Financial Management

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Outline

Financial management

- Scope of financial management:
  - Financial instrument for capital budgeting
  - Financial instrument for working capital
  - Financial instrument for capital structure
- The difference between conventional and Islamic finance management
  - Principles
  - Characteristics

Microfinance as a financial services to poor and low-income people

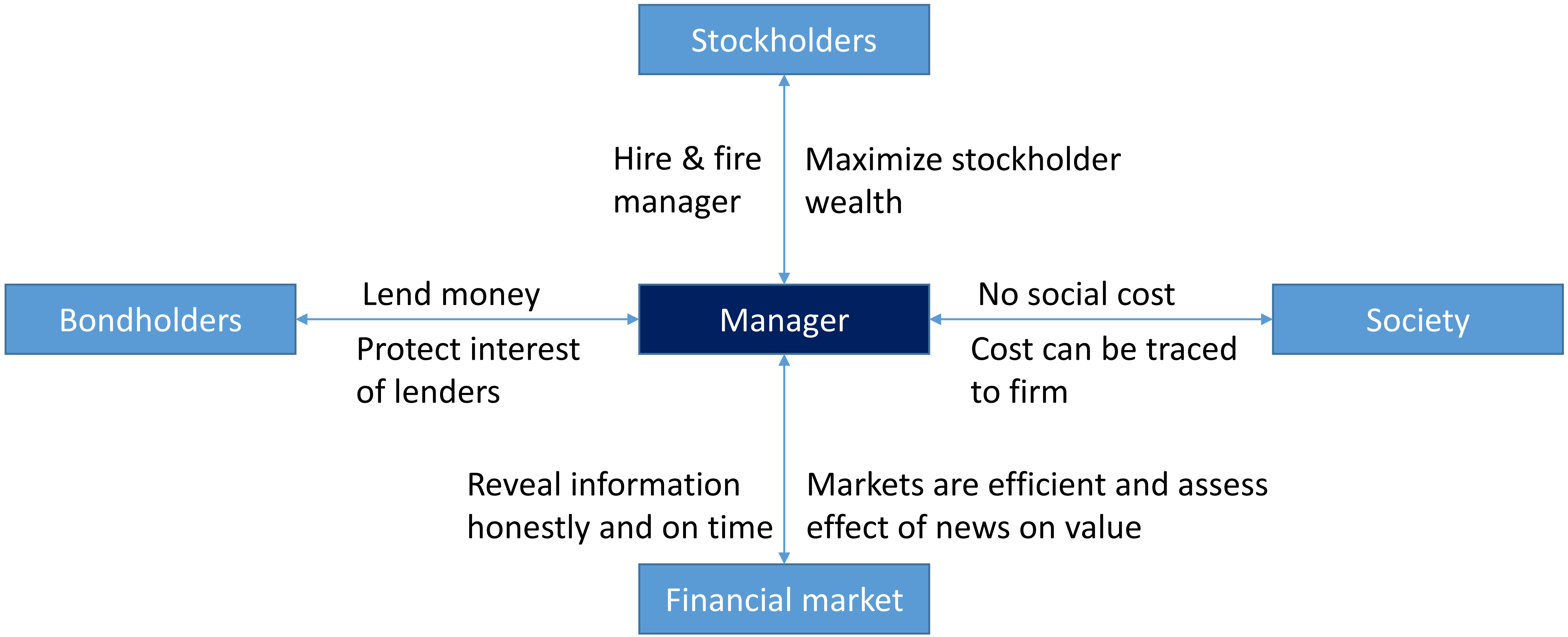
- Definition
- Key principles of microfinance
- Characteristics of microfinance
- The Goal of microfinance

Scope of financial management

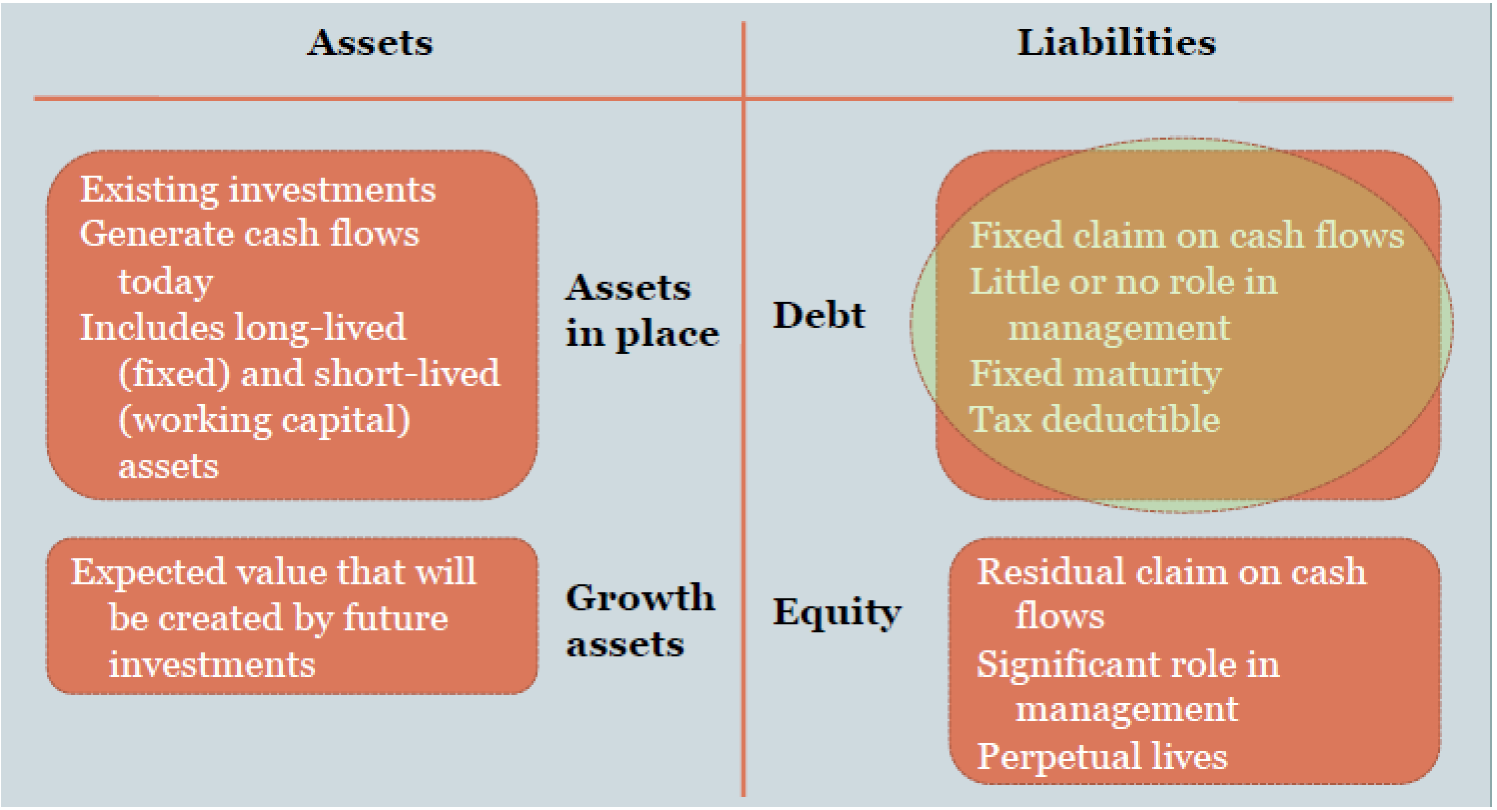
- The nature of company's goals
  - An investor perspectives
  - A creditor perspectives
  - A government perspectives
  - Company's management perspectives
  - Consumen and society perspectives
- Comparison of purpose between conventional and Islamic (syariah) financial manager
  - Syariah compliance issues
- Scope of Islamic financial manager job

Scope of financial management

- Real goals: maximize corporate value through stock prices (cheapest scenario)



Scope of financial management



Financial instrument for capital budgeting

Capital budgeting

- The first question concerns the firm’s long-term investments.
- Is the process of planning and managing a firm’s long-term investments is called capital budgeting**.**
- In capital budgeting, the financial manager tries to identify investment opportunities that are worth more to the firm than they cost to acquire.
- The value of the cash flow generated by an asset exceeds the cost of that asset.

Financial instrument for capital structure

- **Capital Structure** The second question for the financial manager concerns ways in which the firm obtains and manages the long-term financing it needs to support its long term investments. A firm's **capital structure** (or financial structure) is the specific mixture of long-term debt and equity the firm uses to finance its operations. The financial manager has two concerns in this area. First, how much should the firm borrow? That is, what mixture of debt and equity is best? The mixture chosen will affect both the risk and the value of the firm. Second, what are the least expensive sources of funds for the firm?
- If we picture the firm as a pie, then the firm's capital structure determines how that pie is sliced—in other words, what percentage of the firm's cash flow goes to creditors and what percentage goes to shareholders. Firms have a great deal of flexibility in choosing a financial structure. The question of whether one structure is better than any other for a particular firm is the heart of the capital structure issue.
- In addition to deciding on the financing mix, the financial manager has to decide exactly how and where to raise the money. The expenses associated with raising long-term financing can be considerable, so different possibilities must be carefully evaluated. Also, corporations borrow money from a variety of lenders in a number of different, and sometimes exotic, ways. Choosing among lenders and among loan types is another job handled by the financial manager.

Financial instrument for working capital

- **Working Capital Management** The third question concerns **working capital** management. The term *working capital* refers to a firm’s short-term assets, such as inventory, and its short-term liabilities, such as money owed to suppliers. Managing the firm’s working capital is a day-to-day activity that ensures that the firm has sufficient resources to continue its operations and avoid costly interruptions. This involves a number of activities related to the firm’s receipt and disbursement of cash. Some questions about working capital that must be answered are the following: (1) How much cash and inventory should we keep on hand? (2) Should we sell on credit? If so, what terms will we offer, and to whom will we extend them? (3) How will we obtain any needed short-term financing? Will we purchase on credit, or will we borrow in the short term and pay cash? If we borrow in the short term, how and where should we do it? These are just a small sample of the issues that arise in managing a firm’s working capital.

Principles of financial management

- Investment principle: "to invest in assets and projects that generate returns greater than the minimum acceptable hurdle rate"
  - Hurdle rate is the minimum rate of return acceptable to invest resources in new investment
- Financing principle: "choose the composition of financing (debt and equity) that will maximize the value of investments and matching the financing sources with the nature of the asset / project financed"
- Profit sharing principle: "if there is no investment that generates returns exceed the hurdle rate, return the cash to the owner of the company"

Principles of financial management

- The linkage between the various decisions (investment, financing, and profit sharing) with the value of the company.

Conventional:

"The company's value is the present value of cash flows the expected, discounted back at a rate that reflects both the risk of the project and composition financing is used "

Sharia:

"The company's value is the sum of cash flows that can be expected "

Islamic finance principles

- Islamic finance is a system / integrated model within the framework of socio-economic life, based on the corridor Islam and its principles, which is able to provide a positive impetus for economic activity, and is controlled by the concept of a fair balance between the material and spiritual needs, and between individual and social needs.
- These are:
  - Treasure is God entrusted to whom he pleases, and will be held responsible
  - All human activity in the world is within the framework of worship to God
  - The life of the world is one of the phases of human life to the hereafter
  - Whereas the Hereafter is far better than the world
  - Justice, which is put in place, is the right of all beings
  - The interaction between people based on the ridho’ principles
  - Islam based on the benefit of the ummah

Characteristics of financial management

- In economic systems there are:
  - Surplus agents
  - Agents of scarce resource
- In bridging the economic agents, Islamic finance requires the sharing of risk and return.
- Each agent has a level of "risk bearing" when deciding to invest.
- In Islamic Finance based PLS, each agent is seen to have complementary functions to others in fund investment in the social system of Islam (the principle of universal complementary).

Islamic finance characteristics

- Islamic finance instrument, there are:
  - PLS based: musyarakah, mudharabah
  - Sale (margin) based: murabahah, ijarah, salam
- Determined at the beginning of the contract through a "margin" and "ratio"
- Not calculated through the neoclassical tradition: the project IRR exceeds "market interest rate"
- Individually: equalize the opportunity cost of capital to the preferences (function) individual satisfaction
- Aggregate: produce a "complementary social welfare surplus" for both parties (Lofty, 2005; El Gamal, 2001)
- This principle pioneered by Ibn Taymiyah in his books (Selim, 2008).

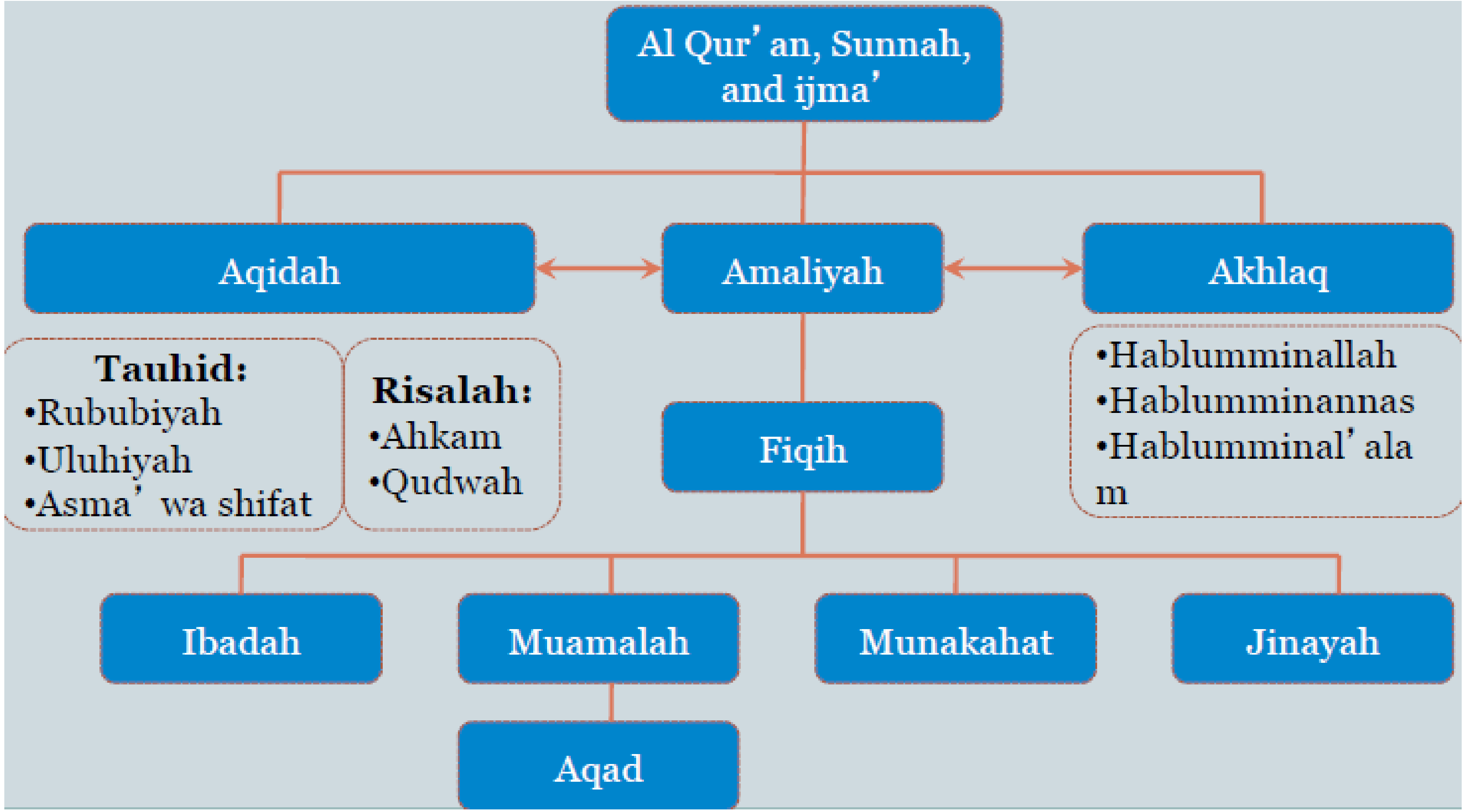
Islamic finance characteristics

- Islamic finance fundamental principle:
  - Principle of universal complementary
    - Each economic agent have a “complementary role” in order to get “maximal social welfare”
    - Opportunity cost is a loss of social opportunity
    - Marginal rate of subsitution not constant between agent
    - There is no “unified interest rate” that act as a reference of “opportunity cost”
    - Proportion of investment and risk is allocated to “return”
  - Principle of the abolition of usury
    - Eliminating “predetermined fixed interest” between economic agent
    - Cooperation agents will share profits and losses based on the actual performance of investment
  - Principle of justice in al hisba
    - Each agent has the authority, responsibilities, rights and obligations of each and act as role.

Islamic finance characteristics

- Some of the values that must exist in every contract of Islamic finance:
  - sincerity
  - honesty
  - truthfulness
  - trust
  - brotherhood
  - science and knowledge
  - justice

Islamic finance characteristics



Microfinance.
What is microfinance?

- **Microfinance (MF) is a powerful poverty alleviation tool.** It implies provision of **financial services to poor and low-income people** whose low economic standing *excludes* them from formal financial systems.
- Micro finance as an economic development tool intended to benefit 'low-income clients' and the self-employed to provide not only 'financial intermediation' which might include credit, saving, insurance, payment *etc., but also 'social intermediation services',* such as "group formation, development of self-confidence, training in financial literacy and management capabilities among members of a group.
- Microfinance operating along conventional lines has witnessed enormous growth during the last couple of decades. IsDB (Islamic Development Bank) member countries that have led the microfinance revolution are Bangladesh (with world leaders like Grameen and BRAC), Indonesia and Morocco. Among non-member countries India, Sri Lanka have sizable Muslim population. These countries have witnessed some of the pioneering experiments to eliminate poverty.

Characteristics of microfinance

Microfinance refers to making small loans available to poor people (especially those traditionally excluded from financial services) through programmes designed specifically to meet their particular needs and circumstances.

Typically, the characteristic features of microfinance programmes are that:

- Loans are usually relatively short term, less than 12 months in most instances, and generally for working capital with immediate regular weekly or monthly repayments – they are also disbursed quickly after approval, particularly for those seeking repeat loans.
- The traditional lender's requirements for physical collateral such as property are usually replaced by a system of collective guarantee (or solidarity) groups whose members are mutually responsible for ensuring that their individual loans are repaid.
- Loan application and disbursement procedures are designed to be helpful to low income borrowers – they are simple to understand, locally provided and quickly accessible.

Key principles of microfinance

- CGAP (Consultative Group to Assist the Poor-a multi-donor consortium dedicated to advancing microfinance.) has come up with eleven key principles of Microfinance based on decade-long consultations with its members and stakeholders. These are:

1. Poor people need a variety of financial services, not just loans. In addition to credit, they want savings, insurance, and money transfer services.
2. Microfinance is a powerful tool to fight poverty. Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.
3. Microfinance means building financial systems that serve the poor. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.
4. Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people. Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.
5. Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.

Key principles of microfinance

6. Microcredit is not always the answer. Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.
7. Interest rate ceilings hurt poor people by making it harder for them to get credit. Making many small loans costs more than making a few large ones.
8. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.
9. The job of government is to enable financial services, not to provide them directly. Governments can almost never do a good job of lending, but they can set a supporting policy environment.
10. Donor funds should complement private capital, not compete with it. Donor subsides should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits.
11. The key bottleneck is the shortage of strong institutions and managers. Donors should focus their support on building capacity.
12. Microfinance works best when it measures—and discloses—its performance. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance. MFIs need to produce accurate

The Goal of Microfinance

- to decrease poverty;
- to empower women or other disadvantage groups;
- to promote employment;
- to assist the client to develop or expand their business;
- to support the improvement of innovative enterprises.
- Increasing small firms’ access to financial and technical services.
- long term goals of microfinance are sustainability and outreach
    - ‘Sustainability’ → the ability to provide frequent loans, to cover the operating costs and to produce sufficient returns
    - ‘Outreach’ is related to ‘depth’, which refers to the poverty level of the clients’, and ‘breath’, in which basically concerns to the total numbers of clients that could be reached and served by the MFI

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