**THE OPEN UNIVERSITY OF TANZANIA**
***FACULTY OF BUSINESS MANAGEMENT***

**DEPARTMENT OF ACCOUNTING AND FINANCE**

# OAF 121 FINANCE I
# MODULE OUTLINE

## 1.0 Introduction to the module

This module is designed to provide you with an introductory knowledge and skills in finance to help you build ability to make useful financial decisions.

The importance of this module arises from a number of factors. First, the firm's success or failure depends largely on the management's ability to evaluate alternative investment projects and to find the capital that it needs to execute them. Second, the financial decisions involve huge sums of money and carry huge risks with them. Third, financial markets in which these companies operate are constantly, and rapidly, changing. Thus, firm managers need more than just rules of thumb to cope with taking financial decisions in such a dynamic environment.

It is very important you note that most of the materials covered in this module will form key inputs all future modules in finance.

### Module aim and objectives

The aim of this module is to impart you with knowledge about the fundamental concepts of financial management and the importance of financial management skills to individuals and enterprises. The objectives of the module include (i) impacting you with the fundamental concepts and tools of financial management; (ii) to enable you critically analyze issues and situations based on the principles and theories of finance; and (iii) to enable you apply the theories and techniques in real life by taking useful financial decisions.

You are expected to gain an initial understanding of the finance function in an organisation, the role of the finance manager, the financial environment in which the firm operates, and the price behaviour on the capital markets. In addition, you are expected to be able to undertake valuation of various cash flow patterns and apply such knowledge and skills in valuing such securities as shares and bonds, appraising project proposals under certain and uncertain conditions as well as to be able to estimate the firm's overall cost of capital. Special capital budgeting decisions will also be discussed including risk, inflation and capital rationing factors.

## 2.0 Module contents

### 2.1 LECTURE 1: **Meaning and Scope of Financial Management.**

#### 2.1.1 Introduction

This lecture introduces you to the meaning of finance and financial management after which it outlines the scope of finance. It then looks at how business firms can be organized, and how the finance function is organized. The lecture further relates the finance function with other managerial functions in the firm. The main aim is to set out the premises within which the finance function in an organization works to create value for the shareholders.

**Objectives**

At the end of this lecture you will be able to:

(i) Define finance and financial management

(ii) Discuss the scope of financial management

(iii) Define the firm and discuss the most common forms of business organisation

(iv) Describe how the finance function in an organization is designed

(v) Relate the finance function to other managerial functions is an organization

**Content**

- Finance and financial management
- Scope of Financial management
- Business organizations
- Organization of the finance function
- Finance management vs. other managerial functions

### 2.2 Lecture 2: **The Finance manager and the financial environment**

This topic introduces you to the firm's finance manager- who he or she is, the decisions that are under his/her responsibility and the roles that he/she plays in the firm. Neither the finance manager nor the firm, local or foreign, operates in a self-contained environment. Thus, the link between the finance manager and financial environment is highlighted where the financial environment will include financial markets, financial institutions and the corresponding financial instruments. The lecture will further help you identify the main goal of the firm. It will finally look at the range of issues surrounding the agency relationships in the firm, the related agency costs and how such conflicts may be mitigated.

**Objectives**

At the end of this lecture you will be able to:

(i) Identify the finance manager and describe the financial environment within which he or she operates;

(ii) Classify financial markets and institutions and identify the roles they play in corporate development and investments;

(iii) Explain the role of the finance manager in the organization;

(iv) Identify and evaluate the possible goals of the firm and explain why it makes sense for corporations to maximise their market values instead profits; and

(v) Show the different conflicts of interest that may arise in large organisation, explain why they arise, and discuss how corporations may deal with such conflicts so as everyone in the organisation works towards a common end.

**Content**

- The finance manager and the financial environment
- Financial markets
- Financial institutions
- The roles of the finance manager
- Goals of the firm
- Agency problems and their mitigation

## 2.3 Lecture 3: **Time Value of Money (TVM)**

### 2.3.1 Introduction

This lecture introduces you to the time value of money (TVM) concept, the principal tool of valuation. In real life you make decisions today which are expected to have financial implications for some time in the future. Investment decisions require you to part with some amount of money today with the hope of receiving more money at a future date. Commonsense requires you to go ahead with such a particular investment project if the money you expect to receive from it at a future date is higher than the amount you should put in today. This is indeed expected of any person behaving rationally. But since these two cash flows occur at different times, they are not easily comparable unless they are translated into the same time base. The question now is how would you do that?

This lecture is the first one three lectures in which you will be introduced to the time value of money concept, the tool that you need to work with cash flows that occur at different time periods and in different patterns. It will deal with single cash flows, while multiple cash flows and how the tools work in our real lives will be treated in the next two lectures.

**Objectives**

**At the end of this lecture you will be able to:**

(i) Define the time value concept and its two perspectives- future and present values;

(ii) Calculate and interpret the future and present values;

(iii) Describe the relationship between future and present values;

(iv) Determine the time required for present amount to grow to certain future value at a specified rate of interest; and

(v) Determine the rate of interest at which an amount invested today will grow to a future amount over a specified time period

**Content**

- The time value of money concept (TVM)
- The role and perspectives of the TVM concept
- Future values
- Present values
- The relationship between future and present values
- Determining the rate of interest
- Determining the time period

## 2.4 Lecture 4: **Multiple cash flows**

This is the second lecture on the time value of money concept. In the previous lecture you learned how to determine the future and present values of a lump sum cash flow. In reality, however, most investments generate multiple cash flows of varied sizes and at different times; i.e. a stream of cash flows. This lecture introduces you to how you would use the tools learned in lecture 3 to work out both future and present values of such cash flow patterns. The multiple cash flows may be unequal or equal, they may occur at the end or at the beginning of each period, and finally they may run for a sometime or forever. This lecture builds in you the ability to determine the future and present values of cash flow in such varied patterns.

**Objectives:**

**At the end of this lecture you should be able to:**

(i) Calculate and interpret the future and present values of unequal cash flows;

(ii) Calculate and interpret the future and present values of level cash flows (Ordinary annuities)

(iii) Calculate and interpret the future and present values of level cash flows (annuity due)

(iv) Calculate and interpret the present values of level cash flows (perpetuities)

**Content**

- Cash flow patterns
- Future and present values of unequal cash flows
- Future and present value of ordinary annuities
- Future and present value of annuity due cash flows
- Present value of perpetuity cash flows

## 2.5 Lecture 5: **Compounding frequency and applications**

In the preceding two lectures you learned how to compute future values and present values of various cash flows and pattern. However, in both lectures we focused on cases where interest is compounded only once in a year. It is very common now days to find financial assets interest of which is compounded more frequently than once a year. This lecture will introduce you to the techniques of handling cash flows with such compounding behaviour. It will begin with definite frequencies followed by look at indefinite frequencies (continuous compounding). It will then establish the impact of compounding frequency on the future and present values. The lecture will finally end with a look at applications of the time value of money concept in some real life cash flow situations.

**Objectives**

At the end of this lecture you will be able to:

(i) Determine future and present values of cash flows in situations with higher compounding frequencies

(ii) Evaluate the impact of higher compounding frequencies on future and present values

(iii) Integrate inflation in the computation of future and present values

(iv) Apply the time value concept to select real life situations

**Content**

- Future and present values of cash flows under high compounding frequency
- Impact of higher compounding frequency
- Inflation and the Time Value of Money
- Selected applications
    - Sinking fund
    - Providing for Retirement
    - Deferred Annuities
    - Loan Amortization

## 2.6 Lecture 6: **Bond valuation**

### 2.6.1 Introduction

In the last three lectures you were introduced to the time value of money concept. The introduction ended, in the preceding lecture, with a demonstration of how the concept could be applied to some selected real cash flow situations. This lecture, as well as the next two lectures extends the application of the concept by showing you how it can be used to value real financial assets – bonds and shares. It begins by explaining what bonds are, their types and the cash flows expected from investing in them. It then demonstrates how the value of bonds can be determined, given their respective yield and that bonds prices are inversely related to interest rates. Finally the lecture demonstrates how different rates of return, from a bond investment can be computed. These rates include current yield, yield to maturity and rate of return expected by an investor who buys and holds the bond for sometime before maturity.

**Objectives**

At the end of this lecture you will be able to:

(i) Define a bond security, distinguish between different kinds of bonds and identify different bond features; i.e. coupon rate, current yield and yield to maturity

(ii) Estimate the value of a bond and demonstrate why bond prices and yields vary inversely.

(iii) Deduce the other important relationships that exist in bond valuation

(iv) Compute a bondholder's expected rate of return

(v) Discuss various risks associated with bond investment returns

**Content**

- Definition, types and features of bonds
- Valuation of bonds (the basic process)
- Basic relationships in bond valuation
- Bondholder's expected rate of return
- Risks associated with bond returns

## 2.7 Lecture 7: **Share Valuation**

### 2.7.1 Introduction

The preceding lecture basically introduced you to how the time value of money concept is used to value bonds and to determine the rate of return expected from holding it. This lecture extends the application but this time to value shares both ordinary and preferred. The lecture begins by looking

at the different features of a share investment including the cash flows expected from an investment in them. It is important to remember that the goal of the firm is maximization of shareholders wealth, which is reflected by the value or price of the company's shares in the capital markets at a point in time. Therefore the lecture continues by looking at how you could determine share prices as well as how you could also infer the return that investors expect. To achieve this, the lecture will capitalize on various assumptions regarding the behavior of expected dividends. Finally, the lecture shows how the value of preferred shares could be determined as well as how the entire company's value could be determined using the same techniques. Given the fact that the expected dividends are related to expected earnings, the lecture will also look at situations where expected earnings can also be used to value shares.

**Objectives**

At the end of this lecture you will be able to:

(i) Define a share security and describe its basic characteristic features;
(ii) Identify the cash flow and non cash flows benefits from a share investments;
(iii) Determine the price of a share given the forecast of dividend;
(iv) Determine the price of a share under the different assumptions about the behavior of dividends;
(v) Use share valuation models and cash flows to infer the expected rate of return on ordinary shares;
(vi) Determine the price of a share using earnings based model;
(vii) Determine the price of preferred shares and the expected rate of return; and
(viii) Value the entire company.

**Content**

- Shares and their basic features
- Benefits from a share investments
- Price of ordinary shares
- Behaviour of expected dividend growth and share price
- Price of shares based on earnings
- Expected rate of return
- Preferred shares and their characteristics
- Price of preferred shared and the expected rate of return
- Valuing the entire business

**2.8** Lecture 8: **Investment appraisal techniques**

This lecture is concerned with strategic investment decisions, a forward-looking process through which the future of the firm and that of its shareholder wealth is determined. Consequently, it is imperative that such decisions are properly appraised and evaluated before they are implemented. The lecture will briefly look at the investment process and types of investment projects. It will then introduce you to appraisal techniques most commonly used by managers to evaluate alternative investment projects and how they work. You will realize that this will partly provide yet another extension of the application of the time value of money concept.
The lecture will assume that the cash flows are certain and the discount rate is known. These assumptions will be relaxed in the coming lectures.

**Objectives**

At the end of this lecture you will be able to:

(i) Define investment, investment appraisal and explain the reasons managers should appraise projects properly before they are implemented
(ii) Develop familiarity with the investment process
(iii) Describe and apply the most commonly used investment appraisal techniques to analyse, select or rank investment alternatives
(iv) Distinguish between the traditional and the discounted cash flow techniques and explain why the discounted cash flow techniques are preferred over the traditional ones.
(v) Evaluate and identify situations in which some techniques yield more reliable results than others.

**Content**

- Investments and investment appraisal
- Types of investment projects
- Investment process
- Non-discounted appraisal techniques
- Discounted Cash flow techniques
- A comparison of the NPV and the IRR methods

## 2.9 Lecture 9: **Cash flow estimation:**

### 2.9.1 Introduction

In the preceding lecture you were introduced to the various investment appraisal techniques – discounted and non-discounted techniques. In so doing, both the cash flows expected from the projects and the discount rates were taken as given. This lecture will continue to assume the discount rates are given, and then proceed to introduce you to the ways in which the cash flows for project appraisal are estimated. It looks and the issues known to be problematic in cash flow

estimation and offer guide on how to treat them in the process. It then uses a mini case to demonstrate how these issues are handled to come up with relevant net cash flows before applying the appraisal techniques to determine whether the projects are worth undertaking.

**Objectives**

At the end of this lecture you will be able to:

(i) Explain the essence of cash flow estimation

(ii) Discuss the concepts of cash flow relevance and analytical framework

(iii) Identify the different types of cash flows

(iv) Discuss the different issues known to complicate the cash flow estimation process, showing how each is treated

(v) Apply the guides on a mini-case and perform a complete capital budgeting decision.

**Content**

- The essence of cash flow estimation
- The concepts of relevant cash flows and the respective analytical framework
- The principle of cash flow analysis
- Types of cash flows
- Treatment of sunk cost
- Treatment of opportunity costs
- Allocated overheads
- Capital costs, depreciation and capital allowance
- Net working capital
- Interest expenses and taxation
- Mini case

## 2.10 Lecture 10: **Risk and Return**

### 2.10.1 Introduction

This lecture introduces you to the concepts of risk and returns. You will agree from this lecture that the aim of both companies and individuals is to either, minimize the risk they face given the return that they expect to receive or to maximize the expected return given the risks they are willing to take. This represents a trade-off between risk tolerable and the return expected. It is important therefore for managers first to understand why risk exists in the first place and how to quantify it so

that they can manage or control it. Thus, this lecture introduces you to how risk and returns are related, how they are measures both for an individual asset and for asset held in a portfolio. This lecture will form an important input to the further lectures on portfolio theory as well as on capital budgeting decisions under uncertainty.

**Objectives**

At the end of this lecture you will be able to:

(i) Define and measure the risk and expected rate of return of an individual asset

(ii) Define and measure the risk and expected rate of return of a portfolio of assets

(iii) Differentiate between systematic and unsystematic risk and identify the reasons why investors may not be concerned with both

**Content**

- Expected returns and risk defined
- Calculating expected return
- Calculating risk (Variance and Standard deviation)
- Portfolios and portfolio weights
- Portfolio expected returns
- Portfolio variance and standard deviation
- Systematic and unsystematic risk

## 2.11 Lecture 11: **Risk and the security market line**

### 2.11.1 Introduction

This lecture extends what you learned in the preceding lecture in a number of ways. It first extends the notion you learned that portfolios risks can in principle be quite different from the risk of the assets that make up the portfolio by looking at how the risk of an individual asset is related to the risk of a portfolio of many assets. From this it discusses how assets held in a portfolio can diversify risk away by looking at the impact of systematic and unsystematic risks on this but also on the size of risk premium. It then introduces you to how the systematic risk is measured after which it looks at how risk is rewarded at the market risk. Here, the lecture derives the security market line (SML) and the capital asset pricing model, both of which are instrumental to the understanding of the relationship between risks and returns.

**Objectives**

At the end of this lecture you will be able to:

(i) Explain and demonstrate how diversification of investments affects the risk and expected return of a portfolio of assets

(ii) Calculate and interpret individual and portfolio betas

(iii) Describe both the security market lines and capital asset pricing model and how they work in the understanding of the risk and return relationship from risky investments.

**Content**

- Diversification and portfolio risk
- The principle of diversification and beta
- Measuring systematic risk
- Portfolio beta
- Beta and the risk premium
- Security market line
- Capital asset pricing model

## 2.12 Lecture 12: **Cost of capital**

### 2.12.1 Introduction

In the previous lectures (lectures 2 to 11) you have used the concept of cost of capital in various situations. Such situations included valuing cash flows e.g. in the time value of money and its application in valuing various assets, evaluating investment projects, and so on. In all these situations, we have assumed that the cost of capital is known. But how really can one determine the cost of capital for a given firm or a given project and which one is most suitable for project analysis? Furthermore, how can one determine the firm's cost of capital given the fact that firms are normally financed by a multitude of capital sources where each source has its own risk profile and demand its own compensation in terms of rate of return? These are, but a few, questions that this lecture will attempt to answer. It will begin with a discussion of the need for estimating the cost of capital, followed with how the cost of capital for each source of capital can be determined. It will then look at the way through which these costs of individual capital are combined to obtain the firm's overall cost of capital. Finally it will look at its uses and respective considerations.

**Objectives**

At the end of this lecture you will be able to:

(i) Develop an understanding of the justification for the firm's need for the overall cost of capital
(ii) Determine the costs of debt, preferred shares, and equity
(iii) distinguish between the projects and firm's cost of capital and identify the situations in which the project's and firm's WACC can be used interchangeably for project analysis
(iv) identify some of the key uses of the cost of capital
(v) identify stakeholders who need the cost of capital and the concerns of each

### *4.9.3 Topics*

- The cost of Capital Concept
- Determination of the costs of capital
    - Cost of debt
    - Cost of preferred shares
    - Cost of equity
    - Cost of retained earnings
- The weighted cost of capital (WACC)
- Other important considerations (book versus market values)
- The difference between the project and the firm's cost of capital
- Usefulness of the cost of capital
- Stakeholders who need the cost of capital and their concerns

2.13. Lecture 13: Special cases in Capital Budgeting

### 2.13.1 Introduction

In lecture nine, you learned on how to accumulate relevant net annual net cash flows from a proposed project and then use them to evaluate its worthiness using either of the Discounted Cash Flow (DCF) techniques. However, in this lecture, you will learn how to apply such skills in carrying out evaluation of three selected (special) cases. The lecture will first look a case involving an investment that is primarily aimed at improving efficiency and thereby cutting costs. Secondly, it will consider a case involving what comes up when a firm is involved in submitting competitive bids. The third and final case arises in choosing between equipment options with different economic lives.

**Objectives**

At the end of this lecture you will be able to:

(i) Evaluate investments that are primarily aimed at improving efficiency (cutting costs).

(ii) Evaluate competitive bids.

(iii) Evaluate and choose between equipment options with different lives.

**Content**

- Cost cutting proposals
- Setting the bid price
- Options with different lives

## 2.14 Lecture 14: **Project analysis**

### 2.14.1 Introduction

In the preceding lecture you learned about how you would identify and organize relevant cash flows for capital budgeting decisions. But in doing so the key purpose is to establish the net annual cash flows, plug them into the net present value equation and determine the initial worthiness of the project. However, the net annual cash flows so determined would be only an estimate. The quality of such estimate would depend on how accurate you were. This signals the possibility that our estimate might have been inaccurate. This lecture presents to you the different ways of assessing the reliability of such an estimate and or some additional but relevant considerations.

**Objectives**

**At the end of this lecture you will be able to:**

(i) The nature of the estimation error in using Net Present Value as an appraisal technique

(ii) Identify and apply some of the organized ways of assessing the quality of cash flows estimates, identify critical components and impact on the projects NPV (what if analysis)

(iii) Perform scenario analysis to establish the impact of variations in project cash flows on NPV decisions

(iv) Apply break-even point analysis to investment appraisal

**Content**

- Nature of cash flow estimation errors
- Sensitivity analysis
- Scenario analysis
- Break-even analysis and investment appraisal

## 2.15 Lecture 15: **Risk and capital budgeting**

### Introduction

In all the lectures in which we discussed capital budgeting techniques we have so far assumed that the proposed investment projects do not involve any risk except for the cash flow estimation errors discussed in the preceding lecture. This was a necessary assumption to facilitate the understanding of the capital budgeting techniques. In real world however, the firm in general and its particular investment projects are exposed to different degrees of risk. This lecture will recall what risk is, how it is measured and analyzed in the investment decision.

**Objectives**

At the end of this lecture you will be able to:

(i) Explain the nature of risk and measure risk related to investment project
(ii) Use the conventional techniques of handling risk in capital budgeting
(iii) Use statistical techniques of handling risk in project appraisal.

**Content**

- Nature of risk
- Nonconventional techniques of handling risk in capital budgeting
    - Payback period
    - Risk adjusted discount rate
    - Certainty equivalent
- Statistical techniques
- Decision tree

## 2.16 Lecture 16: **Inflation, capital rationing and capital budgeting**

### 2.16.1 Introduction

This lecture introduces you to an analysis of how inflation and capital inadequacies complicate investment decisions. Inflation is a fact of life all over the world but significantly more so in developing countries like Tanzania. Because the cash flows of an investment project occur over a long period of time, a firm should usually be concerned about the impact of inflation on the project's profitability. Firms may also have to choose between profitable projects due to limitation of funds. How is that decision done? Can NPV still be used is such conditions? This lecture will also show you how to deal with such investment decisions where capital is inadequate.

**Objectives**

(i) Explain how inflation complicates capital budgeting decisions
(ii) Compare nominal and real rate of return and nominal and real cash flows
(iii) Demonstrate how inflation is handled in capital budgeting
(iv) Define capital rationing and differentiate between internal and external capital rationing
(v) Use profitability index in capital rationing situations
(vi) Use linear programming approach to capital rationing problems
(vii) Discuss the limitation of each method

**Content**

- Inflation defined
- Inflation and expected cash flows

- Inflation and the rate of return (discount rate)
- Capital rationing
- Capital rationing and capital budgeting
- Methods of adjusting for capital inadequacies and their limitations

## 2.17 Lecture 17: **Capital Market efficiency**

### 2.17.1 Introduction

Are capital markets efficient in pricing shares and other securities? This question has fascinated scholars and business people and investors for years. Put it in another way, can one investigate some market inefficiencies in pricing securities and make money by trading on such information? The answer to this question is far from a clear cut.

Lecture two demonstrated how the capital markets interact with the firm. This lecture will deal in depth with capital markets where companies long term securities such as shares and bonds are traded, and it reviews the role of capital markets as means of allocating resources efficiently. It is expected that in an efficient capital market, undervalued or overvalued shares do not exist. It is thus expected that it is not possible to develop trading rules, which bit the market. In addition, the lecture devotes some efforts to discuss the key issue of financial market efficiency and its implications for the financial manager and investors

**Objectives**

At the end of this lecture you will be able to:

- Discuss the meaning of the random walk capital market efficiency hypotheses
- Identify the three types of market information
- Identify the three types of market analysts and their role in maintaining market efficiency
- Distinguish the different forms of market efficiency and their implications
- Develop an understanding of how the market efficiency hypothesis is tested
- Comment on the implication of the evidence for efficiency for investors and corporate management.
- Discuss the joint hypotheses problem and its implication for the interpretation of evidence for and against market efficiency

**Content**

- Capital market efficiency and random walk hypotheses
- Types of market information sets
- Market analysts
- Forms of market efficiency

- Testing for market efficiency
- Evidence on market efficiency and its implication
- The joint hypotheses problem

**ASSESSMENT**

Compulsory Student Progressive Portfolio (SPP)

| | |
|---|---|
| One Timed Test | 30 marks |
| Final Exam | 70 marks |
| **Total** | **100 marks** |

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[1] It has once been available for searching and downloading from www.4shared.com; try your luck if it is still there.

[2] Copies are accessible within the OUT's library network

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And any other text book in financial management, corporate finance, managerial finance, etc., as long as it covers the topics of the module.

**Web resources:**

Biz/ed: business and economics subject launch pad available at Herriot-Watt University, UK at www.hw.ac.uk/libwww/irn/**pinakes**/**pinakes**.html or simply go to http://www.bized.co.uk/

You can also search for learning resources such as podcast and video lecture clips on www.youtube.com

[3] Easily available in bookshops in major cities in Tanzania

[4] As in footnote (2) on the preceding page.