratio.

Features of Capital Market Instruments

a. They are means of long-term sources of investment.
b. Easily marketable since they are traded daily on the stock exchange (If quoted) hence, they ensure liquidity for the holders at all times.
c. Most capital market instruments (e.g. ordinary shares, unit and investments trusts) have growth potentials. Their market values are based on public perception of the economic powers of the issuing companies.
d. They are easily transferrable hence their use as collateral for bank borrowings.