FINANCIAL MANAGEMENT FROM ISLAMIC PERSPECTIVES

handbook

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PREFACE

بسم الله الرحمن الرحيم

In today's dynamic financial landscape, navigating financial decisions with a strong ethical foundation is more important than ever. This book, Financial Management from an Islamic Perspective, addresses this need by providing a comprehensive guide to financial principles and practices based on Islamic values.

This book is tailored specifically for students who are interested in gaining a deeper understanding of financial management from an Islamic perspective. This text explores the fundamentals of Islamic finance theory and concepts, providing the reader with the necessary information. This book is written and composed in an interesting way such as the use of info-graphics and mind maps. This attracts students to study it.

In the initial topic, we outline the basic financial principles and instruments used in modern finance. This book offers a comprehensive introduction to financial analysis, including the examination of financial statements and the valuation of Islamic stocks and bonds (sukuk). It serves as a reliable source for gaining an in-depth understanding of the company's financial well-being and performance.

Next, we also guide analyzing dividend policy, effective working capital management, and the introduction of derivatives in the framework of Islamic finance.

Financial Management from an Islamic Perspective serves as a link between conventional financial theory and Islamic financial principles. This book provides individuals with the knowledge and skills to navigate the world of finance with confidence by offering clear explanations, practical examples and a strong emphasis on ethical issues.

This book is an interesting resource for anyone, including students, business professionals, and individuals who want to manage their finances according to Islamic principles.

SYNOPSIS

FINANCIAL MANAGEMENT FROM ISLAMIC PERSPECTIVES HANDBOOK

Focuses on the understanding theoretical, conceptual and application of financial management in interactive way. Readers will be introduced the financial concepts and tools includes financial statement analysis, stock and Islamic Bond Valuation.This handbook also focus company financial performances and the financial instruments used in financial decision making. It comprises dividends policy, working capital management and introduction to derivatives are discussed.

Content

TOPIC 1

INTRODUCTION TO FINANCIAL MANAGEMENT

Financial management is the process of planning, organizing, controlling, and monitoring financial activities to achieve organizational goals. It is concerned with the efficient and effective use of an organization's financial resources to maximize shareholder value.

Financial management can be applied to individuals, businesses, and organizations of all sizes. For individuals, financial management may involve budgeting, saving, investing, and debt management. For businesses, financial management may involve financial planning, capital budgeting, investment analysis, and risk management.

The art or science of managing money involves the use of variety theory in economy and knowledge in accounting to achieve the firm's and individual's objectives.

Concern about asset acquisition, financing, and management with some overall goal in mind.
Financial management is about managing the money to achieve the firm's overall goal in accordance with the Shariah guidelines.

The ultimate goal is to attain the blessing of Allah by fulfilling our duties and responsibilities as servant and also Khalifah in the world.

FINANCIAL MANAGEMENT FROM ISLAMIC PERSPECTIVES

The financial management is crucial to the formation of individual lives, the development of society, and even to the development of developed and successful countries.

This fact translates to the continuation of social interaction among members of society, which through systematic financial management can promote harmonious living and create a stable economic system within a social community within our country.

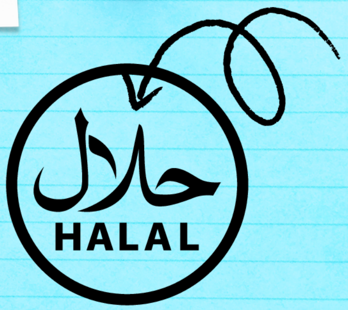
Look at the assertion of Allah SWT in Surah Yusof verses 47 - 48, about the importance of planning before facing something and being wise in managing life so that it will not be difficult in the future.

“He (yusof) said: “That you may plant seven years (in succession) as usual; then what you have to do is leave it at your base except for a little for you to eat. Then after that comes seven very difficult years, which spend what you keep to deal with (hard years), except for a little of what (grain bibits) you keep.

Quran and Hadith

KEY PRINCIPLES THAT CAN BE APPLIED TO FINANCIAL DECISIONS BASED ON QURAN AND HADITH

01



Earning halal income

Al-Baqarah verse 188 : "And eat not up your wealth among yourselves unjustly, nor give it away to the rulers (in bribes) to sin against (innocent) people's blood knowingly."
(This emphasizes earning wealth through lawful means and avoiding exploitation).

Avoiding Usury (Riba):

Ar-Rum verse 39 : "What you give as an interest to increase (your wealth) in people's properties will have no increase with Allah, and what you give to the poor, in order to seek Allah's Face, will grow manifold."
(This discourages interest-based transactions and promotes charity).

02

03

Responsible Spending and Avoiding Waste:

Hadith (Sahih Bukhari): "The best provision is that which suffices, and the worst of earnings is that which comes from usury." (This emphasizes living modestly and avoiding unnecessary expenses).

04

Importance of Saving and Planning for the Future:

Once income is generated, we must spend it wisely by prioritizing the "needs" rather than "wants". Islam promotes moderation in life, as mentioned in Surah Al-Furqan, verse 67: "And [they are] those who, when they spend, do so not excessively or sparingly but are ever, between that, [justly] moderate."

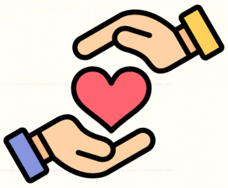
05

Fulfilling Financial Obligations:

Al-Baqarah verse 282: "And if you find yourselves in financial hardship, then postpone (the payment) until you are easy."
(This emphasizes fulfilling debts and financial commitments).

06

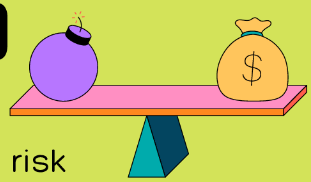
Charity and Social Responsibility:



Al-Baqarah verse 215: "And they ask thee about Zakah (poor-due). Say, 'Zakah is for Allah (to be spent) for the poor and the needy, and for those employed to collect (the funds); and for bringing reconciliation between hearts (of the rich and poor); and for all who are in distress; and for ransom of captives; and for those in debt; and for the way of Allah (Islamic cause); and for the traveler (who is stranded). (This is) a duty (imposed) by Allah. And Allah is Knowing, Wise." (This verse establishes the importance of Zakat, a mandatory charity, and encourages social responsibility).

NINE 9 PRINCIPLE OF FINANCIAL MANAGEMENT

1 TRADE OF RISK AND RETURN



A good portfolio balances risk and return.Higher the risk and higher the expected rates of return

2 OPTIMAL CAPITAL STRUCTURE

Capital structure (debt vs. equity) shows a company's financing mix. Investors use this to judge financial health; ideally, a company balances debt (cheaper) with equity.

3 DIVERSIFICATION

Diversifying your investments (or borrowing) helps manage risk and find the best balance between cost and reward.

4 TIME VALUE OF MONEY

Money now is worth more than money later (time value). Consider inflation and other factors that erode value over time.

5 CASHFLOW MANAGEMENT

Cash flow (money in and out) is crucial for financial health. Forecasting cash needs and managing them wisely is key to good financial management.

9 PRINCIPLE OF FINANCIAL MANAGEMENT

6 PROTECTION PLAN

Its plan to transfer the risk of the organization to others.

- Insurance transfers risk to the insurer.
- You pay a premium for this protection.
- Choose a plan based on your risk and budget.
- It's an important financial management decision.

7 WEALTH MAXIMIZATION

Wealth maximization is the process of maximizing the value of an organization. As a finance manager or top management of an organization if you want to manage your financial condition then you must focus on how you can maximize the value of your organization. A wealthy company can invest more in innovative product development

8 REINVEST RATHER THAN CONSUME

Reinvesting profits can grow your business, create jobs, and benefit the economy. Look for good opportunities to put your money back to work.

9 COST OF CAPITAL

Cost of capital is the average cost of borrowing money (debt & equity). Invest only if expected returns are higher than this cost.

COMPANY OBJECTIVE FROM ISLAMIC PERSPECTIVES

The primary objective of financial management is to ensure that all financial activities and decisions comply with Shariah law, which is derived from the Quran and the Hadith. Here are the key principles and objectives:

COMPLIANCE WITH ISLAMIC LAW

PROHIBITION OF RIBA

Charging or paying interest is strictly forbidden. Instead, profit and loss sharing arrangements like Mudarabah (profit-sharing) and Musharakah (joint venture) are encouraged.

AVOIDANCE OF GHARAR

Transactions should be free from excessive uncertainty and ambiguity. This ensures that all parties have clear and transparent information.

PROHIBITION OF HARAM ACTIVITIES

Investments should not be made in businesses that are considered harmful or unethical, such as alcohol, gambling, and pork-related products.

LEGITIMACY OF PROFIT

Profit is viewed as a legitimate reward for the effort, entrepreneurship, and risk undertaken in business activities. It is earned through the provision of goods and services that benefit society.

PROFIT AND LOSS SHARING

Islamic finance encourages profit and loss sharing arrangements such as Mudarabah (profit-sharing) and Musharakah (joint venture). These models ensure that profits and risks are shared equitably among partners.

PROFIT MAXIMIZATION

Achieving financial gains in a manner that is compliant with Shariah law and aligned with ethical, social, and religious principles.

Profit is allowed but maximization of profit is denounced by many Islamic economists. It includes reward and sin which means Allah's blessing and also His wrath (Al-Qasas: 77)

EQUITABLE WEALTH DISTRIBUTION:

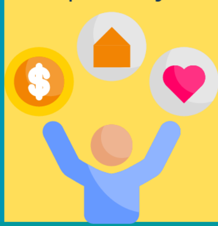
The company should aim to distribute wealth fairly among stakeholders, including employees, customers, and the community.

CHARITABLE CONTRIBUTIONS (ZAKAT):

Companies are encouraged to allocate a portion of their profits to charitable activities and social welfare projects, fulfilling their obligation of zakat (almsgiving).

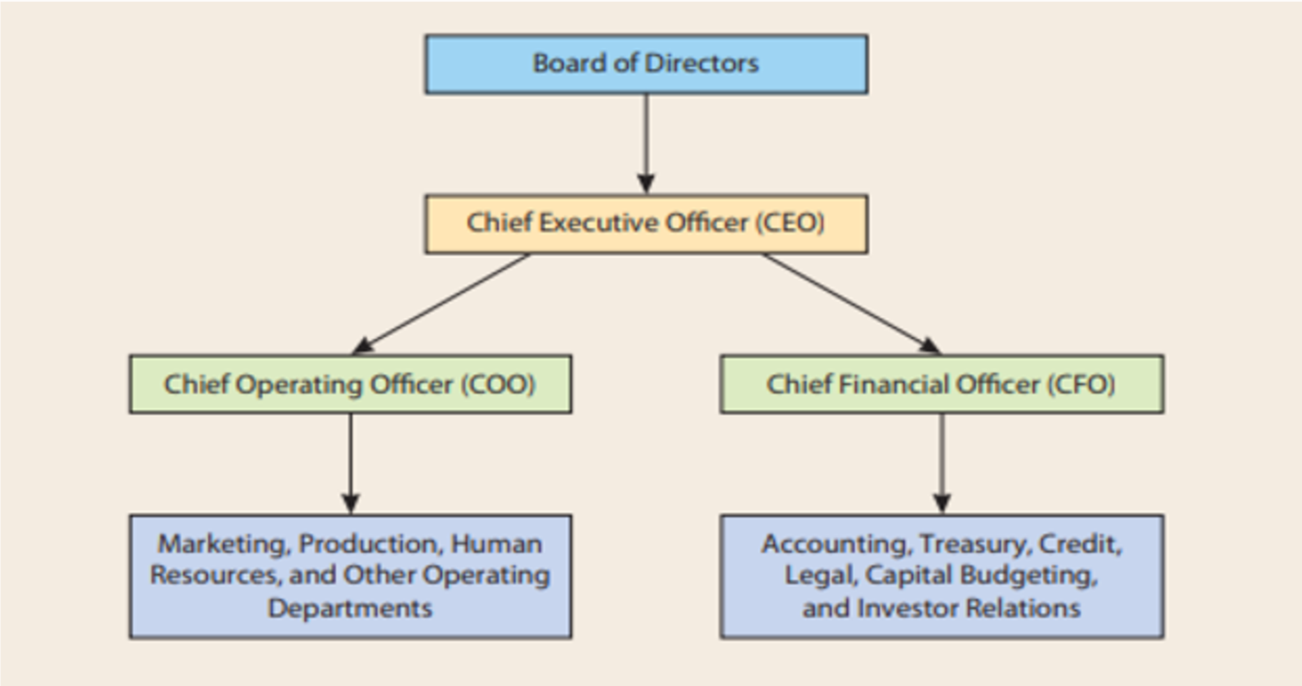
PROMOTION OF SOCIAL JUSTICE AND WELFARE

- Financial management should contribute to social justice, equity, and the welfare of the community. This involves supporting charitable activities, eradicating poverty, and promoting socio-economic development.



FINANCIAL MANAGER RESPONSIBILITY IN AN ORGANIZATION

Finance within an organization



The board of directors is the top governing body, and the chairperson of the board is generally the highest-ranking individual. The CEO comes next, but note that the chairperson of the board often serves as the CEO as well. Below the CEO comes the chief operating officer (COO), who is often also designated as a firm's president. The COO directs the firm's operations, which include marketing, manufacturing, sales, and other operating departments. The CFO, who is generally a senior vice president and the third ranking officer, is in charge of accounting, inancing, credit policy, decisions regarding asset acquisitions, and investor relations, which involves communications with stockholders and the press

DUTIES OF FINANCIAL MANAGER

A Finance Manager distributes the financial resources of a company, is responsible for the budget planning, and supports the executive management team by offering insights and financial advice that will allow them to make the best business decisions for the company

01.

Prepare financial statements, business activity reports, and forecasts

02.

Monitor financial details to ensure that legal requirements are met

03.

Supervise employees who do financial reporting and budgeting

04.

Review company financial reports and seek ways to reduce costs

05.

Analyze market trends to find opportunities for expansion or for acquiring other companies

06.

Help management make financial decisions

07.

Identifying and assessing financial risks. Developing and implementing risk mitigation strategies

08.

Communicating financial information: Presenting financial data and analysis to stakeholders in a clear and understandable manner, providing insights to support informed decision-making across the organization.

Type of capital raising in company

01 Debt capital

This involves borrowing money from lenders, like banks, with the promise to repay it with interest. As alternatives, Islamic banks offer products and services like Mudarabah accounts, Musharakah financing, and Sukuk issuance to support Shariah-compliant capital raising.

Equity Capital 02

Raising capital by selling shares of the company to investors. This can be done through private placements or public offerings (such as an initial public offering, or IPO). Islamic capital markets cater to investors seeking Sharia-compliant options, potentially opening doors to new funding sources.

03 Hybrid capital

Refers to financial instruments that combine equity and debt features in a manner compliant with Shariah principles. Examples include Mudarabah Sukuk, Musharakah Sukuk, and Convertible Sukuk to support Shariah-compliant capital raising.

TOPIC 2

ANALYSIS OF FINANCIAL STATEMENT

What is financial statement

- Financial statements are formal reports that provide a snapshot of a company's financial health and performance. which are officially reported documents. Investors, creditors, and other interested parties are provided with information on the performance of the firm through these reports, which are similar to a report card.

- Financial statements are often audited by government agencies, accountants, firms, etc. to ensure accuracy and for tax, financing, or investing purposes.

Types of financial statement

- **The balance sheet** provides an overview of assets, liabilities, and stockholders' equity as a snapshot in time.

- The **income statement (profit & loss statement)** primarily focuses on a company’s revenues and expenses during a particular period. Once expenses are subtracted from revenues, the statement produces a company's profit figure called net income.

- The **cash flow statement (CFS)** measures how well a company generates cash to pay its debt obligations, fund its operating expenses, and fund investments

THE IMPORTANT OF FINANCIAL STATEMENT

By analyzing financial statements, users can gain valuable insights into the entity's financial performance, liquidity, solvency, and overall financial health. Understanding these statements is crucial for anyone interested in the financial well-being of a business, individual, or organization

Management

- Help the management to understand the position, progress, and prospects of business vis-a-vis the industry
- To formulate appropriate policies and courses of action for the future
- A comparative analysis of financial statements reveals the trend in the progress and position of enterprise

Shareholder

- To know about the efficiency and effectiveness of the management and also the earning capacity and financial strength of the company.
- By analyzing the financial statements, the prospective shareholders could ascertain the profit-earning capacity,

Lender /creditor

- Serve as a useful guide for a company's present and future suppliers and probable lenders.
- It is through a critical examination of the financial statements that these groups can come to know about the liquidity, profitability, and long-term solvency position of a company.

Public

- Business is a social entity. Various groups of society, though directly not connected with business, are interested in knowing the position, progress and prospects of a business enterprise.
- They are financial analysts, lawyers, trade associations, trade unions, tax organization, financial press, research scholars and teachers,

ANALYSE BASIC FINANCIAL STATEMENT

INCOME STATEMENT:

·**Profitability:** Analyze key ratios like gross profit margin, net profit margin, and return on assets (ROA) to assess the efficiency and profitability of the entity's operations.

·**Revenue and expense trends**: Compare revenue and expense trends over time to identify growth patterns, cost control effectiveness, and any significant changes in specific revenue or expense categories.

BALANCE SHEET:

Liquidity: Assess the current assets (cash, inventory, receivables) compared to current liabilities (payables, short-term debt) to evaluate the entity's ability to meet short-term obligations.

Solvency: Compare total assets to total liabilities to gauge the entity's long-term financial stability. Higher debt levels may raise concerns.

Financial health: Analyze trends in current assets and liabilities over time to identify improvements or deterioration in liquidity and solvency

CASH FLOW STATEMENT:

·**Operating cash flow**: Analyze the amount of cash generated from core operations to assess the entity's ability to generate cash internally for funding operations and investments.

·**Investing and financing activities**: Understand how the entity is using its cash for investments and financing activities, and where it's obtaining financing from.

·**Free cash flow:** Calculate free cash flow (operating cash flow minus capital expenditures) to assess the entity's available cash for dividends, debt repayment, or future investments.

FINANCIAL RATIOS

1 LIQUIDITY RATIO

To measure a firm's ability to meet its current obligations as they come due

2 ACTIVITY RATIO

To measure how effective a firm is managing its assets and whether or not the level of those assets is properly related to the level of operations as measured by sales.

3 LEVERAGE RATIO

To measure the extent to which a firm is using debt financing and the degree of safety that the firm provides to the creditors.

4 PROFITABILITY RATIO

To assess a company's ability to generate profit from its operations. These ratios provide insights into how efficiently a company manages its resources and generates returns for its shareholders.

5 P/E RATIO& EPS

- Price earning ratio:

This ratio compares a company's share price to its earnings per share and is used to assess the market's valuation of the company.

- Earning per shares

This ratio indicates the portion of a company's profit allocated to each outstanding share of common stock

6 DIVIDEND PAYOUT & PBV RATIO

- Dividend payout ratio

To shows the proportion of a company's net income that is paid out to shareholders as dividends

- Price to book value ratio

compares a company's market value to its book value. Book value is the net asset value of a company

LIQUIDITY RATIOS

1 CURRENT RATIO

To measures the extent to which the claims of short-term creditors are covered by short-term assets

FORMULA

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

2 QUICK RATIO

Similar to current ratio, but excludes inventory due to its less liquid nature

FORMULA

$$\text{Quick Ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

POSSIBLE CAUSES OF LIQUIDITY PROBLEM

- The company is holding too much inventory
- A poor debt collection system
- Poor cash management
- The company is using short term sources of financing to purchase long-term assets

Scan for example question

SCAN ME

ACTIVITY RATIOS

1 INVENTORY TURN OVER

This ratio indicates how many times the inventory is sold and replaced in a year. A high turnover indicates the firm is rapidly converting its inventory into sales.

$$INVENTORY\ TURNOVER = \frac{COST\ OF\ GOOD\ SOLD}{AVERAGE\ INVENTORY}$$

2 AVERAGE COLLECTION PERIOD

This ratio indicates the number of days taken by a firm to collect its account receivables and is a reflection of the company's credit policy.

formula:

Average Collection period = (Account receiveable/sale) x 360

=_ day

3 FIXED ASSET TURN OVER

Measures how effectively a firm in using its plant and equipment to generate sales & profit

$$fixed\ asset\ turn\ over = \frac{sales}{fixed\ asset}$$

4 TOTAL ASSET TURNOVER

Measures the utilization rate or turnover rate of all the firm's assets.

$$Total\ asset\ turnover = \frac{sales}{total\ asset}$$

LEVERAGE RATIOS

1 DEBT RATIO

What percentage of firm's assets are financed with borrowing

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total asset}}$$

2 RETURN ON INTEREST RATIO

Measures a firm's ability to meet its annual interest cost with its operating income (EBIT)

$$\text{Return on interest} = \frac{\text{Earning before interest (EBIT)}}{\text{interest expense}}$$

3 DEBT TO EQUITY RATIO

Measures the percentage of borrowings used compared with total equity

$$\text{Debt to equity} = \frac{\text{Total liabilities}}{\text{Total equities}}$$

POSSIBLE CAUSES OF HIGH DEBT

- The company may be borrowing more than is necessary
- This could be due to the firm's high dividend payout ratio

PROFITABILITY RATIOS

1 NET PROFIT MARGIN

Ratio of a firm's net income as percentage of its sales

$$Net\ profit\ margin = \frac{Net\ income}{sales}$$

2 GROSS PROFIT MARGIN

The gross profit margin ratio expresses the gross profit as a proportion of sales. It is used as one indicator of a business's financial health.

$$Gross\ profit\ Margin = \frac{gross\ profit}{sales}$$

3 OPERATING PROFIT MARGIN

It indicates how much of each dollar of revenues is left over after both costs of goods sold and operating expenses are considered.

$$Operating\ profit\ margin = \frac{net\ operating\ ncome}{Sales}$$

4 RETURN ON ASSET

Indicates the profitability on the assets of the firm (after all expenses and taxes).

$$ROA = \frac{Net\ income}{Total\ asset}$$

5 RETURN ON EQUITY

Its measures the firm's abilityto earn return on the money that the stockholder has invested

$$ROE = \frac{Net\ income}{Equity}$$

STOCK&DIVIDEND RATIOS

1 PRICE /EARNING RATIO (P/E)

Indicates how much investors are willing to pay per dollar of earnings. A high P/E may suggest that the stock is overvalued, or investors expect high growth rates in the future.

formula:

P/E Ratio = Market Price per Share / Earnings per Share (EPS)

2 EARNING PER SHARE (EPS)

Measures the profitability of a company on a per-share basis.

Formula: EPS = (Net Income - Dividends on Preferred Stock) / Average Outstanding Shares

3 DIVIDEND PAYOUT RATIO

Indicates the proportion of a company's earnings that is distributed to shareholders in the form of dividends.

Dividend payout ratio = (Dividend per share/ Earning per share)x 100

alternatively

Dividend Payout Ratio = (Total Dividends Paid / Net Income) * 100

4 PRICE TO BOOK VALUE

Used to evaluate whether the stock a company is over or undervalued by comparing the price of all outstanding shares with the net assets of the company.

Formula:

P/B Ratio = Market Price per Share / Book Value per Share

Book Value per Share= (Total Asset-Total liabilities)/number of shares

TOPIC 3

TIME VALUE OF MONEY

WHAT IS TVM?

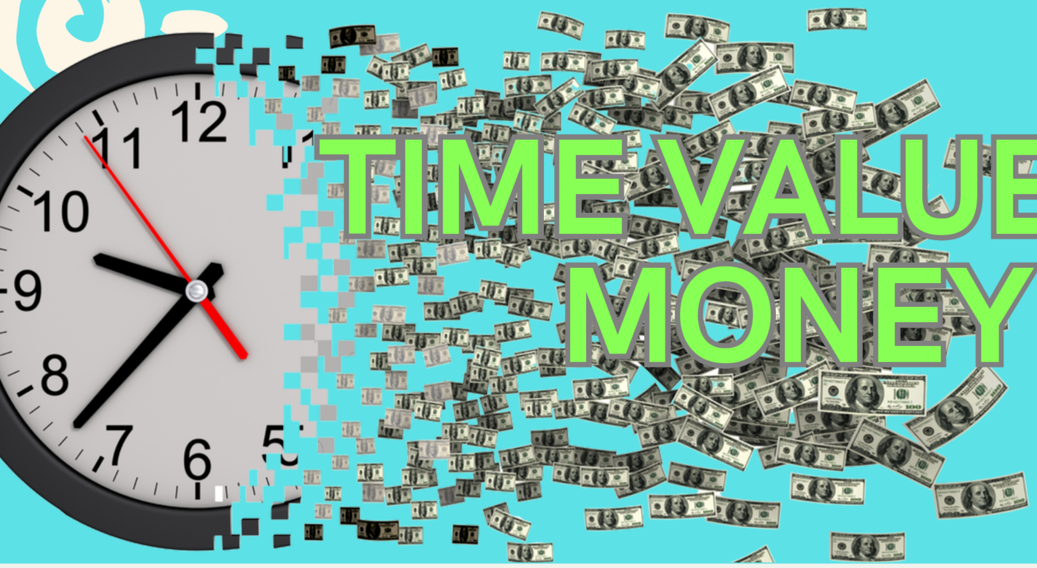
- The Time Value of Money (TVM) is a fundamental concept in finance that states money has a different value depending on when it is received or paid. In simpler terms, a ringgit today is worth more than a ringgit tomorrow, because you can invest that ringgit today and potentially earn interest or returns on it, making it grow in value over time.

RM50

Year 2014

Year 2024

Comparison the value of RM50 for year 2014 and year 2024



TIME VALUE OF MONEY

CONVENTIONAL TIME VALUE OF MONEY VS. ISLAMIC PERSPECTIVE:

Traditionally, the time value of money recognizes that money now is worth more than the same amount of money in the future due to factors like inflation and potential earning opportunities. This concept forms the basis of interest (riba) in conventional finance, which is prohibited in Islam.

ISLAMIC VIEW ON TIME VALUE OF MONEY:

RIBA PROHIBITION

The Quran explicitly prohibits riba (usury or interest) in several verses, such as Al-Baqarah 2:275. This creates a hurdle for directly incorporating a predetermined interest rate into financial transactions.

FOCUS ON UNDERLYING ASSETS

Islamic finance emphasizes the underlying asset or activity in financial transactions. Profit-sharing and risk-sharing mechanisms are preferred over fixed-interest payments.

TIME VALUE RECOGNIZED INDIRECTLY

Islamic scholars acknowledge the time value of money in certain contexts. For instance, some jurists have allowed for a difference in price between a cash purchase and a deferred payment on a sale (bai muajjal). This reflects the time value associated with immediate access to the good.

Concept of Present value & Future value

Future value (FV) and present value (PV) are two fundamental concepts in finance that deal with the time value of money. They help us understand how the value of money changes over time.

01

FUTURE VALUE (FV):

Represents the value of a current amount of money in the future, assuming a specific interest rate and time period.

02

PRESENT VALUE (PV):

Represents the current worth of a future sum of money, considering a specific interest rate and time period.

03

EXAMPLE OF FV

Invest $1,000 today at an annual interest rate of 5%. In one year, your investment will grow to $1,050 (assuming simple interest). This $1,050 is the future value of your initial $1,000 investment.

04

EXAMPLE OF PV

Let's say you're offered $1,050 in one year. Based on the same 5% interest rate, the present value of that future amount would be $1,000 (using the present value formula). In other words, $1,000 invested today at 5% interest for one year would be equivalent to receiving $1,050 in a year.

05

FUTURE VALUE (FV) FORMULA

FV = PV x (1 + r)^n

Where:
FV = Future Value
PV = Present Value
r = Interest Rate (per period)
n = Number of Periods

06

PRESENT VALUE (PV) FORMULA:

PV = FV / (1 + r)^n

Where:
FV = Future Value
PV = Present Value
r = Interest Rate (per period)
n = Number of Periods

The important of Time value of Money

TVM

Investment evaluation

TVM helps companies assess the true value of future cash flows from potential investments. A project promising a high return in 10 years might not be as attractive as one with a lower return but delivering profits sooner. By considering the time value of money, companies can prioritize investments that offer the greatest present value.

Capital Budgeting

When allocating resources, companies need to compare projects with varying costs and benefits spread across different timeframes. TVM allows them to compare these projects on an "apples-to-apples" basis, ensuring they invest in initiatives with the highest potential for present value returns.

Debt Management

Understanding TVM helps companies evaluate the true cost of borrowing. The interest payments over the loan term add to the overall cost, making a seemingly attractive low-interest loan potentially less appealing compared to a higher-interest loan with a shorter payback period.

Cashflow management

VM allows companies to forecast future cash inflows and outflows. This helps them anticipate potential shortfalls and plan for financing needs. By understanding how the time value of money impacts their cash flow, companies can optimize their working capital and avoid liquidity issues.

Profitability Analysis

Measuring a company's profitability solely based on total revenue can be misleading. TVM helps factor in the timing of expenses and revenues, providing a more accurate picture of a company's true profitability.

Valuation

When considering mergers, acquisitions, or going public, companies need to determine their fair market value. TVM plays a role in calculating the present value of a company's future cash flows, which is a key factor in determining its worth.

Example calculation

example FUTURE VALUE

Example 1: Future Value (FV) - Savings Account

Let's say you plan to save for a down payment on a house in 5 years. You currently have RM3,000 (present value) that you'll deposit into a savings account with an annual interest rate of 2%. You like to know how much money you'll have in 5 years (future value) to make a down payment.

FV Formula: FV = PV x (1 + r)^n

- FV = Future Value (unknown)
- PV = Present Value = $3,000
- r = Interest Rate per year = 2% (expressed as a decimal: 0.02)
- n = Number of Years = 5

Calculation

FV = $3,000 x (1 + 0.02)^5

FV = $3,000 x 1.02^5 FV ≈ $3,635.62 (rounded to two decimal places)

Interpretation

In 5 years, with an annual interest rate of 2%, your $3,000 savings will grow to approximately $3,635.62. This future value represents the total amount you'll have accumulated in your savings account for your house down payment.

Example calculation

example **PRESENT VALUE**

Example 2: Present Value (PV) - Investment

Imagine you're considering an investment that promises a return of $10,000 in 7 years. You'd like to know how much you should invest today (present value) to get that $10,000 (future value) in 7 years, assuming an expected annual interest rate of 5%.

PV Formula: PV = FV / (1 + r)^n

- PV = Present Value (unknown)
- FV = Future Value = $10,000
- r = Interest Rate per year = 5% (expressed as a decimal: 0.05)
- n = Number of Years = 7

Calculation

PV = $10,000 / (1 + 0.05)^7
PV ≈ $6,075.77 (rounded to two decimal places)

Interpretation

Based on the expected 5% annual interest rate, you would need to invest approximately $6,075.77 today to receive $10,000 in 7 years. This present value represents the initial amount you should invest to achieve your desired future value.

TOPIC 4

RISK AND RETURN

What is return

- Return refers to the gain or profit you expect to make on an investment over a certain period. This can come from various sources like interest payments, dividends, or an increase in the value of the investment itself.

What is risk

- Risk signifies the uncertainty associated with achieving that expected return. There's always a chance that your investment might not perform as anticipated, and you could even experience a loss.

The relationship between risk and return

- **Higher potential returns come with higher risk**. Investments that promise big profits are more likely to experience significant fluctuations in value, and there's a bigger possibility you might lose money.
- **Lower-risk investments typically offer lower returns**. Think of safe havens like government bonds. They provide a steady stream of income with minimal risk of losing your principal amount, but the growth potential is also limited.

Risk and Return in Islamic Perspective:

01

Profit sharing

Islamic finance emphasizes profit sharing over fixed returns. This aligns with the prohibition of Riba (usury), which refers to predetermined interest on loans. Instead, Islamic instruments like Mudarabah (profit-sharing partnership) link your return directly to the venture's performance. You share profits if the investment succeeds, but also bear losses proportionately.

In Surah Al-Muzammil verse 20: "...and others who are journeying in the land in quest of Allah's bounty" In addition, the hadith of the Prophet Muhammad also explains about Mudarabah (**One of Profit sharing contract**). This hadith was narrated by Ibn Majah of Shuhaib Radiyallahu Anhu. From Shuhaib r.a. that the Messenger of Allah said. "There are three blessed things: buying and selling that are held, giving capital (fund), and mixing wheat with barley family, not for sale" (Ibn Majah From Shuhaib). The hadith clearly shows that financing based on Mudarabah is also done by the Prophet. Thus, the implementation of Mudarabah in our current economic life should be in line with what is disbursed by the Messenger of Allah that the economic activities get a blessing from Allah.

02

Risk Management

Shariah encourages responsible risk-taking. While some risk is inherent in any business activity, excessive speculation (Maysir) and ambiguity (Gharar) are discouraged. Islamic financial products are structured to minimize uncertainty and prioritize ethical business practices.

Risk and Return in Islamic Perspective:

02

Risk Management in Quran

There are many Quranic verses that guide mankind to have risk management in wealth and financial affairs.

It is stated in Surah Yusuf verse 47-49 : [Yusuf] said, "You will plant for seven years consecutively; and what you harvest leave in its spikes, except a little from which you will eat. Then will come after that seven difficult [years], which will consume what you saved for them, except a little from which you will store. Then will come after that a year in which the people will be given rain and in which they will press [olives and grapes]"

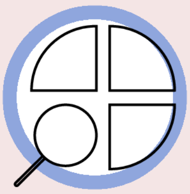
In the above verses, prophet Yusuf (p.b.u.h.) interpreted the dream of the king of Egypt that Egyptian would face seven years of drought after seven years of prosperity. Hence, he advised the king to develop an economic strategy in order to overcome the upcoming catastrophe. To be precise, Egyptians had to implement the proposition by actively planting crops during the first seven years and store much of the proceeds as a preparation to face seven years of drought, as interpreted by prophet Yusuf. As recommendations implemented it resulted in the country surviving the seven years of drought.

Risk Categorization:

03

Shariah scholars categorize risk into three types:

- **Forbidden Risk** (Gharar): This involves excessive uncertainty or deliberate exploitation. It's strictly avoided in Islamic finance.
- **Essential Risk**: This is the inherent risk associated with any business venture. It's accepted and borne by the parties involved.
- **Tolerable Risk**: This is manageable risk that can be mitigated through proper due diligence and risk management strategies. Shariah-compliant instruments often incorporate these strategies.



Risk and Reward Balance

04

The Islamic concept of "al-ghunm bil-ghurm" (gain with burden) emphasizes a fair risk-reward relationship. Just as you share potential profits, you also share potential losses. This discourages purely speculative ventures and promotes responsible investment.

THE TYPES OF RISK IN FINANCIAL MANAGEMENT

FINANCIAL RISK

01

Financial risk refers to the possibility of losing money due to fluctuations in financial markets, or an inability to meet financial obligations. It's a major concern for both individual investors and businesses, as unexpected events can significantly impact financial goals and stability.

BUSINESS RISK

02

Business risk encompasses the various uncertainties associated with a company's operations and strategies. These risks can significantly impact a company's profitability, growth, and overall success.

How Business Risk Affects Financial Risk:

- Poor operational performance (business risk) can lead to decreased revenue and profitability, making it difficult to meet financial obligations (financial risk).
- Strategic blunders (business risk) can result in missed opportunities or losses, impacting the company's financial health (financial risk).
- Regulatory penalties due to non-compliance (business risk) can translate to significant financial burdens (financial risk).

Shariah-Compliant Framework

Islamic financial instruments and practices must adhere to Shariah law. This legal framework guides how risk is perceived and managed. Examples of Risk Management in Islamic Finance:

- Profit-Sharing Models: Islamic instruments like Mudarabah (partnership) or Musharakah (joint venture) avoid fixed returns and emphasize shared risk and reward. This aligns profit with venture performance.
- Screening for Ethical Practices: Investments in industries prohibited by Shariah (e.g., alcohol, gambling) are excluded.

Focus on Underlying Assets: Islamic finance emphasizes financing real economic activity with tangible assets.

Financial risk

Market Risk

The risk that the overall market (stocks, bonds, etc.) will decline, causing investment losses.

Credit Risk

The risk that a borrower defaults on a loan, leading to non-payment.

Foreign Exchange Risk

The risk of losses due to fluctuations in currency exchange rates.

financial risk simplify as:

The risk of financial loss due to fluctuations in financial markets or an inability to meet financial obligations.

Interest Rate Risk

The risk that changes in interest rates will negatively impact investments or borrowing costs.

Liquidity Risk

The difficulty of selling an asset quickly at a fair price when needed.

business risk

THE TYPES BUSINESS RISK

Operational Risk

The risk of losses due to internal inefficiencies, disruptions, or human error.

Strategic Risk

The risk that a company's overall strategy becomes ineffective due to changing market conditions or competitor actions.

Compliance Risk

The risk of legal or regulatory penalties for non-compliance with laws or regulations.

Technological Risk

The risk that a company falls behind due to outdated technology or disruptions from new technologies.

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TOPIC 5

STOCK AND ISLAMIC BOND VALUATION

Concept of stock market

- The stock market is the market in which shares of publicly held companies are issued and traded either through exchanges or over-the-counter markets
- Also known as the equity market, the stock market is one of the most vital components of a free-market economy, as it provides companies with access to capital in exchange for giving investors a slice of ownership in the company
- The stock market makes it possible to grow small initial sums of money into large ones, and to become wealthy without taking the risk of starting a business

What are shares?

- A share is one of a finite number of equal portions in the capital of a company, entitling the owner to a proportion of distributed, non-reinvested profits known as dividends and to a portion of the value of the company in case of liquidation. Equity is a share in the ownership of a company. It represents a claim on the company's assets and earnings. As you acquire more stock, your ownership stake in the company increases. The terms share, equity and stock mean the same thing and can be used interchangeably.

Function of stock market

- Provides a market place to accommodate a large number of buyers & sellers
- Disseminates all relevant information to the potential buyers & sellers
- As a tool to provide resources for corporations and provide them with sufficient funds
- Channel for the corporation to raise funds.

The differences between ordinary and preferred shares

Ordinary share

- Common stock represents equity or ownership position in a corporation.
- Investors are normally interested in investing in common shares because they offer the potential of current income in the form of dividends, stability of capital as well as capital gains.
- A person who bought the common stock of common shares is called as the shareholder or stockholder
- Board representation and in control (has voting right)

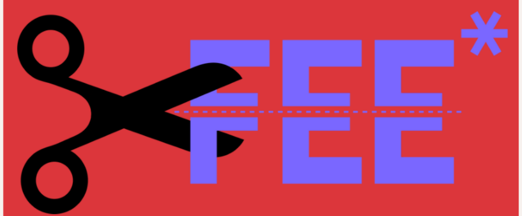
VS

Preferred shared

- Commonly referred to as preferred shares, are shares of a company's stock with dividends that are paid out to shareholders before common stock dividends are issued
- Most preference shares have a fixed dividend
- Typically do not hold any voting rights
- Guaranteed payment in terms of dividend before common share

BONUS ISSUE

The bonus issue is an offer of free additional shares to existing shareholders. A company may decide to distribute further shares as an alternative to increasing the dividend pay out



NO FEE IMPOSED

PRICE ADJUSTMENT

- Price adjustment will be imposed after bonus issue
- By increasing the number of shares, the share price is adjusted to a lower level, making the stock more affordable for smaller investors.

EXAMPLE

Bonus issue Chobee 1:5
•1 unit of bonus shares for every 5 units of shares held
•Example calculation
•Share unit held = 500 unit
•Bonus issue receive = 100 unit
•Total share accumulated = 600 unit

INCREASE SHARES

•The total number of shares outstanding in the company increases.

WHY

Why companies might do a bonus issue:
Reward Shareholders:
It's a way to share the company's success with shareholders without having to pay out a cash dividend.
Attract Investors:
A larger number of shares can make the stock appear more affordable, potentially attracting new investors, particularly retail investors.
Signal Confidence:
Issuing bonus shares can indicate strong financial health and a belief in future growth.

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RIGHT ISSUE

01

INVITATION

A RIGHTS ISSUE IS AN INVITATION TO EXISTING SHAREHOLDERS TO PURCHASE ADDITIONAL NEW SHARES IN THE COMPANY.

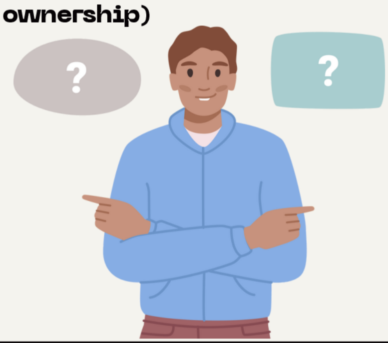
02

TYPE OF OPTION

These are considered to be a type of option since it gives a company's stockholders the right, but not the obligation, to purchase additional shares in the company.

DILUTION

Since more shares are issued, a rights issue can lead to dilution of existing shareholders' ownership stake in the company (percentage of ownership)



03

REDUCE PRICE

Normally at reduced price. Usually the discounted price will stand for a specified time frame

04

REASON FOR RIGHT ISSUE

Raise Capital:
Companies use rights issues to raise additional funds for various purposes like expansion, debt repayment, or funding new projects. , acquire assets, or facilitate expansion without having to take out a loan from a bank.

Maintain Shareholder Loyalty:
It can be a way to reward existing shareholders and give them a
chance to increase their stake in the company at a discounted price.

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INTRINSIC VALUE

The genuine worth of a stock, as determined by fundamental criteria rather than its present market price, is known as its intrinsic value. This figure is the result of a thorough examination of the company's financial standing, potential for future profits growth, dividend payments, and other pertinent business and economic variables.

FACTOR DETERMINING INTRINSIC VALUE

FUTURE CASH FLOW

Estimating the future earnings or dividends the company is expected to generate.

GROWTH PROSPECTS

Evaluate the company's potential for growth in revenue, profits, and market share.

FINANCIAL HEALTH

Analyzing the company's balance sheet, income statement, and cash flow statement for indicators of financial stability and performance.

ECONOMIC AND INDUSTRY CONDITIONS:

Considering the broader economic environment and industry-specific trends that could impact the company's future performance.

EXAMPLE

If an investor calculates the intrinsic value of a stock to be RM100 based on the present value of its expected future cash flows, but the stock is currently trading at RM80, the stock is considered undervalued. Conversely, if the stock is trading at RM120, it may be overvalued.

EQUITY EVALUATION METHOD

1 DIVIDEND YIELD

- The Dividend Yield is a financial ratio that measures the annual value of dividends received relative to the market value per share of a security.
- In other words, the dividend yield formula calculates the percentage of a company's market price of a share that is paid to shareholders in the form of dividends.

2 DIVIDEND DISCOUNT MODEL

- The Dividend Discount Model, often known as the DDM, is a method of valuation that attempts to determine the intrinsic value of a company by calculating the present value of the dividends that are anticipated to be paid in the future.
- The approach is based on the idea that the value of a company is equal to the total of all of its future dividend payments, discounted back to their value at the current time.

SUMMARY

The Dividend Discount Model and Dividend Yield are crucial for evaluating dividend-paying stocks. They provide insights into a stock's value, income potential, and risk, helping investors make informed decisions and build robust, income-generating portfolios.

DIVIDEND YIELD

01

FORMULA

$$\text{Dividend Yield} = \frac{\text{Annual Aividend per Share [\$]}}{\text{Price per Share [\$]}} \text{ x } 100$$

- Find the annual dividends paid by the company per share.
- Divide the annual dividend by the current share price.

02

COMPARE WITH HISTORICAL DIVIDEND YIELD:

- Compare the current dividend yield to the historical average dividend yield of the stock.
- If the current yield is higher than the historical average, the stock may be undervalued.
- If the current yield is lower than the historical average, the stock may be overvalued.

03

COMPARE WITH INDUSTRY PEERS:

- Compare the dividend yield with that of other companies in the same industry.
- A higher yield might indicate a more attractive investment, provided the dividends are sustainable.

DIVIDEND DISCOUNT MODEL

01

ZERO GROWTH MODEL

- Assume a constant dividend every year(dividend expected not to grow)
- The same amount of dividend is paid every year
- Assume that the required rate of return for the share remains constant at k which is equal to the cost of equity for the company
- Formula :

$$\bullet\ V_0 = \sum_{t=1}^{\infty} \frac{D_t}{(1+k)^t} = \frac{D}{K}$$

where,

- D = constant annual dividend
- k = investors' required rate of return

02

CONSTANT-GROWTH MODEL

- The dividend growth rate is forever; perpetual & never changes
- Dividend expected to growth at constant rate over time
- The required rate of return is also constant over time
- The g must less than the k

$$Price\ (V_0) = \sum_{t=1}^{\infty} \frac{D_0(1+g)^t}{(1+k)^t} = \frac{D_1}{k-g}$$

03

VARIABLE/MULTIPLE GROWTH MODEL

- Assume that dividends will grow at different growth rate
- Known as Two-stage Growth DDM or Non-constant Growth DDM
- Assume that dividends in short-term will be different than long-term, LT more stable & predictable
- This model allows for a non-constant growth phase in the beginning years up to year t which thereafter the dividends are expected to grow at a constant rate that last forever

$$V = \frac{D^1}{(1+k)'} + \frac{D^2}{(1+k)^2} + \frac{D^n}{[1+k]^n} + \frac{P_n}{(1+k)}n$$

$$\boxed{p_n = \frac{D(n+1)}{k-g}}$$

EXERCISE DDM

The common stock of Amra Corporation is expected to pay annual dividend of RM0.22 per shares and this dividend is expected to remain constant for an indefinite period. Compute the value of this stock if the required rate of return is 10%.

The common stock of Amra Corporation is expected to pay annual dividend of RM0.22 per shares next year and this dividend is expected to growth at a rate of 5% annually. Compute the value of this stock if the required rate of return is 10%.

Policoop Bhd has discovered a new product with higher potential. The company is expected to gain a super growth rate in its earning thus paying generous dividends to its shareholder.Its dividend expected to grow at 40% this year, 30% next year, 20 % for the following years and 10% thereafter. Its current dividend is RM0.20. What is the value of the stock if the required rate of return is 15%.

CONCEPT OF ISLAMIC BOND

DEFINE

- **Literally**, Sukuk is a plural of sakk .
Sakk means certificate
- **Technically**,
Certificates or securities representing financial rights arising from underlying trade & other commercial activities in accordance to Shariah principles
.

CHARACTERISTICS OF ISLAMIC BOND #1

Document issued in equal value either in the name of the owner or bearer to establish the right of the certificate owner or rights and obligations such certificate is representing

CHARACTERISTICS OF ISLAMIC BOND #2

Sukuk represent a common share of ownership of assets available for investments, including non-monetary, usufructs or monetary assets. Sukuk did not represent debt owed to the issuer by the certificate holder

CHARACTERISTICS OF ISLAMIC BOND #3

Sukuk is issued based on a Shariah-compliant contract in which case the issue of trading of this sukuk is governed by the rules of the respective contract

CHARACTERISTICS OF ISLAMIC BOND #4

The trading of investment sukuk is subject to the terms that govern the trading of the rights they represent (tradability in the secondary market)

CHARACTERISTICS OF ISLAMIC BOND #5

The owner of the certificate shares the return as stated in the subscription prospectus & bears the losses, according to his respective share of ownership

TYPES OF ISLAMIC BOND (SUKUK)

DEBT BASED SUKUK

Sukuk al-Murabaha: This structure resembles a deferred payment sale. The issuer purchases an asset and sells it to the Sukuk holders on a deferred basis with profit. Investors get periodic installments, and the underlying asset is at maturity.

Salam Sukuk: Based on the Islamic financing principle of "Bai Salam," which involves an advance payment for a good to be delivered at a future date. It represents a debt obligation. They provide upfront capital in exchange for a future return on the underlying asset's sale.

istisna sukuk:Based on the Islamic financing principle of "Istisna," which involves commissioning the manufacturing of a specific good according to agreed-upon specifications. functions like a debt instrument from the investor's perspective. They provide upfront capital for the asset's creation with the expectation of a future return.

EQUITY BASED SUKUK

Sukuk al-Musharaka: This represents a partnership where the Sukuk holders co-own an asset with the issuer. Profits and losses are shared based on pre-defined ratios.

Sukuk al-Mudarabah: This Sukuk reflects a profit-sharing partnership. Investors provide capital, and the issuer manages it for a specific project. Profits are shared according to a pre-determined agreement.

LEASED BASED SUKUK

Leased-based Sukuk, also known as **Sukuk al-Ijarah**, is a prominent type of Islamic bond structured around a leasing agreement. Ijarah translates to "leasing" in Arabic. This Sukuk reflects a leasing contract between the Sukuk holders (investors) and the issuer.

BOND VALUATION

PRESENT VALUE METHOD

$$V_b = \sum_{x=1}^{n} \frac{C}{(1+i)^n} + \frac{P}{(1+i)^n}$$

or,

$$V_b = C\left(PVIFA_{i,n}\right) + P(PVIF_{i,n})$$

Annually

$$V_b = \sum_{x=1}^{2n} \frac{C/2}{(1+i/2)^{2n}} + \frac{P}{(1+i/2)^{2n}}$$

or,

$$V_b = C/2\left(PVIFA_{i/2,2n}\right) + P(PVIF_{i/2,2n})$$

Semi Annually

CURRENT YIELD

- The ratio of the coupon interest to the current market price.
- Current Yield = (interest receive)/(market price)

Example A bond with a face value of RM 1000 has a coupon rate at 10% and the market price is RM 920. Calculate its current yield.
Current Yield = 100/920 = 10.9%

YIELD TO MATURITY

- The promised compounded rate of return on a bond purchased at the current market price and held to maturity
- YTM allows investors to compare a bond's expected return with other bonds' returns

$$\text{YTM} = \frac{C + \frac{F-P}{N}}{\frac{F+P}{2}}$$

Approx..YTM

$$r = \text{lower interest (a)} + \frac{distance\ on\ top(b)}{outside\ distance(c)} \text{ x (highest} - \text{lowest i(d))}$$

Interpolation formula for try and error method

TOPIC 6
DIVIDEND POLICY

What is a dividend?

- A dividend is a payment made by a company to its shareholders on a regular basis. The company may use its profits, cash reserves, or even debt to make the payment.
- Dividends are distributed on a per-share basis and can be paid on a quarterly basis, at the end of each half of the fiscal year, or yearly. Dividends can also be given annually.
- Investors who have contributed capital to a company in order to facilitate its expansion are eligible to receive dividend payments as a kind of compensation.
- Despite the fact that the vast majority of dividend payments are delivered in cash to shareholders, dividends can also be distributed in other ways, for as by issuing new shares to investors.

What is dividend policy?

- The amount of cash distributed to shareholders is decided by a dividend policy. A corporation must examine its earnings to determine how much should be maintained for future growth and how much should be distributed to investors in order to determine what dividend, if any, to pay.
- The dividend policy establishes the dividend payment schedule and methodology. If a company has more than one share class, it also makes it clear who gets what. dividends, for instance, on ordinary and preference shares.
- Clauses explaining the mechanics of bonus payments, such as special dividends or share buybacks, may also be included in dividend plans.

FACTOR DETERMINING DIVIDEND POLICY

STABILITY OF EARNINGS

If earnings are relatively stable, a firm is in a better position to predict what its future earnings will be and such companies are more likely to pay out a higher percentage of its earnings in dividends than a concern which has a fluctuating earnings.

LIQUIDITY OF FUNDS

Payment of dividend means, a cash outflow, and hence, the greater the cash position and liquidity of the firm is determined by the firm's investment and financing decisions.

GROWTH OPPORTUNITIES

If a company has significant growth potential, it might prioritize retaining earnings to fund future expansion rather than paying dividends.

DEBT OBLIGATIONS

Large amounts of debt make it impossible for a company to pay bigger dividends to its owners. Keeping earnings is very important for companies that are on a plan to reduce their debt by a large amount.

PAST DIVIDEND RATES

The dividend rate may be decided on the basis of dividends declared in the previous years

FINANCING POLICY OF THE COMPANY

Dividend policy may be affected and influenced by financing policy of the company. If the company decides to meet its expenses from its earnings, then it will have to pay less dividend to shareholders

TYPES OF DIVIDEND POLICY

Residual dividend policy

Company pays whatever cash is left in the business once all expenditures has been taken into account. This means that shareholders receive the sums left after the company has taken the likes of capital expenditure, investment and working capital into account.

Stable dividend policy

Company tries to make a consistent payout each year regardless of how the business has performed. Instead of basing the dividend on the company's performance over the short term, stable dividend policies are more closely linked with long-term prospects and forecasts.

Progressive dividend policy

A company that agrees to a progressive payout strategy will raise the dividend every year. progressive policy tries to raise the dividend by the same amount as earnings growth. If earnings fall, the company will still raise the payment.

Regular dividend policy

Also known as a constant dividend policy,
sees payouts closely linked to the company's performance, both rising and falling in line with earnings. This often involves setting a payout rate.
Gain is high ,earning will high

Irregular dividend policy

- Do not pay regular dividend
- Reason-uncertainty earning
- Lack of liquid resource

Special dividend

These are one-off payments made to shareholders and often made in addition to 'ordinary dividends'. This can happen if a company sells a valuable asset and books a tidy profit. Similarly, if a business makes a large amount of profit one year.

TOPIC 7
WORKING CAPITAL MANAGEMENT

What is working capital

- Working capital refers to the funds that a business has available for day-to-day operations.
- Working capital is essential to a company's ability to pay for its short-term expenses, such as rent, payroll, and supplier payments. Having sufficient working capital is crucial for a business to run smoothly, meet its obligations, and take advantage of growth opportunities.
- Company's working capital needs can vary depending on its industry, size, and growth rate. Companies may need to manage their working capital carefully to maintain financial stability and avoid cash flow problems. This may involve optimizing inventory levels, negotiating better payment terms with suppliers, and improving collections of accounts receivable.

What is working capital management

- Working capital management involves managing a company's current assets and liabilities to meet short-term obligations and continue operations.
- It focuses on the part that will figure out the current assets and current debts.
- It figures out the best way to spend present assets and finds the money that is available to pay for those assets.
- The system of checks and balances at this level of management makes sure that the money coming into the business is enough to keep it running.

NET WORKING CAPITAL

Net working capital = Current Asset- Current Liabilities

NET WORKING CAPITAL

•Positive net working capital shows that there is a surplus of current assets over current liabilities which show part of the asset have been financed with long term funding sources.

=

CURRENT ASSET

Asset owned by company that are expected to converted into cash in a period not exceeding one year.
Component:
-cash= most liquid asset
-current deposit=can be changed anytime
-Account receivable=exist due to credit sale, when customer settle the payment, it turn to cash
-inventories-include goods that have not been sold /pending delivery to customer.

−

CURRENT LIABILITIES

Company short term obligation to be complete within a period of time or not more than one year.
Component:
-account payable-when company get supplies on credit
-accrual-expenses that have been incurred but not yet paid in cash.example , wages to employee are paid at the end of the month.
-short term debt
-loan
-overdraft from FI

CASH MANAGEMENT

Cash management is the efficient handling of a company's cash flows. It involves a delicate balance between having enough cash on hand to meet daily operations and investing excess cash to earn a return. the goal is to optimize cash usage, minimize holding costs, and reduce the risk of cash shortages.• the business objectives of a firm can be unified as bringing about consistency between maximum possible profitability and liquidity of a firm.

CASH MANAGEMENT OBJECTIVES

MAINTAIN ADEQUATE LIQUIDITY

Maintaining sufficient cash balances to meet short-term financial obligations such as payroll, taxes, and supplier payments. A company must have enough liquidity to sustain its operations and prevent financial distress.

MINIMIZE IDLE CASH

Idle cash refers to cash balances that are not being used to generate income. Idle cash can be a wasted resource, as it is not generating a return for the company. By minimizing idle cash, a company can improve its return on cash investments and maximize its cash flow.

INVEST IN ETHICAL AND SHARIAH-COMPLIANT INVESTMENTS

This means investing in assets and businesses that are in line with Islamic principles and values. Examples of Shariah-compliant investments include Islamic mutual funds, Sukuk (Islamic bonds), and halal businesses.

MAXIMIZE RETURN ON EXCESS CASH

- Utilize excess cash to earn a return through marketable securities or other short-term investments.
- Reduce the cost of holding cash by investing idle funds.

CONTROL CASH DISBURSEMENTS

- Efficient payment systems: Use electronic payments and other cost-effective methods.
- Payment discounts: take advantage of early payment discounts when offered.

MAINTAIN GOOD RELATIONSHIPS WITH STAKEHOLDERS

Stakeholders such as customers, suppliers, and employees. this means ensuring that payments are made on time and that cash is managed in a transparent and ethical manner. It can help a company to negotiate favorable terms, reduce late payment fees, and improve its reputation.

MANAGE FINANCIAL RISKS

Such as credit risk, interest rate risk, and currency risk. this means managing credit exposures, hedging interest rate and currency risk, and monitoring market conditions to anticipate and manage financial risks.

MINIMIZE CASH HOLDING COSTS

- Cash concentration: Pool cash from multiple locations to reduce overall cash balances.
- Bank relationships: Negotiate favorable terms with banks to reduce fees.

By effectively managing cash, businesses can improve their financial stability, reduce costs, and enhance overall profitability.

MARKETABLE SECURITIES

Marketable securities are short-term investments that can be easily converted into cash, low risk and short in maturities (less 1 year). Typically held by companies to manage their liquidity and earn a return on excess cash.

TYPES OF MARKETABLE SECURITIES

STOCK

Stock represents an equity investment because shareholders maintain partial ownership in the company they have invested. The company can use shareholder investment as equity capital to fund the company's operations and expansion.

TREASURY BILL

These are short-term debt instruments issued by the government with a maturity period of one year or less. T-bills are considered to be the safest form of marketable securities, as they are backed by the government.

CERTIFICATES OF DEPOSIT (CDS)

This deposit is issued by commercial banks and merchant bank .they verify that sum of money is kept as deposit with the bank for a certain period with the rate specified. The NCD can be traded and the ownership transferred.

MONEY MARKET FUNDS:

Mutual funds that invest in short-term debt securities.

COMMERCIAL PAPER

Promissory note usually issued by large company that already proven their credit standing.it is short term lending instrument where the maturity is between one to six month. It has a face value and is sold at discount. Companies that issue these securities typically have a loan facility with the bank to facilitate the redemption by the holder when the maturity date arrives.

TOPIC 8
INTRODUCTION TO DERIVATIVES

What is derivatives

- Derivatives are contracts that derive their value from the performance of an underlying asset, group of assets, or benchmark. This underlying entity can be a stock, bond, commodity (like oil or gold), currency, or even another derivative.

Key point of derivatives

- **Contractual Agreements:**

Derivatives are essentially agreements between two or more parties. The terms of the contract specify the underlying asset, the contractual obligations of each party, and how the final payout is determined.

- **Derived Value:**

The value of a derivative contract fluctuates based on the changes in the value of the underlying asset. If the price of the underlying asset goes up, the derivative contract linked to it will also generally increase in value, and vice versa.

- **Risk Management and Speculation:**

Derivatives can be used for various purposes, including hedging risk (protecting against potential losses in the underlying asset), speculation (making a profit by betting on price movements), and arbitrage (exploiting price differences between similar assets in different markets).

Derivatives in Islamic Perspective:

The views of scholar

In Islamic finance, derivatives are generally viewed with caution due to their speculative nature, and their permissibility is subject to certain conditions.
Derivatives have raised mixed responses from Shariah scholars who tend to hold them as prohibited due to violating basic requirements in the contract.

The Argument

The argument against the use of derivatives
1.The valuation of derivatives based on the sale of a non-existence asset or asset not in possession of the seller.

2.Mutual deferment on both side of the bargain,which reduces contingency risk but turn a derivatives contract into a sale of one debt for another.

3. Excessive uncertainty or speculation that verges on gambling resulting in zero sum payoof for both sides of bargain.

Islamic derivatives instrument

- Islamic Futures: These are similar to traditional futures but with specific Shariah-compliant features, such as the underlying asset being a tangible commodity and the contract involving the actual delivery of the asset.
- Islamic Options: These are structured to avoid interest-based calculations and excessive uncertainty. They often involve the sale of an asset with a buy-back option at a predetermined price.
- Islamic Swaps: These are based on the principles of murabaha (cost-plus sale) and ijara (leasing) to exchange cash flows without resorting to interest.

Type of derivatives traded on Bursa Malaysia

Commodity derivative

Bursa Malaysia offers futures contracts on various commodities, including crude palm oil, palm kernel oil, rubber, and gold. These contracts allow investors to hedge against price fluctuations in the underlying commodities. Financial Derivatives: These include interest rate futures, which allow investors to take a position on the future movement of interest rates.

Equity Derivatives

This category includes single-stock futures, stock options, and equity index futures. Equity derivatives are based on underlying stocks or stock indices and allow investors to gain exposure to the price movements of those underlying assets

Financial derivatives

This category includes interest rate, futures and options, as well as futures and options on the FTSE Bursa Malaysia KLCI index. These derivatives are based on underlying interest rates or financial indices, and allow investors to manage their exposure to interest rate and market risk.

example

Commodity derivative

- Crude Palm Oil Future (FCPO)
- Gold Future (FGLD)
- Crude palm Oil Kernel Future (FPKO)

Equity derivatives

- KLCI Futures (FKLI)
- KLCI Options (OKLI)
- Single Stock Futures (SSF)

Financial derivatives

- Kuala Lumpur interbank Offered Rate(KLIBOR)
- Mini USD/CNH Future Contract (FCNH)

THE TYPES OF MAIN PLAYERS IN DERIVATIVES

HEDGER

These are individuals or companies who use derivatives to manage their risk exposure to changes in the prices of underlying assets, such as commodities or currencies. Hedgers use derivatives to lock in prices for future purchases or sales, thereby protecting themselves against price fluctuations.

For example, a farmer might use a futures contract to lock in a price for his crops to protect against price fluctuations.

SPECULATOR

These are traders who use derivatives to take positions on the direction of price movements in the underlying assets, with the aim of generating profits. Speculators do not have an underlying exposure to the asset, but are simply betting on the direction of price movements.

They may take either long or short positions, betting that the price of the underlying asset will either increase or decrease.

ARBITRAGEURS

Arbitrageurs make a profit from the price difference arising in an investment of a financial instrument such as bonds, stocks, derivatives, etc They buy and sell derivatives and underlying assets simultaneously to lock in a profit.

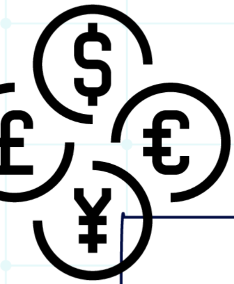
These are traders who seek to profit from discrepancies in the prices of related assets in different markets.

For example, an arbitrageur may buy an asset in one market where it is undervalued, and sell it in another market where it is overvalued, in order to earn a profit.

MARKET MAKER

These are financial institutions or individuals who facilitate trading in the derivatives market by providing liquidity. They buy and sell derivatives to ensure that there is always a market for these instruments.

Islamic derivatives Instrument



Islamic FX forward

- FX forward is (a contract to buy or sell a certain amount of foreign currency) (at a pre-agreed or locked-in exchange rate,) (but the delivery of currencies is done on the future.)
- Based on the Shariah contract of Wa'd or unilateral promise on deal date
- A customer who wishes to enter into the contract will execute a promise (undertaking) to buy a foreign currency at a future date (value date). On the promised date (i.e. the value date), the purchase will take place where the Sarf(currency exchange) contract is applied.

Islamic Option

- Islamic options provide the right, but not the obligation, to buy or sell an underlying asset at a specified price within a certain period.
- The structure of Islamic options must adhere to Shariah principles by avoiding interest-based calculations and excessive uncertainty.

Islamic Future contract

- Islamic future contracts are agreements between two parties to buy or sell a specific asset at a predetermined price on a future date.
- To comply with Shariah, these contracts often involve the actual delivery of the underlying asset, eliminating the potential for speculation

Syariah Viewpoints of

Islamic Derivative Instruments

Islamic fiqh academy	The shariah advisory council
Ruled that to defer both the counter values in trading of commodities (forward contract) is not permissible, but recommended that such commodity trading follow salam rules in order to be permissible.	Resolved that future contract on crude palm oil is permissible
	SAC also resolved the mechanism for share index future contract does not contradict shariah principles as long as index component is made up of shariah compliance securities
Futures contracts are only permissible if they are used for hedging purposes and not for speculation. They require that the underlying asset is halal, delivery is guaranteed, and the price is determined on a spot basis.	Trading in future allowed by SAC • Crude palm oil futures • Crude palm oil kernel futures • Single share future (when the derived are shariah compliance) • Index future (when the derived are shariah compliance)

CONCLUSION

Financial management, when aligned with Islamic principles, offers a comprehensive framework for individuals and businesses to make sound financial decisions. This book has explored the fundamental concepts of financial management through an Islamic lens, encompassing topics from financial statement analysis to advanced derivatives.

By understanding the time value of money and the intricate relationship between risk and return, readers are equipped to make informed investment choices that align with their financial goals and Islamic values. The principles of stock and bond valuation, dividend policy, and working capital management provide practical tools for effective financial planning and management.

It is crucial to recognize that financial decisions have far-reaching implications, not only for individuals but also for society as a whole. By adhering to Islamic principles, financial activities can contribute to economic growth, social welfare, and ethical business practices.

This book serves as a foundational resource for students seeking to build a strong foundation in financial management while upholding Islamic values. For the general public, it provides valuable insights into making informed financial decisions that are both personally rewarding and ethically sound.

We pray that this book may serve as a guiding light and a source of information for those who are seeking to achieve financial wisdom and justice.

TO KNOW MORE ABOUT ISLAMIC FINANCE?

SCAN HERE!

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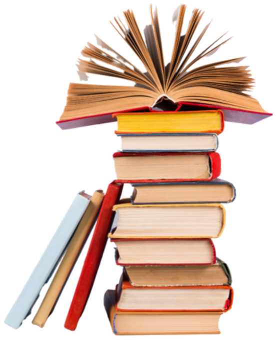

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