PAPER NO. AD24

ACCOUNTING TECHNICIAN DIPLOMA (ATD)

LEVEL II

FUNDAMENTALS OF FINANCE

STUDY TEXT
KASNEB SYLLABUS

GENERAL OBJECTIVES

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to apply the principles of finance in business decision making.

8.0 LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Identify various sources of finance for organisations
- Calculate non-complex risk and return measures
- Determine the cost of capital for an organisation
- Evaluate the viability of capital investments using appropriate appraisal techniques
- Advise on various forms of dividends payable by an organisation
- Apply basic concepts of Islamic Finance.

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8.1 Nature and purpose of finance

- Scope of finance
- Relationship between accounting and finance
- Finance functions
- Roles of a finance manager
- Goals of a firm
- Agency theory: conflicts and resolutions

8.2 Sources of finance

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- Long term sources
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- External sources
- Factors to consider when choosing the source of finance

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- Markets participants and financial innovation
- Types of financial markets
- Characteristics of a good market
- Functions of financial markets
- The flow of funds and the financial system
- Organisation and structure of securities markets
 Automation of securities exchanges; automated trading system (ATS). Central depository system (CDS)
 Role of government in the financial system; capital markets authority, central bank, central depository and settlement company

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 Time preference for money
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 Future value
 Discounting and Compounding
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8.5 Risk and return
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 Components of risk
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 Investment appraisal techniques; Accounting Rate of Return (ARR), Payback period, Internal Rate of Return, Net Present Value, and Profitability index
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Revised on: June 2016
CHAPTER 1

NATURE AND PURPOSE OF FINANCE

Meaning of Finance
The term finance should be understood in two perspectives - finance as a resource and finance as a discipline. Finance, as a resource, refers to monetary means of financing assets of an entity. Finance as a discipline or subject of study, describes how individuals, governments and corporate organizations manage the flows of money through an organization. In other words, finance tells how people make decisions about the collection and allocation of resources in organizations like corporation, school, bank or government agency. Therefore, it is important for all individuals, businesses, governments and non-government organizations to appreciate the significance of finance in their day-to-day businesses.

Finance was a branch of economics till the closure of nineteenth century. Finance as a separate academic discipline is still evolving. Practicing managers and academicians have been contributing in its expansion and enrichment.

SCOPE OF FINANCE

At the present state, the academic discipline of finance includes the following specialized areas in its scope.

1. Public Finance
Like business organizations, governments (local, state or federal) raise and spend large sum of money, but unlike business organizations, they pursue non-profit goals. To deal with governmental financial matters, a separate and specialized field of finance has emerged as public finance.

2. Securities and Investment Analysis
This area is of interest to individuals and institutional investors. It covers mainly measurement of risk and return on investment in securities.

3. Institutional Finance
Institutional finance deals with issues of capital formation and the organizations that perform the financing function of the economy. Therefore, it mainly studies saving and capital formation and institutions involved in this process such as banks, insurance companies, provident and pension funds, etc.
4. International Finance
International finance studies economic transactions among nations, corporations and individually internationally. It is concerned with flows of money across international boundaries.

5. Financial Management
Business firms face problems dealing with acquisition of funds and optimum methods of employing the funds. Thus, financial management studies financial problems in individual firms, seeks low-cost funds and seeks profitable business activities.

RELATIONSHIP BETWEEN FINANCE AND ACCOUNTING

Finance and accounting are two closely related activities in a company. 

Finance includes activities that help a company fund its activities and operations.

Accounting is the process of recording and reporting financial figures from business transactions.

The relationship between finance and accounting exists because the former activity often uses figures from the latter. In other cases, finance analysts review accounting information to determine the efficiency and effectiveness of operations.

A company often separates its finance and accounting functions among several workers. This ensures the company has the proper segregation of duties to prevent employees from manipulating information. The company also needs to create specific job responsibilities to further define roles. Large companies may also need to have two separate departments in order to process their financial data. In many cases, the finance department will have fewer employees than the accounting department.

Financial statements are typically the final output from a company’s accounting department. These statements present a record for a specific period in a company’s life. Finance and accounting personnel work together to present the financial statements to upper management. For example, finance personnel may review and make suggestions on correcting the financial statements. Finance personnel may also create ratios in addition to statements to provide additional insight into the data.

Another relationship between finance and accounting is the creation of a company’s budget or working capital analysis. Finance personnel often create budgets to present the expected
financial outlays in the future. Accountants prepare information at the end of each month that affects current budgets. Finance personnel ensure the company maintains its budget and all figures are in proper accounts. Creating new budgets also requires the use of current accounting information.

Working capital analysis and other uses of accounting information also extend the relationship between finance and accounting. Finance personnel must ensure the company has enough cash to operate. A mix of debt or equity financing is often necessary to overcome any cash shortfalls as computed by a working capital or cash budget. Without accounting information, these budgets and the related shortfalls are nearly impossible to determine. Finance personnel can also make other recommendations for working capital adjustments.

Other possible decisions that result from corporate finance include business valuation, investment decisions, and dividend planning. These decisions are all a working part of the relationship between finance and accounting. Companies can also create other relationships based on their need for financial data.

FINANCE FUNCTIONS

The following explanation will help in understanding each finance function in detail

1. Investment Decision

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision

   a. Evaluation of new investment in terms of profitability
   b. Comparison of cut off rate against new investment and prevailing investment.

Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding
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CHAPTER 2

SOURCES OF FINANCE

Sources of finance mean the ways for mobilizing various terms of finance to the industrial concern. Sources of finance state that, how the companies are mobilizing finance for their requirements. The companies belong to the existing or the new which need sum amount of finance to meet the long-term and short-term requirements such as purchasing of fixed assets, construction of office building, purchase of raw materials and day-to-day expenses.

Sources of finance may be classified under various categories according to the following important heads:

1. Based on the Period
2. Based on Sources of Generation

1. Based on the Period

Sources of Finance may be classified under various categories based on the period.

SHORT-TERM SOURCES

Apart from the long-term source of finance, firms can generate finance with the help of short-term sources like loans and advances from commercial banks, moneylenders, etc. Short-term source of finance needs to meet the operational expenditure of the business concern.

Short-term source of finance include:

- Bank overdraft
- Trade Credit
- Leasing
- Bank loans
- Credit cards
- Factoring

Bank Overdraft

Almost all businesses have an account with a bank. All the deposits and withdrawals are dealt by the bank. All banking institutions are aware that businesses do not always get money from sales
straight away. Due to the differences in its proceeds and its costs the organization can often face problems. This problem can be solved by arranging an overdraft.

However, this source of short term business finance has a few disadvantages as well. For small firms the interest rate on an overdraft can be quite high. Also, the business is not permitted to exceed their overdraft limit beyond a point.

**Trade Credit**

This is a source of short term business finance lent for a specific period of time to a business to pay for goods that they have received. Trade Credit cycle usually runs for a period of 28 days. But sometimes businesses may not pay back the loan for much longer durations. This grants the business the time to be able to deal with their finances, and balance their cash flows more efficiently.

Trade Credit is also an excellent way to finance inventories, which refers to the number of days the vendor will allow before the payment is due. Trade credit usually does not cost anything since the vendors offer it as an inducement to continue doing business.

**Credit Card**

This is the short term source of business finance that is very similar to trade credit. If something is bought using a credit card, the businessman is entitled to a certain period of time to either pay the full amount or a partial amount.

Most of the businesses have a corporate credit card. This can be a very helpful, practical and low cost way of expense management if the payment is made in full.

**Lease**

This source of short term business finance implies that the business is paying for the use of a product but it does not own it. Lease is often referred to as hiring. A lease arrangement on a product might mean that the company pays out a certain amount of money per month for a specific number of years. At the end of the time period the product is returned to the owner.

The Lease agreements have the following benefits:

- It is cheaper to coordinate a lease rather than having to purchase the product.

- Leases have a flexibility factor. Product might be needed for a short time or for a particular project and so there is no need for outright purchase.

- The owner of the product is accountable for the upkeep and this reduces the business costs.

- The payments are usually fixed and do not change with the change of interest rates. This makes the business operate more efficiently.
Bank Loans

Bank loans are a highly flexible option for short term business finance. The length of time that the loan has to be repaid can vary. Loans that are given by the bank for less than one year are considered as short term finance. However, this can be expensive since there are interest payments to be made which can sometime vary.

Disadvantages of Short Term Business Finance

Short term business finance is usually very helpful, but sometimes there could be a few downsides of this facility:

1. **Perception of Poor Financial Health**

Investors that the company may be wooing will look at the economic statements before they make a large contribution. They want to ensure that the organization has available cash flow and the credit rating to get itself out of a fix.

If the company needs more money in a hurry, the presence of a short-term loan can inflate the numbers and make it appear that your business is in financial trouble. Open loans reduce your ability to get approved for long-term loans and increase your current overhead. Investors see your business as a risky investment that could falter under the pressure of a short-term loan.

2. **Negative Credit Risk Assessments**

Late payment on the short term business finance can have a negative effect your credit rating.

3. **Insufficient for Long-Term Goals**

This source of financing is best if the business has a pressing need for more cash. They are not at all recommended for financing complete new business ventures

4. **Strain on the Day-to-Day Operations**

Lenders who give money to small business owners usually have strict penalties for delayed payments. This can hugely increase the interest rate on the loan.

5. **Short Term Business Finance – A Summary**

Short term business finance permits the organizations to take advantage of sudden opportunities to make extra revenues or capture business ahead of the competition. Good short term funding sources provide the company with the edge of flexibility and versatility. The better and more dependable the short term sources of financing, the more competitive the organization will end
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CHAPTER 3
FINANCIAL MARKETS AND SYSTEMS

Financial Market, in very crude terms, is a place where the savings from various sources like households, government, firms and corporates are mobilized towards those who need it. Alternatively put, financial market is an intermediary which directs funds from the savers (lenders) to the borrowers.

In other words, financial market is the place where assets like equities, bonds, currencies, derivatives and stocks are traded.

Some of the salient features of financial market are:

- Transparent pricing
- Basic regulations on trading
- Low transaction costs
- Market determined prices of traded securities

ROLES OF FINANCIAL SYSTEM

One of the important sustainability requisite for the accelerated development of an economy is the existence of a dynamic financial market. A financial market helps the economy in the following manner.

- **Saving mobilization**: Obtaining funds from the savers or surplus units such as household individuals, business firms, public sector units, central government, state governments etc. is an important role played by financial markets.
- **Investment**: Financial markets play a crucial role in arranging to invest funds thus collected in those units which are in need of the same.
- **National Growth**: An important role played by financial market is that, they contribute to a nation's growth by ensuring unfettered flow of surplus funds to deficit units. Flow of funds for productive purposes is also made possible.
- **Entrepreneurship growth**: Financial market contribute to the development of the entrepreneurial claw by making available the necessary financial resources.
- **Industrial development**: The different components of financial markets help an accelerated growth of industrial and economic development of a country, thus contributing to raising the standard of living and the society of well-being.
MARKET PARTICIPANTS:

The principle participants in the financial market are as follows:

**Banks:** largest provider of funds to business houses and corporates through accepting deposits. Banks are the major participant in the financial market.

**Insurance companies:** issue contracts to individuals or firms with a promise to refund them in future in case of any event and thereby invest these funds in debt, equities, properties, etc.

**Finance companies:** engages in short to medium term financing for businesses by collecting funds by issuing debentures and borrowing from general public.

**Merchant banks:** funded by short term borrowings; lend mainly to corporations for foreign currency and commercial bills financing.

**Companies:** the surplus funds generated from business operations are majorly invested in money market instruments, commercial bills and stocks of other companies.

**Mutual funds:** acquire funds mainly from the general public and invest them in money market, commercial bills and shares. Mutual fund is also principle participant in financial market.

**Government:** authorized dealers basically look after the demand-supply operations in financial market. Also works to fill in the gap between the demand and supply of funds.

FINANCIAL INNOVATION

Miller, Silber and Van Horne characterize and describe financial innovations as an unanticipated improvement in the array of financial products and instruments that are stimulated by unexpected tax or regulatory impulses.

They cite the following examples;

1) The Eurobond market emerged in response to a 30% withholding tax imposed by the US government on interest payment on bonds sold in the US to overseas investors.
2) Zero coupon bonds were offered to exploit the mistake of the internal revenue service in the US which permitted deduction of the same amount each year for tax purposes. (the tax authority employed simple interest and not compound interest)
3) Financial futures came into being when Bretton woods system of fixed exchange rates was abandoned in the early 1970s.
4) Paper currency was invented when the British government prohibited the minting of coins by the colonial North America.
5) The euro dollar market was developed in response to the regulation in the US that imposed a ceiling on the interest rate payable on time deposits with commercial banks.

6) Financial swaps emerged initially in response to a restriction imposed by the British government on dollar financing by British firms and sterling financing by non-British

Financial innovations refer to development of new products, formation of new institutions, embracing new technology and other aspects that portray newness in the financial markets.

The common types of financial innovations in regard to development of new products are swaps, Eurobonds, Zero coupons bonds, portfolio insurance, and options.

Factors responsible for financial innovations:

i. High level of transaction costs
ii. Need to reduce agency costs
iii. Existing opportunities to increase liquidity of assets for example, factoring of debts.
iv. Regulatory and legislative changes which leads to volatility of interest and exchange rates.
v. The move to floating exchange rates; the major fluctuations in exchange rates have added uncertainty to all international transactions
vi. Computers and information technology- computers can be used to design and develop new products and strategies since they can provide for a large data processing capacity
vii. The world economic growth: - evidence has it that the growth in the world economy can be attributed to improvement in financial performance.
viii. Regulations and deregulations: some innovations are propelled by government regulations for example swaps
ix. Cross listing of securities across stock exchanges.

Other activities that portray financial innovations include; Strategic decision making, system realignment, institutional setting, injecting new management, expanding to new markets

Financial innovations enable institutions to raise their competitive strengths, improve their risk management skills and better satisfy the needs of their customers and market requirements.

The main types of financial innovations include;

a) Institutional innovations
b) Process innovations
c) Product innovations
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CHAPTER 4

TIME VALUE OF MONEY

What Is Time Value?
If you're like most people, you would choose to receive the $10,000 now. After all, three years is a long time to wait. Why would any rational person defer payment into the future when he or she could have the same amount of money now? For most of us, taking the money in the present is just plain instinctive. So at the most basic level, the time value of money demonstrates that, all things being equal, it is better to have money now rather than later.

But why is this? A $100 bill has the same value as a $100 bill one year from now, doesn't it? Actually, although the bill is the same, you can do much more with the money if you have it now because over time you can earn more interest on your money.

Back to our example: by receiving $10,000 today, you are poised to increase the future value of your money by investing and gaining interest over a period of time. For Option B, you don't have time on your side, and the payment received in three years would be your future value. To illustrate, we have provided a timeline:

If you are choosing Option A, your future value will be $10,000 plus any interest acquired over the three years. The future value for Option B, on the other hand, would only be $10,000. So how can you calculate exactly how much more Option A is worth, compared to Option B? Let's take a look.

Future Value Basics
If you choose Option A and invest the total amount at a simple annual rate of 4.5%, the future value of your investment at the end of the first year is $10,450, which of course is calculated by multiplying the principal amount of $10,000 by the interest rate of 4.5% and then adding the interest gained to the principal amount:

Future value of investment at end of first year:
= ($10,000 x 0.045) + $10,000
= $10,450
You can also calculate the total amount of a one-year investment with a simple manipulation of the above equation:

- Original equation: \((10,000 \times 0.045) + 10,000 = 10,450\)
- Manipulation: \(10,000 \times ((1 \times 0.045) + 1) = 10,450\)
- **Final equation:** \(10,000 \times (0.045 + 1) = 10,450\)

The manipulated equation above is simply a removal of the like-variable \(10,000\) (the principal amount) by dividing the entire original equation by \(10,000\).

If the \(10,450\) left in your investment account at the end of the first year is left untouched and you invested it at 4.5% for another year, how much would you have? To calculate this, you would take the \(10,450\) and multiply it again by \(0.045 + 1\). At the end of two years, you would have \(10,920\):

Future value of investment at end of second year:
\[
= 10,450 \times (1 + 0.045)
\]
\[
= 10,920.25
\]

The above calculation, then, is equivalent to the following equation:

\[
\text{Future Value} = 10,000 \times (1 + 0.045) \times (1 + 0.045)
\]

Think back to math class and the rule of exponents, which states that the multiplication of like terms is equivalent to adding their exponents. In the above equation, the two like terms are \((1 + 0.045)\), and the exponent on each is equal to 1. Therefore, the equation can be represented as the following:

\[
\text{Future Value} = 10,000 \times (1 + 0.045)^2
\]
\[
= 10,920.25
\]

We can see that the exponent is equal to the number of years for which the money is earning interest in an investment. So, the equation for calculating the three-year future value of the investment would look like this:

\[
\text{Future Value} = 10,000 \times (1 + 0.045)^3
\]
\[
= 11,411.66
\]

This calculation shows us that we don't need to calculate the future value after the first year, then the second year, then the third year, and so on. If you know how many years you would like to hold a present amount of money in an investment, the future value of that amount is calculated by the following equation:
Present Value Basics

if you received $10,000 today, the present value would of course be $10,000 because present value is what your investment gives you now if you were to spend it today. If $10,000 were to be received in a year, the present value of the amount would not be $10,000 because you do not have it in your hand now, in the present. To find the present value of the $10,000 you will receive in the future, you need to pretend that the $10,000 is the total future value of an amount that you invested today. In other words, to find the present value of the future $10,000, we need to find out how much we would have to invest today in order to receive that $10,000 in the future.

To calculate present value, or the amount that we would have to invest today, you must subtract the (hypothetical) accumulated interest from the $10,000. To achieve this, we can discount the future payment amount ($10,000) by the interest rate for the period. In essence, all you are doing is rearranging the future value equation above so that you may solve for P. The above future value equation can be rewritten by replacing the P variable with present value (PV) and manipulated as follows:

- **Original equation**: \( FV = PV \times (1 + i)^n \)
- **Manipulation**: Divide both sides by \((1 + i)^n\)
- **Final equation**: \( PV = \frac{FV}{(1 + i)^n} \) or \( PV = FV \times (1 + i)^{-n} \)

Let's walk backwards from the $10,000 offered in Option B. Remember, the $10,000 to be received in three years is really the same as the future value of an investment. If today we were at the two-year mark, we would discount the payment back one year. At the two-year mark, the present value of the $10,000 to be received in one year is represented as the following:

\[
\text{Present value of future payment of } \$10,000 \text{ at end of year two:} \\
= \$10,000 \times (1 + 0.045)^{-1} \\
= \$9,569.38
\]

Note that if today we were at the one-year mark, the above $9,569.38 would be considered the future value of our investment one year from now.
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CHAPTER 5

RISK AND RETURN

Risk
It refers to deviation or variations of the actual outcome from the expected. It’s the possibility of things happening than they are expected. Risk can be measured for either a single or a gap of project (portfolio-collection of securities).

Return
It is the anticipated gain or earnings on any investment. These investments returns could be positive or negative outcomes.

Risk-Return Tradeoff
It’s the principle that the potential return rises with an increase in risk. Low levels of uncertainty (low-risk) are associated with low potential returns, whereas high levels of uncertainty (high-risk) are associated with high potential returns. According to the risk-return tradeoff, invested money can render higher profits only if it is subject to the possibility of being lost.

Expected Return

The future is uncertain. Investors do not know with certainty whether the economy will be growing rapidly or be in recession. As such, they do not know what rate of return their investments will yield. Therefore, they base their decisions on their expectations concerning the future.

The expected rate of return on a stock represents the mean of a probability distribution of possible future returns on the stock. The table below provides a probability distribution for the returns on stocks A and B.

<table>
<thead>
<tr>
<th>State</th>
<th>Probability</th>
<th>Return on Stock A</th>
<th>Return on Stock B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>20%</td>
<td>5%</td>
<td>50%</td>
</tr>
<tr>
<td>2</td>
<td>30%</td>
<td>10%</td>
<td>30%</td>
</tr>
<tr>
<td>3</td>
<td>30%</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>3</td>
<td>20%</td>
<td>20%</td>
<td>-10%</td>
</tr>
</tbody>
</table>
In this probability distribution, there are four possible states of the world one period into the future. For example, state 1 may correspond to a recession. A probability is assigned to each state. The probability reflects how likely it is that the state will occur. The sum of the probabilities must equal 100%, indicating that something must happen. The last two columns present the returns or outcomes for stocks A and B that will occur in the four states.

Given a probability distribution of returns, the expected return can be calculated using the following equation:

\[ E[R] = \sum_{i=1}^{N} p_i R_i \]

where

- \( E[R] \) = the expected return on the stock,
- \( N \) = the number of states,
- \( p_i \) = the probability of state \( i \), and
- \( R_i \) = the return on the stock in state \( i \).

**Expected Return on Stocks A and B**

<table>
<thead>
<tr>
<th></th>
<th>Stock A</th>
<th>Stock B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>( E[R_A] = .20(5%) + .30(10%) + .30(15%) + .25(20%) = 12.5% )</td>
<td>( E[R_B] = .20(50%) + .30(50%) + .30(10%) + .25(-10%) = 20% )</td>
</tr>
</tbody>
</table>

So we see that **Stock B** offers a higher expected return than **Stock A**. However, that is only part of the story; we haven't yet considered risk.

**MEASURING RETURNS:**

1. **Total Return:**

   Percentage measure relating all cash flows on a security for a given time period to its purchase price
A correct returns measure must incorporate the two components of return, yield and price change, as discussed earlier. Returns across time or from different securities can be measured and compared using the total return concept. Formally, the total return (TR) for a given holding period is a decimal (or percentage) number relating all the cash flows received by an investor during any designated time period to the purchase price of the asset. Total return is defined as:

\[ TR = \frac{\text{Any cash payments received} + \text{Price changes over the period}}{\text{Price at which the asset is purchased}} \]

The dollar price change over the period, defined as the difference between the beginning (or purchase) price and, the ending (or sale) price, can be either positive (sales price exceeds purchase price), negative (purchase price exceeds sales price), or zero. The cash payments can be either positive or zero. Netting the two items in the numerator together and dividing by the purchase price results in a decimal return figure that can easily be converted into percentage form. Note that in using the TR, the two components of return, yield and price change, have been measured.

The general equation for calculating TR is:

\[ TR = \frac{\text{CF}_t + (\text{PE} - \text{PB})}{\text{PB}} \]

\[ = \frac{\text{CF}_t + \text{PC}}{\text{PB}} \]

Where;
\[ \text{CF}_t = \text{cash flows during the measurement period } t \]
\[ \text{PE} = \text{price at the end of period } t \text{ or sale price} \]
\[ \text{PB} = \text{purchase price of the asset or price at the beginning of the period} \]
\[ \text{PC} = \text{change in price during the period, or PE minus PB} \]

The cash flow for bond pomes from the interest payments received, and that for a stock comes from the dividends received. For some assets, such as a warrant or a stock that pays no dividends, there is only a price change.

2. Return Relative:
It is often necessary to measure returns on a slightly different basis than TRs. This is particularly true when calculating either a cumulative wealth index or a geometric mean, both of which are explained below, because negative returns cannot be used in the calculation. The return relative (RR) solves this problem by adding 1.0 to the total return.
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CHAPTER 6

COST OF CAPITAL

Introduction of cost of capital
investment decision is major decision for an organization. Under investment decision process, the cost and benefit of prospective projects is analyzed and the best alternative is selected on the basis of the result of analysis. The benchmark of computing present value and comparing the profitability of different investment alternatives is cost of capital. cost of capital is also known as minimum required rate of return, weighted average cost of capital, cut off rate, hurdle rate, standard return etc. cost of capital is determined on the basis of component cost of financing and proportion of these sources in capital structure.

Meaning of cost of capital
Business firms raise the needed fund from internal sources and external sources. Undistributed and retained profit is the main source of internal fund. External fund is raised either by the issue of shares or by issue of debenture (debt) or by both means. The fund collected by any means is not cost free. Interest is to be paid on the fund obtained as debt and dividend is to be paid on the fund collected through the issue of shares. The average cost rate of different sources of fund is known as cost of capital.

From the viewpoint of return, cost of capital is the minimum required rate of return to be earned on investment. In other words, the earning rate of a firm which is just sufficient to satisfy the expectation of the contributors of capital is called cost of capital. Shareholders and debenture holders are the contributors of the capital. For example, a firm needs $ 5,00,000 for investing in a new project. the firm can collect $3,00,000 from shares on which it must pay 12% dividend and $ 2,00,000 from debentures on which it must pay 7% interest. if the fund is raised and invested in the project, the firm must earn at least $50,000 which becomes sufficient to pay $36,000 dividend(12% of $3,00,000) and $14000 interest(7% of $2,00,000). The required earning $50,000 is 12% of the total fund raised. This 12% rate of return is called cost of capital.

In this way, cost of capital is only minimum required rate of return to earn on investment and it is not the actual earning rate of the firm. As per above example, if the firm is able to earn only 10%. All the earnings will go in the hands of contributors of capital and nothing will be left in the business. Therefore, any business firm should try to maximize the earning rate by investing in the projects that can provide the rate of return which is more than the cost of capital.
SIGNIFICANCE AND COMPONENTS OF COST OF CAPITAL

Significance of cost of capital

cost of capital is considered as a standard of comparison for making different business decisions. Such importance of cost of capital has been presented below.

1. Making investment decision
cost of capital is used as discount factor in determining the net present value. similarly, the actual rate of return of a project is compared with the cost of capital of the firm. thus, the cost of capital has a significant role in making investment decisions.

2. Designing capital structure
the proportion of debt and equity is called capital structure. the proportion which can minimize the cost of capital and maximize the value of the firm is called optimal capital structure. cost of capital helps to design the capital structure considering the cost of each sources of financing, investor's expectation, effect of tax and potentiality of growth.

3. Evaluating the performance
cost of capital is the benchmark of evaluating the performance of different departments. the department is considered the best which can provide the highest positive net present value to the firm. The activities of different departments are expanded or dropped out on the basis of their performance.

4. Formulating dividend policy
out of the total profit of the firm, a certain portion is paid to shareholders as dividend. however, the firm can retain all the profit in the business if it has the opportunity of investing in such projects which can provide higher rate of return in comparison of cost of capital. on the other hand, all the profit can be distributed as dividend if the firm has no opportunity investing the profit. Therefore, cost of capital plays a key role formulating the dividend policy.

COMPONENTS OF COST OF CAPITAL

The individual cost of each source of financing is called component of cost of capital. the component of cost of capital is also known as the specific cost of capital which includes the individual cost of debt, preference shares, ordinary shares and retained earnings. Such components of cost of capital have been presented below:
a) Cost of debt

- Cost of perpetual or irredeemable debt
- Cost of non-perpetual or redeemable debt
- Cost of debt issued on redeemable condition
- Cost of callable debt

b) Cost of preference share

- Cost of perpetual preference share
- Cost of redeemable preference share

c) Cost of ordinary/equity shares or common stock

d) Cost of retained earning

Specific costs of capital

Specific costs of capital are the costs of capital of each source of capital such as debt, preference shares and equity.

a) Cost of debt (kd)

The cost of debt for a perpetual debenture will be;

\[
Cost \ of \ debt = \frac{Annual \ interest}{current \ market \ value \ of \ debentures}
\]

\[
K_d = \frac{I}{P_b}
\]

I is the annual interest
\(P_b\) is the current market value of a debenture

If the debenture is redeemable after a certain period of time/it has a maturity period the following formula will be applied to get the cost of debt or yield to maturity;

\[
K_d = \frac{I + \frac{M - P_b}{n}}{\frac{M + P_b}{2}}
\]

I is the annual interest
\(M\) is the par value of the debenture
\(P_b\) is the current market value of the debenture
n is the period to maturity
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CHAPTER 7

WORKING CAPITAL MANAGEMENT

Introduction
Management of Working Capital is also an important part of financial manager. The main objective of the Working Capital Management is managing the Current Asset and Current Liabilities effectively and maintaining adequate amount of both Current Asset and Current Liabilities. Simply it is called Administration of Current Asset and Current Liabilities of the business concern.

Management of key components of working capital like cash, inventories and receivables assumes paramount importance due to the fact the major portion of working capital gets blocked in these assets.

Meaning
Working capital management is an act of planning, organizing and controlling the components of working capital like cash, bank balance inventory, receivables, payables, overdraft and short-term loans.

Definition
According to Smith K.V, “Working capital management is concerned with the problems that arise in attempting to manage the current asset, current liabilities and the inter-relationship that exist between them”.

According to Weston and Brigham, “Working capital generally stands for excess of current assets over current liabilities. Working capital management therefore refers to all aspects of the administration of both current assets and current liabilities”.

NEED AND IMPORTANCE OF WORKING CAPITAL

Working capital is the life blood and nerve center of business. Working capital is very essential to maintain smooth running of a business. No business can run successfully without an adequate amount of working capital. The main advantages or importance of working capital are as follows:
1. Strengthen The Solvency
Working capital helps to operate the business smoothly without any financial problem for making the payment of short-term liabilities. Purchase of raw materials and payment of salary, wages and overhead can be made without any delay. Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

2. Enhance Goodwill
Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill. Goodwill is enhanced because all current liabilities and operating expenses are paid on time.

- Financial Forecast
- Financial Forecasting
- Advantages of solar panels
- Bond

3. Easy Obtaining Loan
A firm having adequate working capital, high solvency and good credit rating can arrange loans from banks and financial institutions in easy and favorable terms.

4. Regular Supply of Raw Material
Quick payment of credit purchase of raw materials ensures the regular supply of raw materials from suppliers. Suppliers are satisfied by the payment on time. It ensures regular supply of raw materials and continuous production.

5. Smooth Business Operation
Working capital is really a life blood of any business organization which maintains the firm in well condition. Any day to day financial requirement can be met without any shortage of fund. All expenses and current liabilities are paid on time.

6. Ability to Face Crisis
Adequate working capital enables a firm to face business crisis in emergencies such as depression.

DETERMINANTS OF WORKING CAPITAL

Requirements Of working capital depend upon various factors such as nature of business, size of business, the flow of business activities. However, small organization relatively needs lesser working capital than the big business organization. Following are the factors which affect the working capital of a firm:
1. Size of Business
Working capital requirement of a firm is directly influenced by the size of its business operation. Big business organizations require more working capital than the small business organization. Therefore, the size of organization is one of the major determinants of working capital.

2. Nature of Business
Working capital requirement depends upon the nature of business carried by the firm. Normally, manufacturing industries and trading organizations need more working capital than in the service business organizations. A service sector does not require any amount of stock of goods. In service enterprises, there are less credit transactions. But in the manufacturing or trading firm, credit sales and advance related transactions are in large amount. So, they need more working capital.

3. Storage Time or Processing Period
Time needed for keeping the stock in store is called storage period. The amount of working capital is influenced by the storage period. If storage period is high, a firm should keep more quantity of goods in store and hence requires more working capital. Similarly, if the processing time is more, then more stock of goods must be held in store as work-in-progress.

4. Credit Period
Credit period allowed to customers is also one of the major factors which influence the requirement of working capital. Longer credit period requires more investment in debtors and hence more working capital is needed. But, the firm which allows less credit period to customers’ needs less working capital.

5. Seasonal Requirement
In certain business, raw material is not available throughout the year. Such business organizations have to buy raw material in bulk during the season to ensure an uninterrupted flow and process them during the entire year. Thus, a huge amount is blocked in the form of raw material inventories which gives rise to more working capital requirements.

6. Potential Growth or Expansion Of Business
If the business is to be extended in future, more working capital is required. More amount of working capital is required to meet the expansion need of business.

- Classifications
- Small business loan
- Small Business
- Small business owner
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CHAPTER 8

CAPITAL BUDGETING DECISIONS UNDER CERTAINTY

Introduction

Capital budgeting decision is also known as the investment decision. The capital budgeting process involves a firm's decision to invest its funds in the most viable and beneficial project. It is the process of evaluating and selecting long term investments consistent with the firm’s goal of owner wealth maximization.

The firm expects to produce benefits to the firm over a long period of time and encompasses tangible and intangible assets. For a manufacturing firm, capital investment are mainly to acquire fixed assets—property, plant and equipment. Note that typically, we separate the investment decision from the financing decision: first make the investment decision then the finance manager chooses the best financing method.

These key motives for making capital expenditures are;

1. **Expansion**: The most common motive for capital expenditure is to expand the cause of operations – usually through acquisition of fixed assets. Growing firms need to acquire new fixed assets rapidly.

2. **Replacements** – As a firm’s growth slows down and it reaches maturity, most capital expenditure will be made to replace obsolete or worn out assets. Outlays of repairing an old machine should be compared with net benefit of replacement.

3. **Renewal** – An alternative to replacement may involve rebuilding, overhauling or refitting an existing fixed asset. A physical facility could be renewed by rewiring and adding air conditioning.

4. **Other purposes** – Some expenditure may involve long-term commitments of funds in expectations of future return i.e. advertising, R&D, management consulting and development of view products. Other expenditures include installation of pollution control and safety devices mandated by the government.

Features/characteristics of investment decisions

1. The investment requires a high outlay of capital which must be planned.

2. Capital budgeting decisions have an influence on the rate and direction of the growth of the organization unlike normal operation costs.

3. The investment has long-term implications. I.e. more than 1 year.

4. The decisions are irreversible. This implies that there might be no second hand market for the assets since it’s usually tailor made for that particular firm.

5. The future expected cash flows from this project are uncertain thus these decisions involve a high degree of risk.
INVESTMENT EVALUATION CRITERIA

Three steps are involved in the evaluation of an investment:

- Estimation of cash flows
- Estimation of the required rate of return (the cost of capital)
- Application of a decision rule for making the choice

Investment decision rule

The investment decision rules may be referred to as capital budgeting techniques, or investment criteria. A sound appraisal technique should be used to measure the economic worth of an investment project. The essential property of a sound technique is that it should maximize the shareholders wealth. The following other characteristics should also be possessed by a sound investment evaluation criterion:

- It should consider all cash flows to determine the true profitability of a project.
- It should provide for an objective and unambiguous way of separating good projects from bad projects.
- It should help rank projects according to their true profitability.
- It should recognize the fact that bigger cash flows are preferable to smaller ones and early cash flows are preferable to later ones.
- It should help to choose among mutually exclusive projects the one which maximizes the shareholders wealth.
- It should be a criterion which is applicable to any conceivable investment project independent of others.

Steps in Capital Budgeting Process

The capital budgeting process consists of five distinct but interrelated steps. It begins with proposal generation, followed by review and analysis, decision making, implementation and follow-up. These six steps are briefly outlined below.

1. Proposal generation: Proposals for capital expenditure are made at all levels within a business organization. Many items in the capital budget originate as proposals from the plant and division management. Project recommendations may also come from top management, especially if a corporate strategic move is involved (for example, a major expansion or entry into a new market). A capital budgeting system where proposals originate with top management is referred to a top-down system, and one where proposals originate at the plant or division level is referred to as bottom-up system. In practice many firms use a mixture of the two systems, though in modern times has seen a shift to decentralization and a greater use of the bottoms-up approach. Many firms offer cash rewards for proposals that are ultimately adopted.
2. **Review and analysis:** Capital expenditure proposals are formally reviewed for two reasons. First, to assess their appropriateness in light of firm’s overall objectives, strategies and plans and secondly, to evaluate their economic viability. Review of a proposed project may involve lengthy discussions between senior management and those members of staff at the division and plant level who will be involved in the project if it is adopted. Benefits and costs are estimated and converted into a series of cash flows and various capital budgeting techniques applied to assess economic viability. The risks associated with the projects are also evaluated.

3. **Decision making:** Generally the board of directors reserves the right to make final decisions on the capital expenditures requiring outlays beyond a certain amount. Plant manager may be given the power to make decisions necessary to keep the production line moving (when the firm is constrained with time it cannot wait for decision of the board).

4. **Implementation:** Once approval has been received and funding availed implementation commences. For minor outlays the expenditure is made and payment is rendered: For major expenditures, payment may be phased, with each phase requiring approval of senior company officer.

5. **Follow-up:** involves monitoring results during the operation phase of the asset. Variances between actual performance and expectation are analyzed to help in future investment decision. Information on the performance of the firm’s past investments is helpful in several respects. It pinpoints sectors of the firm’s activities that may warrant further financial commitment; or it may call for retreat if a particular project becomes unprofitable. The outcome of an investment also reflects on the performance of those members of the management involved with it. Finally, past errors and successes provide clues on the strengths and weaknesses of the capital budgeting process itself.

This topic will majorly discuss on the second step: Review and analysis.

Estimation of cash flows is one of the most important and challenging step because decisions made depend on cashflows projected for each proposal. Cashflows must be relevant and therefore need to have the following criteria,

- They must be future cashflows because cashflows already received or paid are sunk costs hence irrelevant in decision making.
- Cashflows must be incremental. This enables the firm to analyze cashflows of the firm with or without the project.
- Cashflows must involve an actual inflow or outflow of cash. Thus expenses which do not involve a movement of cash e.g. Depreciation are not cashflows.
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CHAPTER 9

DIVIDEND DECISIONS

Meaning of Dividend
Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders.

FORM OF DIVIDEND
Dividend may be distributed among the shareholders in the form of cash or stock. Hence, Dividends are classified into:

a) Cash dividend
b) Stock dividend
c) Bond dividend
d) Property dividend

Cash Dividend
If the dividend is paid in the form of cash to the shareholders, it is called cash dividend. It is paid periodically out the business concerns EAIT (Earnings after interest and tax). Cash dividends are common and popular types followed by majority of the business concerns.

Stock Dividend
Stock dividend is paid in the form of the company stock due to raising of more finance. Under this type, cash is retained by the business concern. Stock dividend may be bonus issue. This issue is given only to the existing shareholders of the business concern.
**Bond Dividend**
Bond dividend is also known as script dividend. If the company does not have sufficient funds to pay cash dividend, the company promises to pay the shareholder at a future specific date with the help of issue of bond or notes.

**Property Dividend**
Property dividends are paid in the form of some assets other than cash. It will distributed under the exceptional circumstance.

**DIVIDEND POLICY**
Dividend policy determines the division of earnings between payment to shareholders and reinvestment in the firm. It therefore involves the following four aspects:

1. **HOW MUCH TO PAY**

   It encompasses the 4 major alternative dividend policies.

   - **a) Constant payout ratio**
     This is where the firm will pay a fixed dividend rate e.g. 40% of earnings. Dividends will therefore fluctuate as the earnings change. Dividends are therefore directly dependant on the firms earning ability. If no profits are made, no dividends are paid. The policy creates uncertainty in ordinary shareholders especially those who depend on dividend income thus they may demand a higher required rate of return.

   - **b) Constant amount per share/fixed dividend per share**
     The dividend per share is fixed in amount irrespective of the earnings level. This creates uncertainty and is thus preferred by shareholders who have a reliance on dividend income. It protects the firm from periods of low earnings by fixing dividends per share at a low level. Thus policy treats all shareholders like preference shareholders by giving a fixed return. Dividend per share could be increased to a higher level if earnings appear relatively permanent and sustainable.

   - **c) Constant amount plus extra**
     Here, a constant dividend per share is paid every year. However, extra dividends are paid in years of supernormal earnings. This policy gives firms the flexibility to increase dividends when earnings are high and shareholders are given a chance to participate in the supernormal profits of the firm. The extra dividends are given in such
a way that it is not seen as a commitment to continue the extra in the future. It is
applied by firms whose earnings are highly volatile e.g. the agricultural sector.

d) Residual amount

Under this policy, dividend is paid out of earnings left over after investment decisions
have been financed. Dividends will therefore only be paid if there are no profitable
investment opportunities available. This policy is consistent with shareholders wealth
maximization.

2. WHEN TO PAY

Dividends can either be interim or final.

Interim dividends are paid in the middle of the financial year and are paid in cash.

Final dividends are paid at the year end and can be and can be in cash and stock form (bonus
issue).

3. WHY PAY

a) Residue dividend theory

Under this theory, a firm will pay dividends from residue earnings ie. Earnings
remaining after all suitable projects with a positive NPV have been financed. It assumes
that retained earnings are the best source of long term capital since it is readily available
and cheap. This is because no floatation costs are involved in the use of retained
earnings to finance new investments therefore the first claim on profit after tax and
preference dividend. There will be a reserve for financing investments. Dividend policy
is therefore irrelevant and treated as a passive variable. It will hence not affect the value
of the firm. However the investment decision will .]

Advantages of residual theory

1. Savings on floatation costs
2. There is no need to raise debt or equity capital since there is a high retention of earnings
   which require no floatation costs.
3. Avoidance of dilution of ownership. A new equity issue will dilute ownership and
   control. This will be avoided if retention is high.
4. Tax position of shareholders. High income shareholders prefer low dividends to reduce
   their tax burden from dividend income. They prefer high retention of earnings which
   are reinvested. This increase the share value and they make capital gains which are not
taxable.
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CHAPTER 10
FUNDAMENTALS OF ISLAMIC FINANCE

Introduction

Islamic finance, despite its name, is not a religious product. It is however a growing series of financial products developed to meet the requirements of a specific group of people.

Conventional finance includes elements (interest and risk) which are prohibited under Shari’ah law. Developments in Islamic finance have arisen to allow Muslims to invest savings and raise finance in a way which does not compromise their religious or ethical beliefs.

It is estimated that between 1.5 and 1.8 billion people (one quarter of the world’s population) are Muslim. Geographically, most Muslims live in Asia (over 60%) or the Middle East and North Africa (about 20%). Despite these figures, Islamic finance is still very much a niche market, with the vast majority of Muslims, who have access to finance, using conventional financial products. The following map shows the geographical spread of the Muslim population throughout the world as a percentage of each country’s population, with the highest concentrations in the darkest shades of purple.

The meaning of Islamic finance

Islamic finance is a term that reflects financial business that is not contradictory to the principles of Shari’ah. Conventional finance, particularly conventional banking business, relies on taking deposits from, and providing loans to, the public. Therefore, the banker-customer relationship is always a debtor-creditor relationship. A key aspect of conventional banking is the giving or receiving of interest, which is specifically prohibited by Shari’ah. For example a conventional bank’s fixed deposit product is based on a promise by the borrower that is the bank to repay the loan plus fixed interest to the lender that is the depositor. Essentially, money deposited will result in more money which is the basic structure of an interest.

In other non-banking businesses, conventional products and services, such as insurance and capital markets could be based on elements that are not approved by Shari’ah principles such as uncertainty (Gharar) in insurance and interest in conventional bonds or securities. In the case of insurance, the protection provided by the insurer in exchange for a premium is always uncertain as to its amount as well as its actual time of happening. A conventional bond normally pays the holder of the bond the principal and interest.
Conventional practices could also involve selling or buying goods and services that are not lawful from a Shari’ah perspective. These might be non-halal foods such as pork, non-slaughtered animals or animals not slaughtered according to Islamic principles, alcohol or services related to gambling, pornography and entertainment. In short, conventional business practices could be non-compliant from a contractual structure perspective (if they are based on interest and uncertainty) and/or from a transactional perspective when they are involved in producing, selling or distributing goods and services that are not lawful according to Shari’ah.

PRINCIPLES OF ISLAMIC BANKING

What is an Islamic Bank?
There is no standard way of defining what an Islamic bank is, but broadly speaking an "Islamic bank is an institution that mobilises financial resources and invests them in an attempt to achieve predetermined islamically-acceptable social and financial objectives. Both mobilisation and investment of funds should be conducted in accordance with the principles of Islamic Shari'a".

1. Prohibition of Interest or Usury
2. Ethical Standards
3. Moral and Social Values
4. Liability and Business Risk

1- Prohibition of Interest or Usury

The principles of Islamic finance are established in the Qur'an, which Muslims believe are the exact Words of God as revealed to the Prophet Mohammed. These Islamic principles of finance can be narrowed down to four individual concepts.

The first and most important concept is that both the charging and the receiving of interest is strictly forbidden. This is commonly known as Riba or Usury. Money, on its own, may not generate profits. When Riba infects an entire economy, it jeopardises the well-being of everyone living in that society. When investors are more concerned with rates of interest and guaranteed returns than they are with the uses to which money is put, the results can only be negative.

Adherents of Islam believe that the Qur'an is the final book of God's word following both the Torah and the Bible. As a result, there are a number of similarities between the Islamic, Christian and Jewish faiths.
Quoting Shaikh Saleh Abdullah Kamel, Chairman and Founder of Albaraka Banking Group; Usury is forbidden in all the three religions, Judaism, Christianity and Islam, but it is the people who forget the rules of Allah. All societies, nowadays - Muslims, Christians and Jews - deal with Usury.

2- Ethical Standards

The second guiding principle concerns the ethical standards. When Muslims invest their money in something, it is their religious duty to ensure that what they invest in is good and wholesome. It is for this reason that Islamic investing includes serious consideration of the business to be invested in, its policies, the products it produces, the services it provides, and the impact that these have on society and the environment. In other words, Muslims must take a close look at the business they are about to become involved in.

In all facets of the financial system, Islam has certain rules, certain regulations as to how Muslims should go about participating in these activities. For example, in share trading or the securities market, Islam looks at the activities of the companies, to establish whether or not the companies are involved in activities which are in line with Sharia'a.

3- Moral and Social Values

The third guiding principle concerns moral and social values. The Qur'an calls on all its adherents to care for and support the poor and destitute. Islamic financial institutions are expected to provide special services to those in need. This is not confined to mere charitable donations but has also been institutionalised in the industry in the form of profit-free loans or Al Quard Al Hasan.

An Islamic bank's business includes certain social projects, as well as charitable donations. Islamic banks provide profit-free loans. For example, if an individual needs to go to hospital or wants to go to university, we give what is called Quard Al Hasan. This Quard Hasan is normally given for a short period of one year and the Islamic bank does not charge anything for that.

4- Liability and Business Risk

The final principle concerns the overarching concept of fairness, the idea that all parties concerned should both share in the risk and profit of any endeavor. To be entitled to a return, a provider of finance must either accept business risk or provide some service such as supplying an asset, otherwise the financier is, from a Sharia'a point of view, not only an economic parasite but also a sinner. This principle is derived from a saying of the Prophet Mohammed (May Peace be upon Him) "Profit comes with liability". What this means is that one becomes entitled to profit
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