AFRICA POPULATION INSTITUTE (API)

FINANCIAL MANAGEMENT AND ACCOUNTING (FMA) HANDBOOK

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Forward:
API is a registered organization with 4 years' experience of supporting voluntary organizations, agencies and individuals in developing quality systems. A major part of our work is providing external evaluations and trainings to organizations or specific projects and also building capacities of the members to have relevant skills applicable to their working environment.

How we work:
We aim to understand the precise needs of your organization and to offer you good value, an integrated service, and work which is based on clear principles. Our style is inclusive, participatory and flexible.

We aim to help you:
- Develop your skills, reflect and gain focus
- Make your organization more confident, effective and efficient, and able to demonstrate this to others
- Help you plan more effectively and strategically for the future
- Demonstrate the benefits (or outcomes) for your service users.

Our approach
- Starts by listening carefully to what you need and tailoring our services accordingly
- Includes clear and practical advice, plans and reports
- Is based on extensive knowledge and experience of the voluntary sector
- Is supportive and friendly.

Courses offered in our training workshops that are client tailored
Monitoring and Evaluation Training
Project Planning and Management
Public Health and HIV/AIDS management
Guidance and Counseling Techniques
Family Planning and RH issues
Research Methods and Data management
Specialized Statistical Packages for data analysis (SPSS, STATA, EVIEWs, ATLAS TI, SUDAN, EPINFO and Epi Data etc)
Training of Trainers Course
Management and Leadership Skills Development
Procurement and Contract Management
Peace and conflict Management/Resolution
Disaster Preparedness and Management Course
Communication Skills and Technique
Heath Care Administration (HCAD)
Interdisciplinary Environmental Health Studies (ENVHs)
Substance Abuse and Addictions Management (SAAM)
Advocacy and Lobbying Techniques
Strategic Planning and Management
Business Sales and Marketing Strategies
Health Marketing and Health Promotion
Logistics, Transport and Supply Chain Management

Our certificate course provides students with a comprehensive understanding of the Financial Services industry and helps develops skills that will lead to a successful career. It also meets the demands of not only one of the fastest grow sectors within the Africa, but also within the world economy.

This course covers both general skills and specific topics required by employers and is suitable for those individuals who are also looking to enter the industry, as well as Financial Services employees who are looking to build on their existing professional qualifications and enhance their career prospects as well as managing personal finances.

MODULE 1: FUNDAMENTALS OF ACCOUNTING

Definitions:
Financial Accounting is the act of collecting financial data which is quantifiable in monetary terms, recording all that has been collected, classifying data and summarising in a significant manner and in terms of money, transactions and events which are at least of a financial character and analyzing data to enable interpreting the result thereof.

1. Any events and transactions of financial nature are recorded in books of accounts. Events of non-financial nature say the quarrel between the project manager and the chairman Board of trustees cannot find room in the books of accounts.

2. The records must portray the significance of all transactions and events individually and collectively class by class and as a whole.

3. The partners involved must be able to gather the true message of the results as embodied in the statement finally prepared.

The account process involves identifying, measuring and communicating economic information to permit judgement and decision by the user of the information.
Measurement is concerned with assessing or evaluating data so as to state its significance correctly.
Communication is done through reports and financial statements.

IMPORTANCE OF ACCOUNTING INFORMATION

- Some user groups use financial accounting primarily for standard purposes and others for decision-making purposes.
- Managers of all forms of organisations whether profit making or non-profit making require information to assist them in their decision making and control activities.
- Information is required about the viability of a project; whether to lease or buy, profitability of production line, the competitive position in the market, the introduction of a new product and whether to recruit or retrench.

COMPONENTS OF ACCOUNTING DISCIPLINE

1. FINANCIAL ACCOUNTING

Kohler's dictionary of accounting defines financial accounting as "Accounting for revenues, expenses, assets and liabilities of a business, a term often limited to the accounting concerned with published financial reports in contrast to internal aspects of accounting such as cost accounting."
According to this definition, financial accounting is that branch of accounting that is concerned with the determination of the results of operation of an organisation during a given period and financial position of the organisation as on a date at the end of the period.
It fulfils this objective by establishing a balance between revenues and expenditures/expenses (Statement of Comprehensive Income) and by laying out the assets and liabilities of the organisation (Statement of Financial Position) as on the date at the end of the trading period. The focus of financial accounting is primarily on historical report.
The information compiled by the financial accounting is intended for external use by investors, employees and their union, government-agencies and others.

The information provided by those groups usually consists of the Statement of Comprehensive Incomes, Statement of Financial Position and statements of changes in the financial position for the period under review.
Financial accounting can also be looked at as a branch of accounts which is heavily constrained by the generally accepted accounting principles and whose major focus is on the historical, custodian and stewardship aspect of accounting.
It is worth noting the features of these definitions as follows:

i) **Accounting principles**

Financial accounts are prepared on the basis of pronouncements of the financial accounting standards board. (F.A.S.B) An independent standard setting body. These pronouncements are referred to as generally accepted accounting principles (G.A.A.P).
The purpose of G.A.A.P is an attempt to ensure that the resulting reports are understandable, reliable and relating consistent between comparable periods.

ii) **Historical**

Financial accounting deals with historical records such as revenues that have either accrued or have been realised and expenses that have been incurred or obligation to incurring has been entered. Further more financial accounting reports comes at the end of the period concerned not before.

iii) **Custodian and store**

Financial accounts are prepared by a person who is responsible in the position of an agent. It is the financial accounting concerned with the custody or management of assets and discharge of liabilities by one person on behalf of another.

2. COST ACCOUNTING

Cost accounting is a form of mechanism by means of which costs of products and services are ascertained and controlled. It is that branch of accounting dealing with classification, recording, allocation, summarisation and reporting of current and prospective costs. Included in the field of cost accounting are the designs and corporations of costing systems and procedures, the method of determining costs by departments, functions, responsibilities, activities, products, territories, periods and other units of forecasted future costs and standards or desired costs as well as historical costs. The comparison of costs on different periods of actual estimated, budgeted or standard costs and of alternative costs and presentation and interpretation of cost data as an aid to management in controlling current and future operations.

3. **MANAGEMENT ACCOUNTING**

Management accounting is that type of accounting that provides information specifically to management for decision-making. It also provides information to management.
The major difference between financial and management accounting is that financial accounting is prepared for the benefit of many other groups apart from management where as management accounting is prepared primarily for purpose of management.
Management accounting is the process of identification, measurement, accumulation, analysis, preparation and interpretation as well as communication of information that assists the executive in fulfilling organisational objectives.
M.A seeks to meet the needs of management or in general the needs of the asset informal to the business.
It is designed for or adopted to the needs of information and control at various administration levels of the organisation.

4. FINANCIAL MANAGEMENT AND AUDITING

Financial management and auditing though not branch of accounting are common financial issues that need to be understood and differentiated from accounting.
Financial management deals with acquisition of funds and allocation of those funds to various competing issues to the organisation. Financial management functions do cover acquisition of funds, allocation of funds in various uses and management of liquidity.
Auditing is an independent examination of accounting and other records of an organisation with the aim of making on the operations of the organisation and financial position of that organisation.

Financial Accounting, management accounting, financial management and auditing

- ⇒ Financial accounting is a process of reporting the results and financial position of a business to satisfy the information needs of persons not involved in the day to day running of the business such as the suppliers, customers, the inland revenue and the general public. It entails the collection of raw-date, the recording, the classifying, the summarising, the analysing, interpreting, the reporting and even forecasting processes
- ⇒ Management accounting is primarily concerned with providing information as a guild to the more efficient conduct of the business. Since management is responsible for planning and controlling the resources of the business, management accounts is an information system which analyses data to provide information as a basis for managerial action. On the basis of the information from the management account, strategies can be drawn for the future that may be collective, preventive, competitive or otherwise in order to achieve the desired goals.
- ⇒ Financial management entails decisions taken to raise finance and control financial resources. Financial management includes decisions as to how the B/s should be funded (financing decisions), how the finance should be invested (investment decision) whether profit should ploughed back or distributed as dividends (dividend decisions) and how much credit should be given/taken (Cash management/or operating decision)

Auditing is the process of giving an independent opinion on financial statements of a business. It is a monitoring process of large businesses when ownership is divorced from management.
Auditors report as to whether or not the accounts of a business show a true and fair view of the business results for the year and financial population at the end of the year. The auditors in their report will refer to the profit and loss account, The Statement of Financial Position and the notes to the account.

THE ROLE OF THE ACCOUNTANT IN SOCIETY
He's role depends on where he works:

1. In the public practice the accountant would prepare accounts, provide general business advice and ensure tax compliance and tax planning of the businesses.

Whereas in industry and commerce, the accountant will make credit management decisions, prepare annual statutory accounts and provide cost information to management. He can also act as internal auditor or a tax adviser.
Generally the accountant interprets financial and complex accounting information to a lay man or he acts as indictor between the business and any authority.

An enterprise is an organisation that has pooled financial and non-financial resources together and operates these resources to achieve it's objectives. This enterprise may be a trading concern or a non-trading concern.

Trading concerns have profit as their main objective. Therefore it pools resources and operates them to generate profit (the excess of revenues over costs).

Trading concerns/enterprises may take the following form:-

a) **Sole proprietorships:** An individual accumulates financial resources and operates them to generate profits
The business is usually relatively small & is operated by one individual plus members of his family if need be. Profits made belong to owners and no other party has a stake in it.

b) **Partnerships:** Unlike the sole proprietorship this business setting is a result of a set of individuals with a common objective of profit who pool financial, managerial and other resources and operate them or engage employees to run the business. Relatively partnerships have a higher capital raised than the sole proprietorships. Profit is shared among the partners as agreed and if no agreement was made, it is shared equally. Where necessary a partner may advance the business a loan.

c) **Body corporate: Ltd - private, plc public co:** Companies unlike the first who forms of businesses have their financial resources pooled by shareholders (owners) who more often than not, are not involved in the operations but share in the profits and ensure that the employees engaged (especially the management team) are satisfying their interests. It is overseen by a board of directors, which hires the business's managerial staff.

d) **Cooperative:** Often referred to as a "co-op business" or "co-op", a cooperative is a for-profit, limited liability entity that differs from a corporation in that it has members, as opposed to shareholders, who share decision-making authority.

Non-trading concerns

These most of the time are NGO, clubs or associations or charitable organizations.
Their objectives vary e.g. disease, control, HIV, poverty eradication, promotion of sports, education, religion etc.
The financial accounts are drawn to account for the financial resources advanced.

Business entity convention

Unlike the legal concept of personality in accounting a business is an entity separate from the person (owner). All the owner does is to provide capital to enable the operations to take off.
This capital (accumulated financial resources) is considered a special obligation (Debt) of the business that lives with the business and may be repaid when the operations cease.

THE NEED FOR ACCOUNTS

The objective of producing corporate reports (accounts inclusive) is to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information. The classes of people who might need information about a business are:

Users of financial Statements and Their Information Needs

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:

(a) *Investors*. The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

(b) *Employees*. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

(c) *Lenders*. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(d) *Suppliers and other trade creditors*. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuation of the enterprise as a major customer.

(e) *Customers*. Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.

(f) *Governments and their agencies*. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.

(g) Public. Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.

Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.

Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Qualitative characteristics of good financial information:

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

i) Materiality

The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the enterprise irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.

ii) Reliable

To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

iii) Faithful Representation

To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a statement of financial position should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

iv) Relevant

To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

v) Complete

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

vi) Comprehensible (comprehensive)/Understandable

An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

vii) Comparability

Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

viii) Neutral (purposeful and unbiased of the information)

To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

ix) Substance over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

x) Prudence

The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognized by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise o the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Constraints on Relevant and Reliable Information

Timeliness

If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

Balance between Benefit and Cost

The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing costs of an enterprise. For those reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

True and Fair View/Fair Presentation

Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an enterprise. The application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

Underlying Assumptions

Accrual Basis

In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Financial Position, Performance and Changes in Financial Position

The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and changes in financial position of an enterprise.

Notes and Supplementary Schedules

The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the statement of financial position and statement of comprehensive income. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognized in the statement of financial position (such as mineral reserves). Information about geographical and industry segments and the effect on the enterprise of changing prices may also be provided in the form of supplementary information.

FACTORS THAT SHAPE FINANCIAL ACCOUNTING

The accounting discipline just like all other discipline is regulated to enable harmonised reporting and comparability. The following factors put together play an important role in the financial reporting:-

a) **Laws**

These result from a parliamentary process. In place are a number of statutes. Most important is the company's Act (Cap 110) of the Laws of Uganda.
It requires that companies prepare financial statements on annual basis to be presented to the owners in the Annual General Meetings (AGM)

b) **Accounting standards**

International Financial Reporting standards (IFRS),
International Accounting standard (IAS),
International Financial Reporting Interpretations Committee Interpretation (IFRIC),
Statements of standard accounting practices (SSAPs),
UK - Financial Reporting Standards (FRS)

The accounting standards committee through the standard setting process came up with a number of statements of standard accounting practices which are guidelines on presentation, disclosure or appropriate treatment of a number of issues that arise during financial reporting. However, due to changes overtime, the International Accounting Standards Board was replaced by the International Financial Reporting Standards Board and the revised International Financial Standards are numbered in order that they are revised.
The recommended treatment is to be complied with by all reporting entities.

c) **Accounting concepts principles (Underlying Assumptions)**

These are principles that underlie the preparation of financial statements unless specifically stated they are implied (read into the financial statements by a knowledgeable user)

d) **European Union Derivatives**

These directives are incorporated in financial reporting practices of the entire European community and any other states that have adopted their reporting culture.

e) **Generally Accepted Accounting Practices (GAAPs)**

These are practices in the accounting discipline that may be traced from time immemorial and have been lived with the profession.

f) **The stock exchange**
This also has an influence on financial reporting in that the values attached to securities are determined by the

g) **Other international influences**
A number of regulatory bodies exist on both local or international levels.
Reporting may be influenced by the needs of a given nation, region (e.g the COMESA) or trade area like (P.T.A)

THE FINANCIAL STATEMENTS

These are summaries of the accounting records prepared usually by senior accounts staff for purposes of the user.
They show the operations of an enterprise over again financial reporting period and the financial position of the enterprise.
The reporting period vary according to the circumstances of a given enterprise but the normal accounting period is one year (any period of twelve months)

Complete set of Financial Statements

A complete set of financial statements comprises:

(a) a statement of financial position as at end of the period;
(b) a statement of comprehensive income for the period;;
(c) a statement of changes in equity for the period;
(d) A statement of cash flows for the period;
(e) Notes, comprising a summary of significant accounting policies and other explanatory information; and
(f) A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

An entity may use titles for the statements other than those used in this standard.
Then financial statements are sometimes referred to as 'final accounts'.

- **Features of Financial Accounting Information:**
- **Accounting Standards:** Financial accounts are prepared on the basis of standards set by the board of the International Financial Reporting Standards Committee (IASC), an independent standard setting body. These Standards are referred to as International Financial Reporting Standards (IFRS). The purpose of IFRS is an attempt to ensure that the resulting reports are understandable, reliable and relating consistent between comparable periods.
- **Historical:** Financial accounting deals with historical records such as revenues that have either accrued or have been realised and expenses that have been incurred or obligation to incurring has been entered. Further more financial accounting reports comes at the end of the period concerned not before.
- **Custodian and store:** Financial accounts are prepared by a person who is responsible in the position of an agent. It is the financial accounting concerned with the custody or management of assets and discharge of liabilities by one person on behalf of another.

The Elements of Financial Statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the statement of financial position are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of comprehensive income are income and expenses. The statement of

changes in financial position usually reflects statement of comprehensive income elements and changes in financial position elements.
The presentation of these elements in the statement of financial position and the statement of comprehensive income involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position

The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

(a) An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

(b) A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

(c) Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognized in the statement of financial position. Thus, the definitions embrace items that are not recognized as assets or liabilities in the statement of financial position because they do not satisfy the criteria for recognition. In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion before an asset or liability is recognized.

Assets

The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

An enterprise usually employs its assets to produce goods or services capable of satisfying the wants of needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flow of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:

(a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;
(b) exchanged for other assets;
(c) used to settle a liability; or
(d) distributed to the owners of the enterprise.

Many assets for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the enterprise and if they are controlled by the enterprise.

Liabilities

An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of he other party. Settlement of a present of a present obligation may occur in a number of ways, for example, by:

(a) payment of cash;
(b) transfer of other assets;
(c) provision of services;
(d) replacement of that obligation with another obligation; or
(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

Equity

Although equity is defined as a residual, it may be sub-classified in the statement of financial position. For example, in a corporate enterprise, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

Performance

Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements.

The elements of income and expenses are defined as follows:

(a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or than those relating to distributions to equity participants.

The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognized in the statement of comprehensive income.

Income

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element.

Expenses

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the enterprise. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.

Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element.

Capital Maintenance Adjustments

The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of comprehensive income under certain concepts of capital maintenance. Instead these items are included in equity as capital adjustments or revaluation reserves.

Recognition of the Elements of Financial Statements

Recognition is the process of incorporating in the Statement of Financial Position or statement of comprehensive income an item that meets the definition of an element and satisfies the criteria for recognition set out. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the Statement of Financial Position or statement of comprehensive income totals. Items that satisfy the recognition criteria should be recognized in the Statement of Financial Position or statement of comprehensive income. The failure to recognize such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

An item that meets the definition of an element should be recognized if:

(a) it is probable that any future economic benefit associated with the item will flow to or form the enterprise; and

(b) the item has a cost or value that can be measured with reliability.

The Probability of Future Economic Benefit

The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterizes the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed by an enterprise will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognize the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognized.

Reliability of Measurement

The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognized in the Statement of Financial Position or statement of comprehensive income. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognized as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets

An asset is recognized in the Statement of Financial Position when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.

An asset is not recognized in the Statement of Financial Position when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the statement of comprehensive income. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of liabilities

A liability is recognized in the Statement of Financial Position when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognized as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

Income is recognized in the Statement of Comprehensive Income when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

Recognition of Expenses

Expenses are recognized in the Statement of Comprehensive Income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).

Measurement of the Elements of Financial Statements

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the Statement of Financial Position and Statement of Comprehensive Income. This involves the selection of he particular basis of measurement. They include the following:

(a) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(d) Present value. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Concepts of Capital and Capital Maintenance

A financial concept of capital is adopted by most enterprises in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

Concepts of Capital Maintenance and the Determination of Profit

The concepts of capital above give rise to the following concepts of capital maintenance:

(a) Financial capital maintenance. Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) Physical capital maintenance. Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the enterprise (or the resources or funds need to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

THE ACCOUNTING CONCEPTS /ASSUMPTIONS /PRINCIPLES

Accounting practice has developed gradually over a long period of time. Many of its procedures are operated automatically by accounting personnel and there procedures in common use imply the acceptance of certain concepts. These concepts are the basis of our current accounting system.

Fundamental accounting concept

These are the broad basic assumptions, which underlie the periodic financial accounts of businesses enterprises. They are referred to by all accounting committees and above all, identified as fundamental by statute (The companies Act 1985) which also adds the separate valuation principles, They are:-

1- The going concern concept
This is the assumption that the business will continue in its operational existence for the foreseeable future (at least 12 months from all the reporting date) and that there is no intention or necessity to cut back the scale of its operations significantly (e.g shut down one of the departments or shop, supplying to a given sales deport) or to cease operations completely (wind-up)

2- The matching/accruals concept
This is the assumption that the financial statements disclose items in the period that they relate the revenues shown are those generated/earned during the given period and they are treated together with costs necessary incurred in generating such revenues. Any incomes received in the period which they don't relate to are not disclosed in the comprehensive income statement and any expense the benefits of which are not enjoyed during the period are also not shown in the financial statement (the comprehensive income statement).

3- The consistency concept
The consistency concept is the assumption that similar items have been awarded similar treatment and the same treatment is applied from one period to another in accounting for such items to allow for comparisons and decision making.
For example, if stocks are valued at their stocks cost during period 1, the period 2 stocks should as well be valued at cost and not at market price or replacement cost.

4- The prudence concept
A person is said to be prudent when he gives the most cautions presentation of the situation in accounting a knowledgeable user assumes that the prepares has been cautions to the extent that he has not anticipated any gains (all gains reported have been realised) and any expenses or losses foreseen with reasonable certainty have been recognised in the financial statements. One accounting standard; statements of standard accounting practices (SSAP). Disclosure of accounting policies describes these four concepts as fundamental accounting concepts. The companies Act 1985 adds to these four a fifth:

5- Materiality concept
This is the assumption that only material items appear in financial statements. Any immaterial items have not been highlighted or reported distinctly.Items are material if their omission or misstatement would affect the impact of the financial statements on the reader. Materiality as a concept is relative but some items disclosed in amounts are particularly sensitive and even a very small misstatement of such item would be seen as a material error.For example where the disclosure of the absolute amount if a statutory requirement. In assessing materially the content of the item is important; not only its amount i.e. consider the class of transactions, the amount balances and from the financial statement as a whole.

6- Historical cost concept
The basic principles of accounting is that transactions are normally stated in accounts at their historical amount i.e. at their values when they occurred and the value of items in the financial statements is based on the price that was paid for them. This is because there is an objective documentary evidence to prove the transaction e.g. the purchase price of an asset or amount paid for an expense on the invoice.
Accountants prefer to deal with objective costs rather than estimates. However the principle is faced with problems when the market value of property is higher than cost or where the assets wear and tear out and reduce value with usage and passage of time and the effects of inflation.

7- The money measurement concept
Accounting deals with quantifiable information i.e the information that can be measured in monetary terms. Much as most people will agree to the monetary valuations, accounting can never tell every thing about a business (qualitative workforce problems etc are not easy quantifiable.

8- Entity Concept:-This is the assumption that the affairs of an entity are treated as separate from the non-business activities of its owners. The items recorded in the books of the business are therefore restricted to the transactions of the business. The only time that the personal resources of the proprietor affects the accounting records of a business is when the proprietor introduces capital into the business or makes a drawing.

9- The dual aspect concept

This is the assumption that the preparer of the financial statements recorded the two aspects of each of the transaction of the business. The financial effect of each of the aspects is equal but opposite, one representing an asset of the business and the other representing claims against the assets.

10- The realisation concept

This concept is the reverse of prudence. It holds the view that incomes should never be anticipated unless they are realised. This guards against exciting owners about revenue that will never arise.
Income is realised when the goods or services sold are provided for the buyer who accepts liability to pay for them the monetary value agreed. At this point income is in cash or near cash form. The point at which income is realised may be different from time the customer pays for the goods or takes delivery.

The accounting period convention

For accounting purposes the life time of the business is divided into arbitrary periods of a fixed length, usually one year. At the end of each arbitrary period, at least two financial statements are prepared, the Statement of Financial Position and the profit and loss account which is drawn on the basis of matching concept. This is done to strike a compromise between theoretical accuracy and the needs of uses who require periodic financial statements which will form the basis of subsequent financial decisions.

The substance over form convention

This is the assumption that the preparer reflected the economic. Substance of transactions in the accounts irrespective of their legal form. For example, where assets are acquired on hire purchase or lease terms, those assets are not owned by the user until (in the hire purchase agreement) the final instalment has been paid and the hire purchase has exercised the option to buy. However, he should record as fixed assets in his amounts at the start of the hire purchase I lease agreement the cost of such assets. The substance of the transaction is that the accounts should reflect the use of a fixed asset in the business and the legal form is that the user does not have title to the fixed asset.

THE ACCOUNTING EQUATION

The whole of financial accounting is based upon a very simple idea; The accounting equation
If a business is to be set up and start trading then it needs resources.
Assuming that it is the owner of the business who has supplied all of the resources; This can be shown as;
Resources in the business = Resources supplied by the owner.

The amount of resources supplied by the owner is called CAPITAL. The actual resources that are then in the business are called ASSETS. This means that when the owner supplies all the resources the equation above can be shown as

Assets = Capital

It is assumed that people other than the owner supply assets to a business. The amount owing to these people is known as LIABILITIES. Therefore the equation can be modified as;

Assets = Capital + Liabilities

Each side of the equation will always have the same total value because it is the same thing thus

Resources: what are they? = Resources: who supplied them
= Assets (CAPITAL + LIABILITIES)

Its a fact that the total value of each side will always equal one another, and that this will always be true no matter how many transactions they may be. The actual assets, liabilities and capital may change, but the total of these assets will always equal the total liabilities + capital.

Assets consists of tangible, intangible, investments and current assets where as liabilities consists of long term and current liabilities. Capital is the owner's equity or the network of a business and comprises the initial out lay and any further capital introduction and any reserves adjusted for what is drawn out of the business by the owner.

MODULE 2: PRINCIPLES OF BANKING

Objective

Understand the delivery of key bank services to personal and business customers.

Definitions

- acceptance house" means a company licensed to conduct the financial institution business in Uganda which is specified in the Second Schedule to this Act as its principal business and which consists mainly in the granting of acceptance facilities;
- "bank" means any company licensed to carry on financial institution business as its principal business, as specified in the Second Schedule to this Act and includes all branches and offices of that company in Uganda;
- "Bank of Uganda securities" includes bills and bonds issued by the Bank of Uganda;
- "board" in relation to the Central Bank means the board of directors of the Central Bank and in relation to a financial institution, means the board of directors of the financial institution;
- "commercial bank" means a company licensed to carry on
  financial institution business in Uganda and whose principal business consists mainly in the acceptance of call, demand, savings and time deposits withdrawable by cheque or otherwise, in the capacity of a bank, provision of overdrafts and short to medium term loans; provision of foreign exchange, participation in inter-bank clearing systems and the provision and assumption of guarantees, bonds and other warranties on behalf of others;
- "company" means a company incorporated or registered under the
  Companies Act and includes—
  (a) *th*e Uganda Development Bank established by the Uganda Development Bank Act;
  (b) a building society duly incorporated under the
  Building Societies Act; and
  (c) any institution classified as a financial institution under this Act;
- core capital" means permanent shareholders equity in the form of issued and fully paid-up shares plus all disclosed reserves, less goodwill or any intangible assets;
- "credit accommodation" includes contractual commitments to lend, letters of credit and guarantees issued on behalf of any persons;
- credit institution" means any company licensed to carry on financial institution business in Uganda which is specified in the Second Schedule to this Act as its principal business, and any other body specified by the Central Bank to be a credit institution for the purposes of this Act; and includes all branches and offices of that company or body in Uganda;
- "demand deposits" means deposits which are repayable on demand and are withdrawable by cheque, draft, order or by other means;
- "demand liabilities" means the total deposit liabilities of a bank or credit institution which are denominated in any currency and payable upon demand;
- "deposit advertisement" means any advertisement containing an invitation to make a deposit or information, which is intended or might reasonably be presumed to be intended to lead directly or indirectly to the making of a deposit;
- "deposit substitutes" means funds received from the public through the issue, endorsement or acceptance of debt instruments of any kind other than deposits, or through the issue of participations, certificates of assignment, repurchase agreements or similar instruments;
- "disclosed reserves" includes all reserves created or increased through share premiums, retained profits, after deducting all expenses, provisions, taxation, and dividends and general reserves if the disclosed reserves are permanent and unencumbered and thus able to absorb losses;
- "discount house" means a company licensed to carry on or conduct the financial institution business in Uganda which is specified in the Second Schedule to this Act as its principal business and which consists mainly in the acceptance of deposits from banks and other financial institutions, discounting of bills of exchange, bankers' acceptances and trade in money market making in a variety of short-term financial instruments;

- "draft" means a bankers' draft payable on demand drawn by or on behalf of a bank upon itself whether payable at the head office or some other office of the bank;
- "entity" means a body corporate, trust, partnership, fund or organization;
- "exposure" shall include loans, advances, overdrafts, holding of papers as well as off balance sheet commitments such as acceptances, guarantees, underwriting, endorsements, placements, documentary credits, performance bonds and other contingent liabilities;
- "finance house" means a company licensed to conduct financial institution business in Uganda which is specified in the Second Schedule to this Act as its principal business and which consists mainly in acceptance of time deposits, hire purchase financing, operational and finance leasing, and factoring and provision of short and medium term loans;
- "financial institution" means a company licensed to carry on or conduct financial institutions business in Uganda and includes a commercial bank, merchant bank, mortgage bank, post office savings bank, credit institution, a building society, an acceptance house, a discount house, a finance house or any institution which by regulations is classified as a financial institution by the Central Bank;
- "financial institution business" means the business of—

(a) acceptance of deposits;
(b) issue of deposit substitutes;
(c) lending or extending credit, including—
(i) consumer and mortgage credit;
(ii) factoring with or without recourse;
(iii) the financing of commercial transactions;
(iv) the recovery by foreclosure or other means of amounts so lent, advanced or extended;
(v) forfeiting, namely, the medium term discounting without recourse of bills, notes and other documents evidencing an exporter's claims on the person to whom the exports are sent;
(vi) acceptance credits;
(d) engaging in foreign exchange business, in particular buying and selling foreign currencies, including forward and option type contracts for the future sale of foreign currencies;
(e) issuing and administering means of payment, including credit cards, travellers' cheques and banker's drafts;
(f) providing money transmission services;
(g) trading for own account or for account of customers in—
(i) money market instruments, including bills of exchange and certificates of deposit;
(ii) debt securities and other transferable securities;
(iii) futures, options and other financial derivatives relating to debt securities or interest rates;
(h) safe custody and administration of securities;
(i) soliciting of or advertising for deposits;
(j) money broking;
(k) financial leasing if conducted by a financial institution;
(l) merchant banking;
(m) mortgage banking;
(n) creating and administration of electronic units of payment in computer networks;
(o) dealing in securities business as an exempt dealer within the meaning of section 48 of the Capital Markets Authority Act;
(p) transacting such other business as may be prescribed by the Central Bank.

- "financial statements" includes the balance sheet, profit and loss accounts, statements of funds flow and notes to the financial statements;
- "fit and proper person" means fit and proper person as determined according to the criteria specified in the Third Schedule to this Act; Cap. 84.
- "foreign bank" means a body corporate or entity incorporated or formed under the laws of a country other than Uganda that—

(a) is a bank according to the laws of any foreign country where it carries on business;
(b) carries on a business in a country other than Uganda that if carried out in Uganda , would be wholly or to a significant extent, financial institution business;
(c) employs, to identify or describe its business, a name that includes the word "bank", "banque", "banking" or "bancaire", either alone or in combination with other words or any word or words in any language other than English or French corresponding generally to any such word;

- "foreign company" means a company not being a local company;
- "foreign currency" means a currency other than legal tender of Uganda;
- "foreign exchange business" means any facility offered, business undertaken or transaction executed with any person involving a foreign currency inclusive of any account facility, credit extension, lending, issue of guarantee, counter- guarantee, purchase or sale by means of cash, cheque, draft, transfer or any other instrument denominated in a foreign currency;
- "forward transaction" or "forward purchase" or "forward buy" or "forward sale" means a transaction that is to be executed after more than two working days from the date the transaction is contracted or agreed;
- "government securities" includes treasury bills and government bonds issued by the Government of Uganda;
- "home country regulator" means the supervisory authority of the home country where the head office of the parent financial institution is based ;
- "insider" means a director or person who has executive authority or a shareholder of a financial institution and includes any related person and any related interest of such person;
- "large exposure" means an exposure, which is equal to or exceeds ten percent of a financial institution's core capital;
- "local company" means a company registered or incorporated under the Companies Act in which the majority shares and actual controlling interest are held by citizens of Uganda;
- "long position" or "long open position" or "overbought position" of a financial institution in a foreign currency Nmeans the holding by the financial institution of that foreign currency for its own account in excess of all its contractual spot, same day value and forward transaction commitments in that foreign currency;
- "merchant bank" means a company licensed to carry on financial institution business in Uganda and whose business consists mainly in the acceptance of call and time deposits from corporate, institutional and international clients, withdrawable by cheque or otherwise and engaging in the financing of international trade, provision of corporate services advisory services, provision of foreign exchange facilities; engaging in bond issues and other securities, buying and selling of shares, investment portfolio management, investment advisory services; arranging finance, lending or participation in syndicated loans and acting as guarantors and financing or lending in the institutional money markets;
- "micro finance deposit-taking institution" means a company licensed to carry on, conduct, engage in or transact microfinance business in Uganda;
- "microfinance business" means the business of accepting deposits from and providing short-term loans to small micro enterprises and low income households, usually characterised by the use of collateral substitutes, such as group guarantees;
- "money laundering" has the meaning assigned to it by section 130(2) of this Act;
- "mortgage bank" means a company licensed to carry on Financial institutions business in Uganda and whose business consists mainly in the granting of loans for the acquisition, construction, enlargement, repair, improvement and maintenance of urban or rural real estate and for the substitution of mortgages taken out for that same purpose; acceptance of deposits of participation in mortgage loans and in special accounts; provision of guarantees, bonds or other forms of collateral connected with the operations in which they may take part and acting as an intermediary in loans extended in local and foreign currency;
- "net open position" of a financial institution in a foreign currency means the sum of all its assets and liabilities inclusive of all its spot, same day value and forward transactions and its off balance sheet items in that foreign currency;

- "non-bank financial institution" includes a credit institution, a building society, an acceptance house, a discount house and a finance house and any other institution classified by the Central Bank as a non-bank financial institution;
- "off balance sheet items" includes all items not shown on the balance sheet but which constitute credit risk and such other risks as in guarantees, acceptances, performance bonds, letters of credit, and other off balance sheet items deemed to constitute risk as such by the Central Bank;
- "order" when used in conjunction with the word "cheque" or "draft", means an unconditional order in writing constituting a bill of exchange as defined in the Bills of Exchange Act;
- "person" means any individual, a personal representative, company, partnership, trust, fund, foundation or enterprise wherever located or incorporated;
- "personal representative" means a person who stands in a place of and represents another person and without limiting the generality of the foregoing, includes, as the circumstances require, a trustee, an executor, an administrator, a guardian, a tutor, a curator, an assignee, a receiver, an agent, or an attorney of any person;
- "prudential standard" means formal rules, bench marks and regulations set by the Central Bank;
- "public company" for the purposes of this Act means a company which is owned by at least fifty people and whose articles of association do not restrict the right to transfer its shares;
- "related person" or "group of related persons" means—

  (a) in relation to natural persons—

  (i) an associate or close relative of the person; Cap. 68.

  (ii) any person who has entered into an agreement or arrangement with the first-mentioned person, relating to the acquisition, holding or disposal of, or the exercising of voting rights in respect of shares in the financial institution in question;

  (b) in relation to a company means any—

  (i) subsidiary or holding company of that company, any other subsidiary of that holding company and any other company of which that holding company is a subsidiary;

  (ii) associate of the company;

  (c) in relation to a non- natural person which is not a company, means another non-natural person which would have been a subsidiary of the first mentioned non- natural person—

  (i) had the first-mentioned non-natural person been a company; or

  ii) where that other non-natural person, is not a company, had both the first mentioned nonnatural person and that other non- natural person been a company;

(d) any person in accordance with whose direct or indirect directions or instructions the board of directors or where the non-natural person is not a company, the governing body of that non-natural person is accustomed to act; and

(b) in relation to any person—

(i) means any non- natural person of which the board of directors or, where that non- natural person is not a company, of which the governing body is accustomed to act in accordance with directions or instructions of the person first-mentioned in this paragraph; and

(ii) includes any trust controlled or administered by that person;

- "repurchase agreement" means an agreement between a seller and a buyer of securities, by which the seller agrees to repurchase the securities at an agreed upon price or interest rate or both, and usually at a stated price;
- "resident" mean—

(a) an individual who is ordinarily resident in Uganda for one year or more;

(b) the Government of Uganda and its diplomatic representations located outside of Uganda;

(c) a company, firm or enterprise whose principal place of business or centre of control and management is located in Uganda;

(d) a corporation, firm or enterprise incorporated or formed under the laws of Uganda;

(e) a branch located within Uganda of a company, firm or other enterprise whose principal place of business is located outside of Uganda; except that "resident" does not include a foreign diplomatic representation or an accredited official of that representation located within Uganda, office of an organization established by international treaty located within Uganda, or a branch located outside Uganda of a company, firm, or enterprise whose principal place of business is located in Uganda;

- "same day transaction" or "same day purchase" or "same day buy" or a "same day sale" means a transaction having a same day value;
- "same day value" means the transaction to which it is referred is to be executed on the very day it is contracted or agreed; "securities" includes—

(a) debentures, stocks or bonds issued by or proposed to be issued by a Government;

(b) debentures, stocks, bonds or notes issued or proposed to be issued by a body corporate;

(c) any right, warrant, option or futures in respect of any debenture, stocks, shares, bonds, notes or in respect of commodities; or

(d) any instrument commonly known as securities, but does not include bills of exchange, promissory notes or certificates of deposit issued by a financial institution;

- "significantly undercapitalised" has the meaning assigned to it in section 87(4) of this Act;
- "short position" or "short open position" or "oversold position" of a financial institution in a foreign currency means that the holding by the financial institution of that foreign currency for its own account is less than all its contractual spot, same day value and forward transaction commitments in that foreign currency;
- "spot transaction" or "spot purchase" or "spot buy" or "spot sale" means a transaction having a spot value;
- "spot value" means the transaction to which it is referred is to be executed two working days from the date it is contracted or agreed;
- "substantial shareholder" means any person who holds more than five percent of the shares of a financial institution;
- "supplementary capital" means general provisions which are held against future and current unidentified losses that are freely available to meet losses which subsequently materialize, and revaluation reserves on financial institution premises which arise periodically from independent valuation of those premises, and any other form of capital as may be determined from time to time by the Central Bank;
- "time deposits" means deposits repayable after a fixed period or after notice and includes saving deposits;
- "time liabilities" means deposit liabilities other than demand liabilities of a financial institution which are denominated in any currency and are subject to payment after a fixed period of time or after notice;
- "total capital" means the sum of core capital and supplementary capital;
- "unsecured advances or unsecured credit facilities" means advances or credit facilities made without security or, in respect of any advance or credit facility made with security or any part of it which at any time exceeds the market value of the assets constituting that security, or where the Central Bank is satisfied that there is no established market value, on the basis of a valuation approved by the Central Bank;
- "value date" of a transaction means the date on which it is to be executed.

LECTURE PLAN

1. Discuss the relationship Banks have with their customers and their communities.
2. Describe the traditional, non-traditional and electronic services that banks provide.
3. Identify the various statutory reserves that banks maintain
4. Discuss the various deposit instruments, the many ways that customers can make deposits
5. Discuss the means that tellers have for establishing a customer identity
6. Define negotiable instruments as they relate to cheques and describe features that make them negotiable.
7. Distinguish between paying a cheque and cashing a cheque.
8. Discuss the legal restrictions on bank loans
9. Explain the objective of fund management, including asset and liability management
10. Explain specialized services offered by banks including safe deposit services.
11. discuss the need to have a savings preference Vs liquidity preference.
12. follow through the definitions and discuss issues that will encourage a savings culture and bring out the various business options a bank may offer.

MODULE 3: MORTGAGE ADVISE

Identify which mortgage is best for you.

Regardless of what mortgage needs you have, it is important to establish upfront what mortgage type you are after, and whether you want to take it out on a repayment or an interest-only basis, as this will narrow down your search considerably. Even if you are planning to consult an adviser, it makes sense to understand the basics and have some idea of what mortgage type you want, before you meet with them.

The most popular mortgage types tend to be fixed rates and discounted mortgages, and we take you through the pros and cons of these and the other mortgage types on the market.

It is also important for you to understand the difference between repayment (or capital and interest) mortgages, and what mortgage type is best for you.

Around 70% of borrowers consult a financial adviser or mortgage broker who can quickly scour the market and find out which mortgage is the most appropriate, given your financial circumstances, plans, attitude to risk and other preferences. Others arrange their mortgage via a lender's branch, over the phone or on the internet

Financial institutions that offer mortgage services: DFCU Bank, Housing finance bank, etc.

Six things about buying life insurance

1. Shop around

Always shop around and be careful not to trust your bank or any other tied source to provide the best advice. High street mortgage lenders are often tied to one provider and can be very expensive. Make sure to either contact a range of companies or speak to an independent specialist who can search the market for you as no one insurance company can ever be competitive for everyone.

2. Get the right type of policy

This sounds obvious, however, there are dozens of different types of life cover plans available. Known as 'Term Assurance', the most common form of life cover pays out should you pass away during a specific time period. However cover can be level, increasing or even decreasing to suit a mortgage. Cover can also be paid as an income or a lump sum, and a range of options will be offered including critical illness, waiver of premium, conversion, renewal and so forth.

3. How much cover?

10 x your salary? 15 x your salary? Ã�Â£100,000 per child? Double the mortgage? We don't believe that any set formula works for every individual. It makes sense to firstly work out how much you would need to cover all your debts (mortgage, loans and credit cards) on a lump sum basis and to then consider dependants and earnings.

4. Always consider single life insurance policies

Traditionally joint life cover was far cheaper than taking one policy each. However, in recent years this has changed. Buying two single policies potentially provides double the cover, doesn't leave a surviving partner without cover later in life and often only costs a few percent more.

5. Use a trust

Every Ã�Â£100,000 of life insurance is a potential Ã�Â£40,000 tax bill under current Inheritance Tax legislation. A trust is a free and simple way to ensure that the monies go to the right person quickly and, as any asset under trust is not considered part of your estate, upon death the pay out is not taxable.

6. Be honest

Forgetting to mention a minor health issue could result in your policy not paying out for 'non-disclosure' hence our advice is always to be as honest as possible. Whether it is smoking habits, a bad back or occasional pins & needles - make sure your insurance company knows about it, this way you are safe in the knowledge that your policy will pay out when you need it to.

Critical illness insurance

Critical Illness Insurance pays out on the diagnosis of certain specified critical illnesses. Most policies will pay out following heart disease, a stroke, renal failure, cancer, paralysis, or a major organ transplant and coronary artery bypass surgery.

How does critical illness insurance work?

Remember:

Do not buy a critical illness insurance policy purely on the basis of cost.
Ensure that the insurance company supplying your policy is financially secure.
Check that permanent disability cover is covered by your policy.
Check that the insurance company is a number of an ombudsman scheme.
Ten things to consider before buying critical illness insurance cover:

1. Premium
How competitive is the price you are paying?

2. Employee benefits
Find out whether your employer offers critical illness insurance as a benefit.

3. Guaranteed rates
Your premiums might seem cheap today but will they stay that way?

4. Life cover
Most critical illness insurance policies include life cover free of charge. Does yours?

5. Number of conditions covered
Make sure you read exactly what you are covered for. Some policies cover just a few conditions, some cover nearly 40. But how many are you covered for? And does your insurer hold the right to change them or are they fixed?

6. Children's cover
Now one of the highest areas of claims, but not all policies automatically cover your children. Does yours?

7. Occupation class
Are you insured if you cannot do you own job or if you cannot do somebody else's?

8. Amount of cover
Do you have enough cover? Do you have too much?

9. Length of term
Are you covered for long enough? What will you do when your cover runs out?

10. Trusts
Critical Illness Cover often comes with life cover included. If the policy is not written in a trust 40% of the pay out could go to the tax man. Is your policy in trust?

<u>Income protection</u>
You can protect against losing your income through disability, no matter how it is caused, with Income Protection Insurance (sometimes also referred to as Permanent Health Insurance).

Permanent Health Insurance (PHI) should not be confused with Private Medical Insurance (PMI).
Providing an income when you can't work
<u>An income protection, or permanent health insurance plan will provide an income if you are unable to work through disability, no matter how it is caused.</u> The policy pays a monthly tax-free income for a set length of time - normally until retirement.
<u>The payout can be level or set to rise with inflation</u>. It pays as long as doctors agree that you are unable to work for health reasons.
The maximum cover you can have is typically half of your provable income before tax. This is paid tax free, so should you make a claim you will only be a bit worse off than you were before.
The insurers limit the amount of cover you can have so that you have an incentive to get back to work! Everyone should have this cover, because the State simply does not provide adequate protection, but many employers do offer it, so check your contract.
Premiums are kept down by setting it up with a "waiting period" between the onset of disability and the income kicking in, usually to coincide with the sick pay arrangements with your employer. In other words, it's not meant for the flu, and the huge majority of claims are caused by back or mental health problems.

Remember
<u>Make sure you know the length of the deferral period before the policy pays out</u>.
Check that the income you will receive will be sufficient to meet your needs.
Do not opt straight for the latest premiums as these policies may not be suitable.
Do shop around.
<u>Ten Things to Consider before buying income protection</u>

1. Premium
How competitive is the price you are paying?

2. Other benefits of income protection/PHI
It is vital to know the other benefits you are entitled to as these will affect the amount that any insurance policy pays out. Do you know how much the State and how much your employer will pay you, and how long for?
3. Guaranteed premiums
Your premiums might seem cheap today but will they stay that way?
4. Occupation class
Are you insured if you cannot do you own job or if you cannot do somebody else's?
5. Amount of cover
Typically you can insure up to approximately 65% of your gross salary free of tax. But how much do you need each month to live on?
6. Length of term
Are you covered for long enough? What will you do when your cover runs out? Typically income protection policies should run until your intended retirement age, unless your mortgage term exceeds this. If premiums are too expensive then cover can be limited to either one or two years, which while not ideal is far better than nothing at all.
7. Deferred period
Income Protection policies will begin to pay out after you have been unable to work for a set period of time. This time period is up to you and ranges from 4 weeks to 2 years. The longer the waiting period the less expensive insurance policies will be. How long could you survive financially without your income?
8. Indexation
Whilst most insurance policies can be linked to inflation it is particularly important to make sure income protection increases with inflation as your earnings typically would.
9. Unemployment
Income Protection policies do not automatically cover unemployment, although with most providers this can be added at an additional cost.
10. Housewives/ house husbands
Just because you don't work this doesn't mean you cannot insure an income. House persons can typically insure up to Â£15,000 per year.
Remember to always consider the alternatives. Critical Illness might be more suitable for your circumstances.

Mortgage insurance top tips

Many people end up paying too much for insurance or getting the wrong type of cover. For the right insurance for your circumstances, at the right price, simply follow our expert advice.
1. Use a Specialist: Your mortgage lender may well offer to provide your mortgage-related insurance policies. But remember, they are not necessarily insurance specialists and may not offer the best cover or the most competitive premiums. However, when it comes to buildings insurance, it can be wise to accept your lenders' insurance as they will then have a vested interest in your property should the worst happen.

2. Shop Around: It is very easy to look around and compare the simpler types of insurance, what they cover and how much they cost, on the internet.

3. Visit an Adviser: An independent financial adviser can help you to select and arrange your insurance. They can be invaluable when it comes to more complex types of insurance, such as convertible life insurance.

4. Don't pay for Unsuitable Cover: There is no point in being over-insured, or paying for cover that is not relevant to you. For example, if you are self-employed, then the unemployment element of Accident, Sickness and Unemployment (ASU) insurance is not needed.

5. Don't Under-insure: If you do not have sufficient cover, you will regret it when something goes wrong. When it comes to contents insurance, for example, there is no point cutting corners : you must go through your house and add up the value of everything, and make sure your insurance would cover it.

First-time buyer top tips

Buying your first home can be a very daunting affair when it needn't be. We at Your Mortgage want to make sure that you are comfortable with the processes of getting your first mortgage, choosing your property and seeing your investment through.

1. Shop around : There are thousands of mortgage deals on offer in the UK, so it is vital that you research the market thoroughly and do not simply go for the first mortgage you are offered.

2. Seek advice : If you feel lost or confused, then it could make sense to consult a mortgage adviser. They are fully qualified professionals who have access to a wide range of mortgage deals and can find you the best first-time buyer mortgage to suit your needs.

3. Make up your mind: There is no one ideal mortgage product for everyone. Only you can decide whether you would be best suited to a fixed rate or a variable deal - it is often a question of your attitude to risk.

4. Don't be afraid to ask: Whether you are talking to a mortgage lender or an independent broker, make sure you understand everything that they are telling you. If there is something you don't understand, don't be afraid to ask. You are a first-time buyer so you aren't expected to know it all. Taking out your first mortgage a huge financial commitment, so make sure you know exactly what you are getting into.

5. Read the small print: None of us like doing it, but it is vital that you look at the detail of your mortgage offer, and the lender's terms and conditions.

6. **Be realistic:** Don't try to borrow more than you can afford to pay back. When you buy your first home it is vital that you are able to comfortably meet your monthly repayments and that you could continue to make them should interest rates rise. The lender will run checks to make sure you are not biting off more than you can chew, but you should also discipline yourself in this regard.

7. **Be honest:** Many lenders these days will base how much they will lend you on your income and your outgoings. Do not be tempted to overstate your income or to play down your expenditure or other debt commitments. Note that it is illegal to lie about your income on a mortgage application form.

8. Think ahead: When selecting your mortgage, think about your next likely home move or next mortgage. As a first-time buyer, this may be the last thing on your mind. But it is important. Find out, for example, whether the lender you have chosen will offer you a full range of deals when you get to the end of your current arrangement. Many only offer their best deals to new customers, so next time round you could be forced to move lender for the best rate, which can take time and cost money.

9. Shop around – again: Once you have found the mortgage deal you're happy with, shop around again for your insurance. You will need buildings insurance and are strongly advised to take out contents cover and life insurance. And possibly mortgage payment protection insurance. Your mortgage lender may offer to sort this out for you, but remember that they are not insurance specialists and may not offer the best cover or the cheapest rates.

10. Be happy: First-time buyers face a huge challenge just getting on the property ladder these days. Congratulate yourself for achieving this feat!

The top 10 questions to ask the mortgage lender or your financial adviser about remortgages:

1. What types of remortgage deals are available and how do they work?

Many lenders offer a wide range of remortgage products - fixed rates, capped rates, discounts, cash-backs, flexible deals and Base Rate trackers, for example. Make sure the new lender or advisor explains the pros and cons of whichever deal or deals you are interested in.

2. What interest rate will I be charged on the new deal?

Whichever type of remortgage deal you opt for, the lender or adviser should tell you what interest rate you will be paying and, in the case of a fixed or capped rate for how long.

3. How much better will my new mortgage rate be?

The lender or advisor should be able to favourably compare the new rate on offer with the old rate you were paying, and work out for you how much you will be saving per month (unless you are increasing the size of your mortgage at the same time, in which case repayments might not be coming down).

4. What is the standard variable rate (SVR)?

If you are going for a discount, fixed or capped rate you may have to pay their SVR when the mortgage deal finishes. While, as the name suggests, variable rates vary over time, comparing today's SVR with that charged by other lenders may give you some idea of how truly competitive your new lender is.

5. What will the monthly mortgage payments be at the new quoted interest rate?

The adviser should tell you exactly what your monthly payments will be at the rate quoted. In addition, make sure they show you how much you would be paying at the standard variable rate to give you an idea of what you will be paying after your product term comes to an end.

6. What is an annual percentage rate (APR?)
The annual percentage rate (APR) has to appear in all adverts alongside the headline mortgage rate. APR's are meant to provide customers with true reflections of the cost of loans, and help them compare different deals. In practice, the APR is unreliable and no substitute for individually-prepared quotes listing all upfront and ongoing costs.
7. What are the early redemption charges (ERCs)?
Most mortgage lenders apply early redemption charges (ERCs) to certain deals, such as fixed rates and discounts, for example. An ERC is usually calculated a several month's interest on a loan, and can run to thousands of pounds. You may be charged an ERC if you pay off or switch your mortgage within a certain time period. Before you remortgage, check whether ERCs apply to your existing deal, and if so, how much they will cost. And check whether the new deal will carry early redemption charges too.
8. Will I have to pay remortgage arrangement fees?
Some lenders may pick up the tab for the valuation, and even pay your legal fees. Otherwise it may cost you a few hundred pounds.
9. How long should the remortgage process take?

How long is a piece of string? If there are complications, it may take a while to sort out a new deal. Most people who have remortgaged in the last year have sorted the whole thing out in a week, and some within a number of days. Your adviser, if you have one, should give you an idea of the timescale involved
10. Can I remortgage more than once?
You can remortgage as many times as you like, and as often as you like, provided you have sufficient equity in your property to meet the lenders' requirements. But bear in mind that you may well be liable to pay ERCs if you are currently on a fixed, capped or discounted rate. And you may have to pay arrangement fees. But you should look at your mortgage every year and see whether remortgaging would save you money.

Top tips for buy-to-let mortgages
There are lots of things to consider before taking the plunge and investing in property, but follow our fundamentals and you won't go far wrong.
1. Consider the location: You shouldn't buy a duff property just because it is in a good area, but try and strike a balance between a suitable home in an area where there is demand. Think about what tenants might like to be close to, for example shops, amenities, schools, transport and major cities.
2. Know your audience: When thinking about building type, bear in mind the type of person you intend to let to. If you are buying in a student area for example, is a penthouse apartment a good idea? Will young professionals need to be close to transport links for their jobs? Talk to estate agents and find out what people are after.
3. Vet your tenants: After securing your property, perhaps the next most important step is filling it with the right people. You may want to interview them yourself to see if you get along with them and it is well worth asking for character references to try and ensure they are responsible. You may also want to seek some kind of confirmation of their financial status from their employer or bank to confirm they are trustworthy and likely to pay their rent on time.
4. Navigate the mortgage maze: Don't just plump for the first mortgage you come across. Shop around to try and find the most suitable deal for your circumstances. You may like to enlist the services of a mortgage broker if you need some help. They will also be able to access special deals that you, as a consumer, aren't privy too.
5. Compile a budget: The start up costs of buying to let can be fairly expensive, so make sure you have sufficient capital before getting involved. There are running costs that you will need to account for.
6. Cushion the blow: Make sure you have some money to spare to cover unexpected expenditure such as repairing a broken boiler. Your property may also be vacant at some points (known as rental void periods) so you will need to have enough money to cover the mortgage repayments until you find new tenants.
7. Consider the professionals: It may well be cheaper to go it alone, but if you are finding it difficult to cope there is an army of qualified experts on hand, from letting agents to solicitors and accountants.
8. Keep it simple: Don't decorate the property to your own tastes – think about what prospective tenants might want. For this reason, it may be wise to keep décor and furnishings plain and uncluttered.
9. Get insurance: Make sure you have the relevant cover for your property. Tenants themselves will be responsible for covering their own possessions, but make sure you have all other relevant cover in place or you could be left out of pocket if the worst happens.

10. Go long: Buy to let is not a means of making a quick buck, so view it as a long-term investment and don't expect overnight success.

Top tips for the self employed

If you are self employed, it is worth taking the following tips into consideration when looking for a mortgage.

1. Shop around. Don't assume that just because you are self employed, you have to take out a self-cert mortgage. If you have audited accounts for more than three years, you may be better off opting for a conventional mainstream mortgage which is likely to carry a lower rate of interest.

2. Get help. Don't be afraid to enlist the services of qualified professionals such as mortgage brokers, accountants and solicitors. Self-cert mortgages can be quite complex, so you need to know what you are doing.

3. Save a healthy deposit. Lenders view self-cert mortgages as more of a risk than mainstream mortgages, so bear in mind you may need to collect a larger deposit.

4. Be flexible. If you receive bonuses and want to use them to help pay off your mortgage, ensure that overpayments are allowed. You may also want payment holidays if you work on a contract basis.

5. Do your sums. Remember to add mortgage fees into your budget when taking out a self-cert mortgage. Given that you may have to use a broker, account for their charges too.

Top tips for bad credit mortgage borrowers

If you have a damaged credit record you may well need specialist mortgage advice. Take a look at our top tips as a starting point for finding the right deal:

Equity Release Top Tips

It is important that you approach equity release cautiously and methodically. Follow our Equity Release top tips and you should not go wrong.

1. Gather Information: By reading this you have already taken the first step. You know what equity release entails so it's time to start looking at the products on the market. For your protection you should only consider lenders that are members of SHIP.

2. Talk to an Adviser: Talk to a qualified financial adviser, who will look at your whole financial situation and recommend the most suitable option for you.

Ask about the options and costs, early repayment charges, taxation implications and whether your welfare benefits will be affected.

3. Consider the Alternatives: Equity release is not the only possible means of raising finance, and it doesn't suit everyone. Make sure you have researched all of the other possibilities available to you before committing.

4. Take your Time: Many people who end up opting for equity release take up to two years to mull over the decision. So don't feel that you have to rush into it. A good adviser should put you at your ease, exercise patience and not put any pressure on you.

5. Involve your Family: Using the equity in your home affects the amount you will be able to leave as an inheritance, so talk through all the issues before you take the next step.

6. Gather the Right Documents: When you apply, you will need to provide birth and marriage certificates; evidence of who you are and details of your home buildings insurance.

7. Expect a Valuation: Usually, your lender will arrange for an independent valuer to assess what your home is worth **-** the valuation figure will not necessarily correspond with an estate agent's estimate, which may be higher. Once your home is valued, your lender can establish the maximum loan available to you.

8. Use a Solicitor: As with any mortgage application, solicitors are there to protect the interests of the borrower and the lender. All SHIP members insist that you consult an independent solicitor to ensure that you fully understand the terms and conditions of the product that you choose. If you do not already have a legal adviser in mind, The National Solicitor's Network can help you find one. It ensures that each firm affiliated with the network adheres to a specified standard of service and will provide you with the names of at least two firms in your area.

9. Be Patient: It usually takes about 10 weeks for you to get your money once your application has been received. The money will be paid to you by the equity release company via your legal adviser. The only responsibilities you then have, are to maintain your home buildings insurance, keep your house in good order and let the lender know if your circumstances change.

10. Spend the Money: There are lots of ways of using the cash released from your home to make your retirement more comfortable, and you can use the money you receive for any purpose you like, from a new car to home improvements, or the holiday of a lifetime. If you are feeling a little less frivolous, your financial adviser can tell you how lifetime mortgages can also be used as part of your general financial planning.

MODULE 4: PRINCIPLES OF INSURANCE

Insurance, in law and economics, is a form of risk management primarily used to hedge against the risk of a contingent loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for a premium, and can be thought of as a guaranteed and known small loss to prevent a large, possibly devastating loss. Risk management, the practice of appraising and controlling risk, has evolved as a discrete field of study and practice.

Definition of Key Terms:

An **insurer** is a company selling the insurance;
An **insured** or **policyholder** is the person or entity buying the insurance.
The **insurance rate** is a factor used to determine the amount to be charged for a certain amount of insurance coverage, called the **premium**.
Caps is the upper limit of insurance to be compensated
Co-payment is where only a certain fraction of the loss is paid.

Insurance companies

Insurance companies may be classified into two groups:

- *Life* insurance companies, which sell life insurance, annuities and pensions products. coverage for life assurance or a pension can cover risks over many decades
- *Non-life*, *General*, or *Property/Casualty* insurance companies, which sell other types of insurance. Cover usually covers a shorter period, such as one year.

General insurance companies can be further divided into these sub categories.

- Standard Lines - are "mainstream" insurers. These are the companies that typically insure autos, homes or businesses. They use pattern or "cookie-cutter" policies without variation from one person to the next. They usually have lower premiums than excess lines and can sell directly to individuals. They are regulated by state laws that can restrict the amount they can charge for insurance policies
- Excess Lines - typically insure risks not covered by the standard lines market. They are broadly referred as being all insurance placed with non-admitted insurers.

In most countries, life and non-life insurers are subject to different regulatory regimes and different tax and accounting rules.

mutual insurance companies - owned by the policyholders

stock insurance companies – owned by stockholders (who may or may not own policies).

Demutualization of mutual insurers to form stock companies, as well as the formation of a hybrid known as a mutual holding company.

reciprocals insurance companies, in which policyholders 'reciprocate' in sharing risks.

Reinsurance companies sell policies to other insurance companies, allowing them to reduce their risks and protect themselves from very large losses. The reinsurance market is dominated by a few very large companies, with huge reserves.

Captive insurance companies may be defined as limited-purpose established with the specific objective of financing risks emanating from their parent group or groups (an in-house self-insurance vehicle).

"association" captive (which self-insures individual risks of the members of a professional, commercial or industrial association).

The types of risk that a captive can underwrite for their parents include property damage, public and product liability, professional indemnity, employee benefits, employers' liability, motor and medical aid expenses.

Captives are an important component of the risk management and risk financing strategy of their parent. This can be understood against the following background:

- heavy and increasing premium costs in almost every line of coverage;
- difficulties in insuring certain types of fortuitous risk;
- differential coverage standards in various parts of the world;
- rating structures which reflect market trends rather than individual loss experience;
- insufficient credit for deductibles and/or loss control efforts.

'insurance consultants' (a mortgage broker): these companies are paid a fee by the customer to shop around for the best insurance policy amongst many companies.

an 'insurance broker' also shops around for the best insurance policy amongst many companies. However, with insurance brokers, the fee is usually paid in the form of commission from the insurer that is selected rather than directly from the client.

The financial stability and strength of an insurance company should be a major consideration when buying an insurance contract.

An insurance premium paid currently provides coverage for losses that might arise many years in the future. For that reason, the viability of the insurance carrier is very important.

Rating Insurance Companies

in recent years, a number of insurance companies have become insolvent, leaving their policyholders with no coverage (or coverage only from a government-backed insurance pool or other arrangement with less attractive payouts for losses). A number of independent rating agencies, such as Best's, Fitch, Standard & Poor's, and Moody's Investors Service, provide information and rate the financial viability of insurance companies.

Assurance and Insurance/Indemnity:
If the event is bound to happen (e.g. death or expiration of a period of time), it is termed a contract of assurance.
If the event is not bound to happen, it is termed a contract of insurance or indemnity.

Regulation of Insurance Industry in Uganda: The Uganda Insurance Commission

Regulatory Framework:

- Insurance statute, 1996
- The Insurance Regulations, 2002.
- International financial Reporting Standards (IFRS),
- the Companies Act
- the Insurance Act (cap213) Laws of Uganda, and
- Other international law on insurance

The law of Large Numbers:

The vast majority of insurance policies are provided for individual members of very large classes. Automobile insurance, for example, covered about 175 million automobiles in the United States in 2004. The existence of a large number of homogeneous exposure units allows insurers to benefit from the so-called "law of large numbers," which in effect states that as the number of exposure units increases, the actual results are increasingly likely to become close to expected results.
There are exceptions to this criterion. Lloyd's of London is famous for insuring the life or health of actors, actresses and sports figures. Satellite Launch insurance covers events that are infrequent. Large commercial property policies may insure exceptional properties for which there are no 'homogeneous' exposure units.

Common Characteristics of Commercially Insurable Risks

1. Definite Loss. The event that gives rise to the loss that is subject to the insured, at least in principle, take place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational disease, for instance, may involve prolonged exposure to injurious conditions where no specific time, place or cause is identifiable. Ideally, the time, place and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements. Despite failing on this criterion, many exposures like these are generally considered to be insurable.

2. **Accidental Loss**. The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be 'pure,' in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements, such as ordinary business risks, are generally not considered insurable.

3. Large Loss. The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses these latter costs may be several times the size of the expected cost of losses. There is little point in paying such costs unless the protection offered has real value to a buyer.

4. Affordable Premium. If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, it is not likely that anyone will buy insurance, even if on offer. Further, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, the transaction may have the form of insurance, but not the substance. (See the U.S. Financial Accounting Standards Board standard number 113)

5. Calculable Loss. There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.

7. Limited risk of catastrophically large losses. The essential risk is often aggregation. If the same event can cause losses to numerous policyholders of the same insurer, the ability of that insurer to issue policies becomes constrained, not by factors surrounding the individual characteristics of a given policyholder, but by the factors surrounding the sum of all policyholders so exposed. Typically, insurers prefer to limit their exposure to a loss from a single event to some small portion of their capital base, on the order of 5 percent. Where the loss can be aggregated, or an individual policy could produce exceptionally large claims, the capital constraint will restrict an insurer's appetite for additional policyholders. The classic example is earthquake insurance, where the ability of an underwriter to issue a new policy depends on the number and size of the policies that it has already underwritten. Wind insurance in hurricane zones, particularly along coast lines, is another example of this phenomenon. In extreme cases, the aggregation can affect the entire industry, since the combined capital of insurers and reinsurers can be small compared to the needs of potential policyholders in areas exposed to aggregation risk. In commercial fire insurance it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

Indemnification:

The technical definition of "indemnity" means to make whole again. There are two types of insurance contracts;

1. an "indemnity" policy and
2. a "pay on behalf" or "on behalf of" policy.

The difference is significant on paper, but rarely material in practice.

An "indemnity" policy will never pay claims until the insured has paid out of pocket to some third party; for example, a visitor to your home slips on a floor that you left wet and sues you for $10,000 and wins. Under an "indemnity" policy the homeowner would have to come up with the $10,000 to pay for the visitor's fall and then would be "indemnified" by the insurance carrier for the out of pocket costs.

Under the same situation, a "pay on behalf" policy, the insurance carrier would pay the claim and the insured (the homeowner) would not be out of pocket for anything. Most modern liability insurance is written on the basis of "pay on behalf" language.

An entity seeking to transfer risk (an individual, corporation, or association of any type, etc.) becomes the 'insured' party once risk is assumed by an 'insurer', the insuring party, by means of a contract, called an insurance 'policy'.

Elements of an Insurance Contract:

Generally, an insurance contract includes, at a minimum, the following elements:

1. The parties (the insurer, the insured, the beneficiaries),

2. The premium,

3. The period of coverage,

4. The particular loss event covered,

5. The amount of coverage (i.e., the amount to be paid to the insured or beneficiary in the event of a loss),

6. And exclusions (events not covered).

An insured is thus said to be "indemnified" against the loss covered in the policy.

Profit and/or Reserves

When insured parties experience a loss for a specified peril, the coverage entitles the policyholder to make a 'claim' against the insurer for the covered amount of loss as specified by the policy. The fee paid by the insured to the insurer for assuming the risk is called the 'premium'. Insurance premiums from many insureds are used to fund accounts reserved for later payment of claims—in theory for a relatively few claimants—and for overhead costs. So long as an insurer maintains adequate funds set aside for anticipated losses (i.e., reserves), the remaining margin is an insurer's profit.

Insurers' business model:

Underwriting and investing

The business model can be reduced to a simple equation: Profit = earned premium + investment income - incurred loss - underwriting expenses.

Insurers make money in two ways:

1. Through underwriting, the process by which insurers select the risks to insure and decide how much in premiums to charge for accepting those risks;
2. By investing the premiums they collect from insured parties.

The most complicated aspect of the insurance business is the underwriting of policies. Using a wide assortment of data, insurers predict the likelihood that a claim will be made against their policies and price products accordingly. To this end, insurers use actuarial science to quantify the risks they are willing to assume and the premium they will charge to assume them. Data is analyzed to fairly accurately project the rate of future claims based on a given risk. Actuarial science uses statistics and probability to analyze the risks associated with the range of perils covered, and these scientific principles are used to determine an insurer's overall exposure. Upon termination of a given policy, the amount of premium collected and the investment gains thereon minus the amount paid out in claims is the insurer's underwriting profit on that policy. Of course, from the insurer's perspective, some policies are "winners" (i.e., the insurer pays out less in claims and expenses than it receives in premiums and investment income) and some are "losers" (i.e., the insurer pays out more in claims and expenses than it receives in premiums and investment income); insurance companies essentially use actuarial science to attempt to underwrite enough "winning" policies to pay out on the "losers" while still maintaining profitability.

Claims

Claims and loss handling is the materialized utility of insurance; it is the actual "product" paid for, though one hopes it will never need to be used. Claims may be filed by insureds directly with the insurer or through brokers or agents. The insurer may require that the claim be filed on its own proprietary forms, or may accept claims on a standard industry form such as those produced by ACORD. In Uganda, the various forms are found in 'The Insurance Regulations, 2002'.

Types of insurance

Any risk that can be quantified can potentially be insured. Specific kinds of risk that may give rise to claims are known as "perils". An insurance policy will set out in detail which perils are covered by the policy and which are not. Below are (non-exhaustive) lists of the many different types of insurance that exist. A single policy may cover risks in one or more of the categories set out below. For example, auto insurance would typically cover both property risk (covering the risk of theft or damage to the car) and liability risk (covering legal claims from causing an accident). A homeowner's insurance policy in the U.S. typically includes property insurance covering damage to the home and the owner's belongings, liability insurance covering certain legal claims against the owner, and even a small amount of coverage for medical expenses of guests who are injured on the owner's property.

Business insurance can be any kind of insurance that protects businesses against risks. Some principal subtypes of business insurance are (a) the various kinds of *professional liability insurance*, also called *professional indemnity insurance*, which are discussed below under that name; and (b) the business owner's policy (BOP), which bundles into one policy many of the kinds of coverage that a business owner needs, in a way analogous to how homeowners insurance bundles the coverages that a homeowner needs.

1. Auto insurance

Auto insurance protects you against financial loss if you have an accident. It is a contract between you and the insurance company. You agree to pay the premium and the insurance company agrees to pay your losses as defined in your policy. Auto insurance provides property, liability and medical coverage:

1. Property coverage pays for damage to or theft of your car.
2. Liability coverage pays for your legal responsibility to others for bodily injury or property damage.
3. Medical coverage pays for the cost of treating injuries, rehabilitation and sometimes lost wages and funeral expenses.

An auto insurance policy comprises six kinds of coverage. Most countries require you to buy some, but not all, of these coverages. If you're financing a car, your lender may also have requirements. Most auto policies are for six months to a year. In Uganda, insurance policies are drawn and renewed on an annual basis, by payment of the premium.

2. Home insurance (not common in Uganda)

Home insurance provides compensation for damage or destruction of a home from disasters. In some geographical areas, the standard insurances excludes certain types of disasters, such as flood and earthquakes, that require additional coverage. Maintenance-related problems are the homeowners' responsibility. The policy may include inventory, or this can be bought as a separate policy, especially for people who rent housing. In some countries, insurers offer a package which may include liability and legal responsibility for injuries and property damage caused by members of the household, including pets.[12]

3. Health Insurance and Dental Insurance (AAR,etc)

Health insurance policies by the National Health Service in the United Kingdom (NHS) or other publicly-funded health programs will cover the cost of medical treatments. Dental insurance, like medical insurance, is coverage for individuals to protect them against dental costs. In the U.S., dental insurance is often part of an employer's benefits package, along with health insurance.

4. Accident, Sickness and Unemployment Insurance

- Disability insurance policies provide financial support in the event the policyholder is unable to work because of disabling illness or injury. It provides monthly support to help pay such obligations as mortgages and credit cards.
- Disability overhead insurance allows business owners to cover the overhead expenses of their business while they are unable to work.
- Total permanent disability insurance provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.
- Workers' compensation insurance replaces all or part of a worker's wages lost and accompanying medical expenses incurred because of a job-related injury.

5. Casualty Insurance

Casualty insurance insures against accidents, not necessarily tied to any specific property.

- Crime insurance is a form of casualty insurance that covers the policyholder against losses arising from the criminal acts of third parties. For example, a company can obtain crime insurance to cover losses arising from theft or embezzlement.
- Political risk insurance is a form of casualty insurance that can be taken out by businesses with operations in countries in which there is a risk that revolution or other political conditions will result in a loss.

6. Life Insurance

Life insurance provides a monetary benefit to a decedent's family or other designated beneficiary, and may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity.

Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies and regulated as insurance and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pensions that pay a benefit for life are sometimes regarded as insurance against the possibility that a retiree will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

7. Property Insurance

This tornado damage to an Illinois home would be considered an "Act of God" for insurance purposes

Property insurance provides protection against risks to property, such as fire, theft or weather damage. This includes specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler insurance.

- Automobile insurance, known in the UK as *motor insurance*, is probably the most common form of insurance and may cover both legal liability claims against the driver and loss of or damage to the insured's vehicle itself. Throughout the United States an auto insurance policy is required to legally operate a motor vehicle on public roads. In some jurisdictions, bodily injury compensation for automobile accident victims has been changed to a no-fault system, which reduces or eliminates the ability to sue for compensation but provides automatic eligibility for benefits. Credit card companies insure against damage on rented cars. Driving School Insurance insurance provides cover for any authorized driver whilst undergoing tuition, cover also unlike other motor policies provides cover for instructor liability where both the pupil and driving instructor are equally liable in the event of a claim.
- Aviation insurance insures against hull, spares, deductibles, hull wear and liability risks.
- Boiler insurance (also known as boiler and machinery insurance or equipment breakdown insurance) insures against accidental physical damage to equipment or machinery.
- Builder's risk insurance insures against the risk of physical loss or damage to property during construction. Builder's risk insurance is typically written on an "all risk" basis covering damage due to any cause (including the negligence of the insured) not otherwise expressly excluded.
- Crop insurance "Farmers use crop insurance to reduce or manage various risks associated with growing crops. Such risks include crop loss or damage caused by weather, hail, drought, frost damage, insects, or disease, for instance."
- Earthquake insurance is a form of property insurance that pays the policyholder in the event of an earthquake that causes damage to the property. Most ordinary homeowners insurance policies do not cover earthquake damage. Most earthquake insurance policies feature a high deductible. Rates depend on location and the probability of an earthquake, as well as the construction of the home.
- A fidelity bond is a form of casualty insurance that covers policyholders for losses that they incur as a result of fraudulent acts by specified individuals. It usually insures a business for losses caused by the dishonest acts of its employees.
- Flood insurance protects against property loss due to flooding. Many insurers in the U.S. do not provide flood insurance in some portions of the country. In response to this, the federal government created the National Flood Insurance Program which serves as the insurer of last resort.
- Home insurance or homeowners' insurance: See "Property insurance".

- Landlord insurance is specifically designed for people who own properties which they rent out. Most house insurance cover in the U.K will not be valid if the property is rented out therefore landlords must take out this specialist form of home insurance.
- Marine insurance and marine cargo insurance cover the loss or damage of ships at sea or on inland waterways, and of the cargo that may be on them. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier's insurance. Many marine insurance underwriters will include "time element" coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss.
- Surety bond insurance is a three party insurance guaranteeing the performance of the principal.
- Terrorism insurance provides protection against any loss or damage caused by terrorist activities.
- Volcano insurance is an insurance that covers volcano damage in Hawaii.
- Windstorm insurance is an insurance covering the damage that can be caused by hurricanes and tropical cyclones.

8. Liability Insurance

Liability insurance is a very broad superset that covers legal claims against the insured. Many types of insurance include an aspect of liability coverage. For example, a homeowner's insurance policy will normally include liability coverage which protects the insured in the event of a claim brought by someone who slips and falls on the property; automobile insurance also includes an aspect of liability insurance that indemnifies against the harm that a crashing car can cause to others' lives, health, or property. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against the policyholder and indemnification (payment on behalf of the insured) with respect to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of wilful or intentional acts by the insured.

- Directors and officers liability insurance protects an organization (usually a corporation) from costs associated with litigation resulting from mistakes made by directors and officers for which they are liable. In the industry, it is usually called "D&O" for short.
- Environmental liability insurance protects the insured from bodily injury, property damage and cleanup costs as a result of the dispersal, release or escape of pollutants.
- Errors and omissions insurance: See "Professional liability insurance" under "Liability insurance".
- Prize indemnity insurance protects the insured from giving away a large prize at a specific event. Examples would include offering prizes to contestants who can make a half-court shot at a basketball game, or a hole-in-one at a golf tournament.
- Professional liability insurance, also called *professional indemnity insurance*, protects insured professionals such as architectural corporation and medical practice against potential negligence claims made by their patients/clients. Professional liability insurance may take on different names depending on the profession. For example, professional liability insurance in reference to the medical profession may be called *malpractice insurance.* Notaries public may take out *errors and omissions insurance (E&O).* Other potential E&O policyholders include, for example, real estate brokers, Insurance agents, home inspectors, appraisers, and website developers.

9. Credit Insurance

Credit insurance repays some or all of a loan when certain things happen to the borrower such as unemployment, disability, or death.

- Mortgage insurance insures the lender against default by the borrower. Mortgage insurance is a form of credit insurance, although the name *credit insurance* more often is used to refer to policies that cover other kinds of debt.

10. Other types of Insurance

- Collateral protection insurance or CPI, insures property (primarily vehicles) held as collateral for loans made by lending institutions.
- **Defense Base Act Workers' compensation** or DBA Insurance provides coverage for civilian workers hired by the government to perform contracts outside the U.S. and Canada. DBA is required for all U.S. citizens, U.S. residents, U.S. Green Card holders, and all employees or subcontractors hired on overseas government contracts. Depending on the country, Foreign Nationals must also be covered under DBA. This coverage typically includes expenses related to medical treatment and loss of wages, as well as disability and death benefits.
- Expatriate insurance provides individuals and organizations operating outside of their home country with protection for automobiles, property, health, liability and business pursuits.
- **Financial loss insurance** or **Business Interruption Insurance** protects individuals and companies against various financial risks. For example, a business might purchase coverage to protect it from loss of sales if a fire in a factory prevented it from carrying out its business for a time. Insurance might also cover the failure of a creditor to pay money it owes to the insured. This type of insurance is frequently referred to as "business interruption insurance." Fidelity bonds and surety bonds are included in this category, although these products provide a benefit to a third party (the "obligee") in the event the insured party (usually referred to as the "obligor") fails to perform its obligations under a contract with the obligee.
- Kidnap and ransom insurance
- Locked funds insurance is a little-known hybrid insurance policy jointly issued by governments and banks. It is used to protect public funds from tamper by unauthorized parties. In special cases, a government may authorize its use in protecting semi-private funds which are liable to tamper. The terms of this type of insurance are usually very strict. Therefore it is used only in extreme cases where maximum security of funds is required.
- **Nuclear incident insurance** covers damages resulting from an incident involving radioactive materials and is generally arranged at the national level. See the Nuclear exclusion clause and for the United States the Price-Anderson Nuclear Industries Indemnity Act)
- Pet insurance insures pets against accidents and illnesses - some companies cover routine/wellness care and burial, as well.
- **Pollution Insurance** which consists of first-party coverage for contamination of insured property either by external or on-site sources. Coverage for liability to third parties arising from contamination of air, water, or land due to the sudden and accidental release of hazardous materials from the insured site. The policy usually covers the costs of cleanup and may include coverage for releases from underground storage tanks. Intentional acts are specifically excluded.
- **Purchase insurance** is aimed at providing protection on the products people purchase. Purchase insurance can cover individual purchase protection, warranties, guarantees, care plans and even mobile phone insurance. Such insurance is normally very limited in the scope of problems that are covered by the policy.
- Title insurance provides a guarantee that title to real property is vested in the purchaser and/or mortgagee, free and clear of liens or encumbrances. It is usually issued in conjunction with a search of the public records performed at the time of a real estate transaction.
- Travel insurance is an insurance cover taken by those who travel abroad, which covers certain losses such as medical expenses, loss of personal belongings, travel delay, personal liabilities, etc.
- **Media Insurance** is designed to cover professionals that engage in film, video and TV production.
- Legal Expenses Insurance covers policyholders against the potential costs of legal action against an institution or an individual.

Insurance financing vehicles

- Fraternal insurance is provided on a cooperative basis by fraternal benefit societies or other social organizations.
- No-fault insurance is a type of insurance policy (typically automobile insurance) where insureds are indemnified by their own insurer regardless of fault in the incident.
- Protected Self-Insurance is an alternative risk financing mechanism in which an organization retains the mathematically calculated cost of risk within the organization and transfers the catastrophic risk with

specific and aggregate limits to an insurer so the maximum total cost of the program is known. A properly designed and underwritten Protected Self-Insurance Program reduces and stabilizes the cost of insurance and provides valuable risk management information.

- Retrospectively Rated Insurance is a method of establishing a premium on large commercial accounts. The final premium is based on the insured's actual loss experience during the policy term, sometimes subject to a minimum and maximum premium, with the final premium determined by a formula. Under this plan, the current year's premium is based partially (or wholly) on the current year's losses, although the premium adjustments may take months or years beyond the current year's expiration date. The rating formula is guaranteed in the insurance contract. Formula: retrospective premium = converted loss + basic premium × tax multiplier. Numerous variations of this formula have been developed and are in use.
- Formal self insurance is the deliberate decision to pay for otherwise insurable losses out of one's own money. This can be done on a formal basis by establishing a separate fund into which funds are deposited on a periodic basis, or by simply forgoing the purchase of available insurance and paying out-of-pocket. Self insurance is usually used to pay for high-frequency, low-severity losses. Such losses, if covered by conventional insurance, mean having to pay a premium that includes loadings for the company's general expenses, cost of putting the policy on the books, acquisition expenses, premium taxes, and contingencies. While this is true for all insurance, for small, frequent losses the transaction costs may exceed the benefit of volatility reduction that insurance otherwise affords.
- Reinsurance is a type of insurance purchased by insurance companies or self-insured employers to protect against unexpected losses. Financial reinsurance is a form of reinsurance that is primarily used for capital management rather than to transfer insurance risk.
- Social insurance can be many things to many people in many countries. But a summary of its essence is that it is a collection of insurance coverages (including components of life insurance, disability income insurance, unemployment insurance, health insurance, and others), plus retirement savings, that requires participation by all citizens. By forcing everyone in society to be a policyholder and pay premiums, it ensures that everyone can become a claimant when or if he/she needs to. Along the way this inevitably becomes related to other concepts such as the justice system and the welfare state. This is a large, complicated topic that engenders tremendous debate, which can be further studied in the following articles (and others):
- Stop-loss insurance provides protection against catastrophic or unpredictable losses. It is purchased by organizations who do not want to assume 100% of the liability for losses arising from the plans. Under a stop-loss policy, the insurance company becomes liable for losses that exceed certain limits called deductibles.

Closed community self-insurance

Some communities prefer to create virtual insurance amongst themselves by other means than contractual risk transfer, which assigns explicit numerical values to risk. A number of religious groups, including the Amish and some Muslim groups, depend on support provided by their communities when disasters strike. The risk presented by any given person is assumed collectively by the community who all bear the cost of rebuilding lost property and supporting people whose needs are suddenly greater after a loss of some kind. In supportive communities where others can be trusted to follow community leaders, this tacit form of insurance can work. In this manner the community can even out the extreme differences in insurability that exist among its members. Some further justification is also provided by invoking the moral hazard of explicit insurance contracts.

Global insurance industry

Life insurance premia written in 2005

Non-life insurance premia written in 2005

Global insurance premiums grew by 11% in 2007 (or 3.3% in real terms) to reach $4.1 trillion. The macro-economic environment was characterised by slower economic growth in 2007 and rising inflation. Profitability improved in life insurance and fell slightly in the non-life sector during the year. Life insurance premiums grew by 12.6%, accelerating in the advanced economies with the exception of Japan and Continental Europe. Non-life insurance premiums grew by 7.6% during the year. Figures for premium income are not yet available for 2008, but the insurance industry is likely to see a slowdown in new business and falling investment revenue.

Advanced economies account for the bulk of global insurance. With premium income of $1,681bn, Europe was the most important region, followed by North America ($1,330bn) and Asia ($814bn). The top four countries accounted for nearly 60% of premiums in 2007. The US and UK alone accounted for 42% of world insurance, much higher than their 7% share of the global population. Emerging markets accounted for over 85% of the world's population but generated only around 10% of premiums.

Controversies

Insurance insulates too much

By creating a "security blanket" for its insureds, an insurance company may inadvertently find that its insureds may not be as risk-averse as they might otherwise be (since, by definition, the insured has transferred the risk to the insurer,) a concept known as moral hazard. To reduce their own financial exposure, insurance companies have contractual clauses that mitigate their obligation to provide coverage if the insured engages in behavior that grossly magnifies their risk of loss or liability.[*citation needed*]

For example, life insurance companies may require higher premiums or deny coverage altogether to people who work in hazardous occupations or engage in dangerous sports. Liability insurance providers do not provide coverage for liability arising from intentional torts committed by the insured. Even if a provider were so irrational as to want to provide such coverage, it is against the public policy of most countries to allow such insurance to exist, and thus it is usually illegal.[*citation needed*]

Complexity of insurance policy contracts

Insurance policies can be complex and some policyholders may not understand all the fees and coverages included in a policy. As a result, people may buy policies on unfavorable terms. In response to these issues, many countries have enacted detailed statutory and regulatory regimes governing every aspect of the insurance business, including minimum standards for policies and the ways in which they may be advertised and sold.

For example, most insurance policies in the English language today have been carefully drafted in plain English; the industry learned the hard way that many courts will not enforce policies against insureds when the judges themselves cannot understand what the policies are saying.

Many institutional insurance purchasers buy insurance through an insurance broker. While on the surface it appears the broker represents the buyer (not the insurance company), and typically counsels the buyer on appropriate coverage and policy limitations, it should be noted that in the vast majority of cases a broker's compensation comes in the form of a commission as a percentage of the insurance premium, creating a conflict of interest in that the broker's financial interest is tilted towards encouraging an insured to purchase more insurance than might be necessary at a higher price. A broker generally holds contracts with many insurers, thereby allowing the broker to "shop" the market for the best rates and coverage possible.

Insurance may also be purchased through an agent. Unlike a broker, who represents the policyholder, an agent represents the insurance company from whom the policyholder buys. An agent can represent more than one company.

An independent insurance consultant advises insureds on a fee-for-service retainer, similar to an attorney, and thus offers completely independent advice, free of the financial conflict of interest of brokers and/or agents. However, such a consultant must still work through brokers and/or agents in order to secure coverage for their clients.

The insurance industry and rent seeking

Certain insurance products and practices have been described as rent seeking by critics. That is, some insurance products or practices are useful primarily because of legal benefits, such as reducing taxes, as opposed to providing protection against risks of adverse events. Under United States tax law, for example, most owners of variable annuities and variable life insurance can invest their premium payments in the stock market and defer or eliminate paying any taxes on their investments until withdrawals are made. Sometimes this tax deferral is the only reason people use these products.[*citation needed*] Another example is the legal infrastructure which allows life insurance to be held in an irrevocable trust which is used to pay an estate tax while the proceeds themselves are immune from the estate tax.

*Main principles of Insurance***:**

Utmost Good Faith (Uberrimae Fides)

As a client it is your duty to disclose all material facts to the risk being covered. A material fact is a fact which would influence the mind of a prudent underwriter in deciding whether to accept a risk for insurance and on what terms. The duty to disclose operates at the time of inception, at renewal and at any point mid term.

Indemnity

On the happening of an event insured against, the Insured will be placed in the same monetary position that he/she occupied immediately before the event taking place. In the event of a claim the insured must:

- Prove that the event occurred
- Prove that a monetary loss has occurred
- Transfer any rights which he/she may have for recovery from another source to the Insurer, if he/she has been fully indemnified.

Subrogation

The right of an insurer which has paid a claim under a policy to step into the shoes of the insured so as to exercise in his name all rights he might have with regard to the recovery of the loss which was the subject of the relevant claim paid under the policy up to the amount of that paid claim. The insurer's subrogation rights may be qualified in the policy.

In the context of insurance subrogation is a feature of the principle of indemnity and therefore only applies to contracts of indemnity so that it does not apply to life assurance or personal accident policies. It is intended to prevent an insured recovering more than the indemnity he receives under his insurance (where that represents the full amount of his loss) and enables his insurer to recover or reduce its loss.

Contribution

The right of an insurer to call on other insurers similarly, but not necessarily equally, liable to the same insured to share the loss of an indemnity payment i.e. a travel policy may have overlapping cover with the contents section of a household policy. The principle of contribution allows the insured to make a claim against one insurer who then has the right to call on any other insurers liable for the loss to share the claim payment.

Insurable Interest

If an insured wishes to enforce a contract of insurance before the Courts he must have an insurable interest in the subject matter of the insurance, which is to say that he stands to benefit from its preservation and will suffer from its loss.

In non-marine insurances, the insured must have insurable interest when the policy is taken out and also at the date of loss giving rise to a claim under the policy.

Proximate Cause

An insurer will only be liable to pay a claim under an insurance contract if the loss that gives rise to the claim was proximately caused by an insured peril. This means that the loss must be directly attributed to an insured peril without any break in the chain of causation.

There are several principles that govern what is insurance and what isn't. These are the basic principles of insurance.

First, insurance is a repayment of a random loss. The timing or occurrence of the loss must be uncertain. For example, you can't know your house is going to be destroyed in three weeks by a demolotion team and still get home owner's insurance.

Overall losses by the insurance company must be somewhat predictable. In other words the insurance company needs to be able to rely on the law of averages. By pooling in a number of insured, the insurance company can be sure that a given percentage of the insured will never place claims allowing the company to make a profit on the overall business. They must also be able to understand what the costs will be for benefits over a large number of policies.

To be able to fully service major claims, small claims are not covered. This is what the deductable is for. Only damage or loss over the amount of the deductable is covered by the insurance policy.

The loss cannot be so large as to put the insurance company out of business.

MODULE 5: RISK ASSESSMENT IN FINANCIAL SERVICES

Risk – Uncertainty that matters (where you are not sure of what will happen in future)

Financial System – a set of markets and other institutions used for financial contracting and exchange of assets, and risks, eg markets for stocks and bonds and other financial instruments, financial intermediaries. They provide financial services

Function Of Financial Systems

Transfer resources across time and space
Manage risk
Clear and settle payments –credit cards, travellers cheques, digital money
Pooling resources and subdividing ownership – e.g. privatisation
Providing price information – interest rate, ratios, etc.
Dealing with incentive problems – moral hazard; insurance, adverse selection, Principal-agent.

Risk Assessment

Quantification of the costs associated with the identified risk.

Selection of Techniques

Risk avoidance – some risks can be reduced but not eliminated
Loss prevention and control eg feasibility study
Risk retention – in times of super profits, take reserves for bad times
Risk Transfer – Hedge, insure or diversify

Implementation – decide strategy**.** Dimensions should be cost reduction and desired quality.

Review : Monitor (observe process) and evaluate (assess the value of) results

Why supervise Financial Institutions (FIs)?

FIs and their activities are generally subject to much closer
official supervision than other kinds of businesses; what is it about their role and nature which justifies this?

The role of FIs

The economic and financial life of a country depends on FIs, especially banks in three important respects.
(a) They occupy a central place in the payments mechanism for
households, government and business.

(b) They accept deposits, which are widely regarded as "money"; which are expected to be repaid in full, either on demand or at their due term; and which constitute part of society's financial assets.

(c) Banks in market economies play a major role in the allocation of financial resources, intermediating between depositors of surplus funds and would-be borrowers, on the basis of active judgements as to the latter's ability to repay.

The primary justification for FIs supervision is to <u>limit the risk of loss to depositors, and by so doing to maintain public confidence</u> in FIs, especially banks. And while supervision naturally focuses on the individual bank, <u>supervisors must also be alert to the possibility that problems in one institution may have wider, systemic repercussions on others,</u> or on the integrity of the payments system.

The nature of banking-inherent instability

The business of banking has a number of attributes which have the potential to generate instability.

(a) <u>High gearing (or "leverage")</u> results from banks' financial intermediation between depositors and borrowers; by comparison with the generality of industrial and commercial companies, a bank's capital is small in relation to the size of its balance sheet. Therefore, any loss can have a profound effect on the bank's viability.

(b) <u>Typically, the term structures of assets and liabilities</u> are fundamentally mismatched, with assets tending to have a longer maturity than liabilities - again a virtually inevitable consequence of the role of the banks as intermediaries.

(c) Flowing from these observations, a <u>bank's solvency</u> depends on its ability to retain the confidence of both its depositors and the financial markets or institutions on which it may rely for funding.

(d) Sometimes, <u>the lack of transparency in published</u> financial statements hinders, or even defeats, counterparties' efforts at rational analysis of a bank's strengths and weaknesses; banks' balance sheets and off-balance sheet positions can change more rapidly than industrial and commercial companies', and customers' knowledge of their banks is inevitably imperfect.

Wider considerations

Although, as noted above, the focus of supervision is the individual bank, with the aim of limiting the risk to depositors, the safety and soundness of the banking system as a whole is so critical to the proper functioning of the economy, that supervisors must also be concerned about the possible wider, "systemic" implications of problems or failures in individual banks.

General principles of supervision

Underlying the diversity of supervisory regimes and practices which exist in different countries are some common objectives and judgments.

As objectives, supervisors seek to ensure that banks are

(a) financially sound
(b) well managed, and
(c) not posing a threat to the interests of their depositors

In pursuing these objectives supervisors are trying to form three judgments

(a) how much risk is each bank undertaking?
(b) what resources are available to manage that risk?
The resources may be tangible (eg capital, liquidity) or intangible (eg quality of management and control systems).
(c) whether the identified level of resources is sufficient to balance the risk.

The supervisor monitors and evaluates the overall strategies, policies and performance of the bank or other financial institution - where appropriate with reference to specific legal or prudential criteria - and reaches a view as to the soundness of the bank and the competence of those running it.

Basis for an effective supervisory system

An effective supervisory system rests on: legislation relating to the financial institution/banking and its supervision; the supervisory regime itself; and an appropriate legal and accounting environment.

Attention may therefore need to be given to possible overlaps or gaps in regulation; to questions of consistency and fairness across the financial sector; and to the justification for any gradations of treatment as between different classes of institution

The supervisory regime

It is for national consideration whether licensing and supervision should be entrusted to the central bank or to some other agency. In either event, it is most important that the supervisory authority be independent of political or other outside pressure, so that its decisions can be made on objective supervisory grounds. It is equally important that there should be a mechanism by which the supervisory authority is accountable to government or parliament for the discharge of its duties.

Legal and accounting environment

An appropriate legal and accounting framework is essential not only for effective supervision in a market economy, but also for banks themselves to serve their economic purposes; this proposition rests on the underlying presumption that in a market-orientated system private enterprises can, and do, fail.

The legal framework must deal with:

(a) business organisation - the formation, ownership, rights and obligations of privately owned enterprise

(b) the ownership of property - and in particular the means by which banks to whom collateral is pledged by a borrower can register and, in extremis, enforce their claims

(c) insolvency - the circumstances and manner in which an unpaid creditor of an enterprise may call for its liquidation, the process by which that liquidation is to be effected and the priority to be accorded to different classes of creditors.

Accounting systems must encompass:

(a) an agreed set of accounting standards to be followed by all enterprises in the preparation of their accounts, facilitating the resource allocation process - for example, by enabling banks to undertake informed credit assessments.

(b) independent review and certification of the accounts prepared by enterprises, undertaken by external auditors

(c) public disclosure of audited financial statements.

Banking/Financial institutions risks

The risks to which banks are exposed can be categorised thus

(a) Credit risk - the risk that the FIs' counterparty might not pay on the due date. Though most often associated with lending, credit risk arises whenever another party enters into an obligation to make payment or deliver value to the bank, eg in foreign exchange or securities transactions.

(b) Liquidity risk - the risk that the FI might itself fail to meet its obligations when they fall due.

(c) Yield risk - the risk that the FI's assets may generate less income than the expense generated by its liabilities.

(d) Market risk - the risk of loss resulting from movements in the market price of financial instruments in which the FI has a position. Such instruments include bonds, equities, foreign exchange and associated derivative products.

(e) Operational risk - the risk of a failure in the bank's procedures or controls, whether from external causes or as a result of error or fraud within the institution.

(f) Ownership/management risk - the risk that shareholders, directors or senior management might be unfit for their respective roles, or actually dishonest.

Any banking risk is heightened if it appears in concentrated form -
for example through large exposures to single or related counterparties, industrial sectors, countries or currencies.

BASIC ISSUES

1. The FSC has been successfully applying a risk assessment methodology across all supervisory divisions since 2003. In 2005 the FSC revised the basis of profiling firms.

2. The FSC has re-engineered the assessment methodology building on the experience of these past years to deliver a more efficient and effective process through which the risks of a firm are assessed and mitigated.

3. In arriving at the revised methodology the FSC is seeking to concentrate on high level risks rather than regulatory compliance issues. The focus of attention of the revised methodology is to arrive at a conclusion as to the ability and competence of a firm's senior management to identify and mitigate risks as well as to put into place adequate systems of control to meet regulatory requirements.

4. The intensity of the FSC's interfacing with a firm will be completely dependent on the perceived risks that a firm poses to its customer base and the jurisdiction. The more a firm's senior management does to address its risks, the less interfacing with the FSC it will have.

5. Those firms in which senior management has shown little attention to the identification and mitigation of risks or in meeting regulatory compliance requirements will find it a very onerous experience. The FSC is seeking to make greater use of the Reporting Accountants Regime (Skilled Persons under the Insurance legislation) in order verify to regulatory compliance issues where the FSC perceives there to be failings.

6. The revised methodology will continue to assess firms based on two Risk Types (Business and Control) and six Risk Groups (Financial Soundness & Capital, Environment, Business Plan, Controls, Organisation & Management) as well as using an Impact Score as a multiplier. The Impact Score has been aligned across all divisions under the revised methodology.

Outline of 2009 methodology of risk management

7. The revised methodology has changed from the previous version to the following;

Figure 1 - Outline of methodology

8. The main difference of approach is the earlier profiling of a firm. This is necessary in order for the intensity of the on-site to be proportionate to the FSC perception of the risks it faces and the impact the firm has on the jurisdiction.

9. The following sections describe each of the steps in greater detail;

a) Off-site

This is the main element of the FSC's work programme as it consists of pulling together information from a variety of different sources into the assessment. Some of the information is already existent within the FSC but other information will be sought directly from the firm.

In revie wing the information already held by the FSC the following source documents will be examined:

- **Correspondence.** In order to identify major changes to the firm's business plans, licensing requirements, compliance arrangements.
- **Appointments and Resignations**. In order to take a view on the adequacy of the composition of the Board and Senior Management as well as corporate governance arrangements.
- **Returns & Financial Statements.** To view adequacy of capital and liquidity both in terms of meeting the minimum regulatory prudential requirements as well as to support current and future business needs.
- **Complaints.** To determine if there are systemic failures in the management of the firm's affairs.
- **Outsourced functions.** To determine if a firm's head office and mind and management requirements continue to be met.

Additionally, the FSC will seek to obtain at a very early stage of the risk-assessment process additional answers to risk specific or regulatory compliance matters through the use of questionnaires.

Examples of these generic questionnaires are included in this document but may be varied for a given firm or sector. Additional questionnaires may, from time to time also be issued.

Compliance specific questionnaires may also be issued by a division in order to ascertain regulatory compliance with a set of requirements (e.g. seeking to review the firm's completion of the AML/CFT Compliance Report).

In most cases the FSC will also seek to obtain up to date financial forecasts for the following three years indicating, where appropriate, compliance with prudential requirements (e.g. capital adequacy, solvency margins, etc).

b) Profiling

The FSC seeks to obtain a risk profile of the firm through the assessment of six separate Risk Groups. The risk profile of the firm will determine the FSC's approach to that firm.
During the preliminary stages, the FSC will use its available information of a firm to arrive at a risk profile. This may change once the FSC has effected its on-site work.

Business risks

The analysis of the business risk will be performed using the following risk groups: Financial Soundness & Capital, Environment and Business Plan ("FEB"). This review will comprise an analysis of the financial position of the firm, the firm's overall business and external environment and its future strategy. This will facilitate a historical, current and forward-looking assessment of the firm's key business risks.

The objectives behind each of the Business Risk Groups assessment are:

- **Financial Soundness and Capital -** To determine the adequacy of capital, funding and insurance cover in light of the current and future business plans of the firm.
- **Environment -** To determine what operational and other market risks the firm is subject to in carrying out its business plan.
- **Business Plan -** To determine where the current and future risks lie in a firm's business plan, products and strategy.

This analysis will be undertaken, for example, using prudential data, annual accounts, and information requested from the firm together with information already held on the FSC's files.

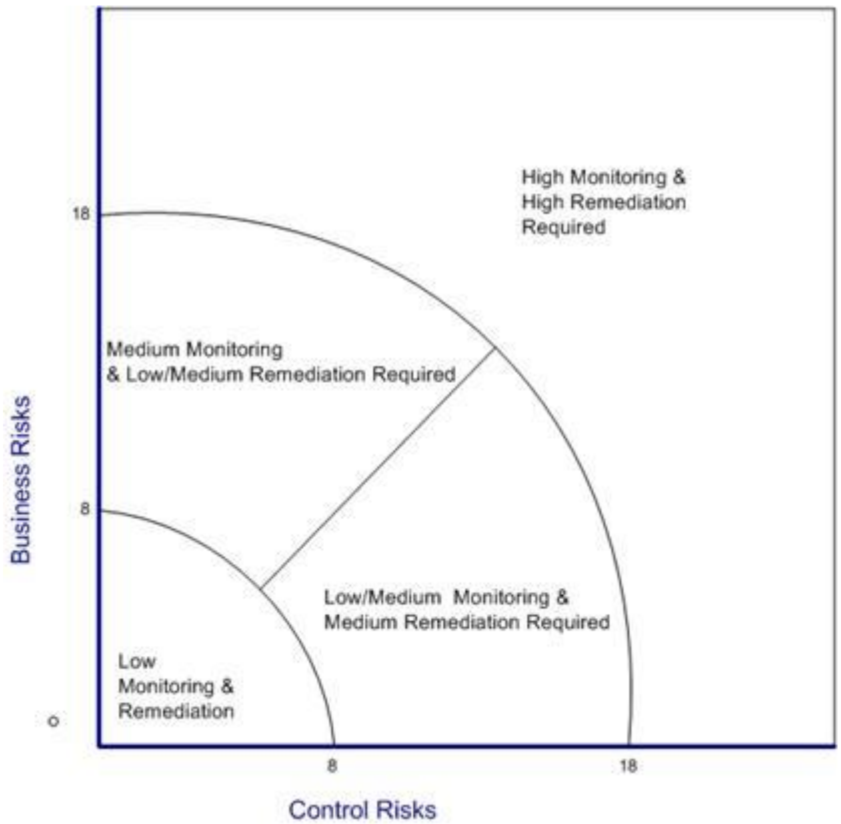
Control risks

In analysing the controls over the business, the FSC will undertake an assessment using another three risk groups: Controls, Organisation and Management (COM). As mentioned above, most of the information for this analysis will come from information already held on the FSC's files, including reporting accountants' reports. The objectives of the Control Risk Group assessment are:

- **Controls -** To determine the control environment of a firm and management's ability to put into place proper oversight procedures.
- **Organisation -** To determine if the legal ownership structure and/or Passporting of services of the firm provides any impediments to the supervision of the firm.
- **Management -** To determine if the firm's corporate governance arrangements and management are adequate for the nature, size and complexity of the firm.

The scoring by FSC staff of each of the elements is a vital constituent of the revised methodology as previously the FSC only scored at the higher level of Risk Group. The previous method showed some distortions in the scoring and this new approach seeks to provide greater consistency of approach.

The weighting of each of the risk elements and risk groups has been carefully considered by the Executive of the Commission based on the experience of the Heads of Division and previous risk assessments.
A pro-forma spreadsheet on the scoring of a firms risk elements and effect of the impact score can be found in Appendix 1.
The FSC will, for each Risk Element, document why it assigned such a value to it. This will also translate into what items the FSC will consider important enough to raise with the firm going forward. Therefore an element which is scored as "Negligible" or "Possible" will not generally feature in discussions with the firm nor as part of the on-site verification process.
The scoring of each of the Risk Elements when multiplied by the Impact score produces two values that can be plotted on a simple chart to produce the risk profile of a firm;



Risk profile chart

By having obtained a preliminary risk profile the FSC is able, at this stage, to decide upon the scope and intensity of its remaining work, including the on-site verification programme.

Firms will fall into one of the following risk profiles;

- **Low Monitoring & Remediation** : Firms who have a strong control environment supported by good governance as well as stable business plans and who generally are lower impact firms. These firms will have little by way of regular contact with the FSC in between risk assessments other than the occasional prudential meeting.
- **Low/Medium Monitoring and Medium Remediation** : Firms who are making improvements to their control environment and regulatory compliance arrangements. It is likely that these firms will be the subject of focused visits or reporting accountants reports to validate the work being conducted by senior management.
- **Medium Monitoring & Low/Medium Remediation** : This would apply to firms who's business plan is changing quickly, either because they are in a start-up scenario or changing their business plan. Although some changes to their control environment may be required the

FSC will want to maintain regular contact through prudential visits to keep abreast of developments.

- **High Monitoring & High Remediation** : These firms are the ones that the FSC will be most concerned about. The cause for the additional monitoring and/or remediation will be greater magnified by the impact score of the firms. The FSC will be seeking to maintain very regular contact on a formal as well as informal basis with senior management of the firms as well as subjecting these firms to focused compliance visits and/or reporting accountants reporting.

In the description for each of the profiles, a number of terms have been used. It is useful to outline what each one of these means.

- **Focused Visit** : These are performed by FSC staff and will focus on a specific area of regulatory compliance (e.g. AML/CFT processes, Mifid Compliance, Returns Preparation, Corporate Governance, Outsourcing arrangements, etc). The firm will be reviewed for its compliance arrangements against specific regulatory requirements be these regulations, administrative notices or guidance notes which the firm should already have put in place.
  These focused visits will be requested if the FSC knows or suspects that the firm is not addressing specific regulatory compliance matters. The number of FSC staff present to conduct such visits and the amount of time that the team will spend on these visits is dependant on the risk profile of the firm.
- **Prudential Visit** : Also performed by FSC staff. The meetings, which may take between a couple of hours to a complete day will generally be held with senior management of a firm but may also wish to interview other members of the firm's staff. The prudential meeting seeks to update the FSC with developments in a firm's business plan, operating environment or financial situation.
- **Reporting Accountants Report** : This is, for the firm, the most onerous type of reporting that the FSC will impose as part of the risk assessment process. The FSC will use the powers under the Supervisory Acts to require a firm to appoint a set of Reporting Accountants so that they can review the firm's regulatory compliance arrangements with any aspect of the legislation including regulations, administrative notices or guidance notes. It is onerous on the firm for two reasons [1] the breath, depth and scope is far deeper than the equivalent report produced by the FSC and [2] the costs of this report are borne by the firm.
  The reporting accountants report will be used more frequently by the FSC in the case of larger, more complex firms or where the FSC considers that it does not have the resources or expertise to look at a particular area.

It is clear from the descriptions given above that a firm's senior management can, through pro-active risk management, reduce the regulatory burdens of an FSC risk assessment by taking appropriate action throughout its daily operations. By doing so a firm may actively reduce its risk profile and therefore the intensity of any FSC interfacing.

Initial risk profile

By having arrived at an initial risk-profile of a firm the FSC will set its general tone for the rest of the risk-assessment process. Therefore firms with an initial profile of Low Monitoring and Low Remediation will not require an intensive on-site verification programme. Conversely those with an initial High Monitoring & High Remediation profile will require greater allocation of resources to the next stages of the assessment.

Risk Assessment On-Site

Through the on-site the FSC seeks to validate its initial profiling, to identify the mitigation programmes already in place at a firm as well as being able to gain first hand experience of a firm's senior management and compliance culture. Through the initial profiling, the FSC will have identified those risk elements which it considers are most likely to contribute to the materialisation of an actual risk. Through the initial profiling stages, the FSC will have documented its reasons why it considers this to be the case.

Prior to carrying out an on-site the FSC will:

- Determine the time it expects to spend with the firm.
- Arrange with the firm mutually convenient dates for the on-site to take effect.
- Provide the firm with a formal agenda which will:
  - List all the issues/risk elements that it wishes to discuss with the firm's senior management.
  - Identify any individuals that the FSC wishes to speak with on any of the matters.
  - Allow the firm's senior management to invite to the meeting any other person it feels would contribute to the on-site.
  - Provide a list of any additional document or information that it may wish to review on the firm's premises together with a list of any documents that it may wish to take copies of.

The on-site will end with a close-out meeting. **This close-out meeting will seek to:**

- Summarise the areas reviewed by the FSC team.
- Summarise any areas which the FSC considers it requires additional information.
- Summarise the findings as they relate to the risk elements.
- Invite the senior management of the firm to provide input to the team on areas which they wish to add to the risk assessment.

Final Profiling

All of the information gained from the process to date are compiled and reviewed prior to making a final assessment.
The FSC will look through its initial profile and document where, if any, amendments to the profiling or impact score are required based on the information gleaned from the on-site work and subsequent review.
Once a final profile has been obtained the FSC will, based on the risk profile of firm, design a risk mitigation programme:

- Addressing the outstanding risks identified in the assessment. This will include specific mitigation that the firm is to carry out to address these issues and this may take the form of action required to be taken or a recommendation that it be carried out. Where a firm is required to take action, specific outcomes milestones and target dates will be set by the FSC. In most cases the FSC will seek to address no more than five issues which it considers are the highest priority, but may extend this, in exceptional cases, to more should circumstances require this. The FSC will make it clear which risk elements are affected by the mitigation required to be conducted.
- Setting out the interfacing between the FSC and the firm including expected numbers and scope of Prudential and Focused Visits planned to be carried out and likely timescales for these.
- Identifying any areas to be covered by a reporting accountant's report and the timescales by which these should be carried out.
- Providing the firm with its Risk Profile score. The firm will be prohibited from sharing this score with any party outside of its senior management team and may not use this score to promote or market itself or its products.
- Establishing the date when the next formal risk assessment of the firm will be conducted.

The FSC will communicate its findings, most of which should have been raised at the close-out meeting, via a draft feedback letter which will be sent to the firm within four weeks of the conclusion of the on-site.

The firm will be given two weeks to respond to the draft feedback letter in respect of factual inaccuracies that may be contained in the letter but not to discuss the risk mitigation programme elements described in the letter. The FSC will formally finalise the feedback letter in writing within two weeks of receiving the firm's views.

Interfacing and Risk Mitigation

Once the risk mitigation programme is agreed with the firm the risk mitigation programme is set into action. For the most part the FSC will rely on a firm's senior management to carry out the risk mitigation programme established in the feedback letter. The FSC will seek to verify that the action plan is being complied with through ad-hoc communications with the senior management or more formal Prudential Visits that have already been planned.

Failure by a firm to give effect to any aspect of the risk mitigation programme will have serious consequences for a firm ranging from conducting focused visits and the imposition of formal conditions or directions, the commissioning of reporting accountant's reports up to the imposition of penalty fees. In certain circumstances, the withdrawal of authorisation may also be considered by the FSC.

MODULE 6: RETIREMENT PLANNING AND PENSIONS

Objective: Raising awareness about pensions and other sources of income for later life.

Definitions:

A **pension** is an arrangement to provide people with an income when they are no longer earning a regular income from employment

A retirement plan is an arrangement to provide people with an income during retirement when they are no longer earning a steady income from employment.

An **occupational or employer pension** created by an employer for the benefit of an employee

A pensioner or *retiree*- *a* recipient of a retirement pension.

A defined contribution plan will provide a payout at retirement that is dependent upon the amount of money contributed and the performance of the investment vehicles utilized.

A traditional form of defined benefit plan is the *final salary* plan, under which the pension paid is equal to the number of years worked, multiplied by the member's salary at retirement, multiplied by a factor known as the *accrual rate*. The final accrued amount is available as a monthly pension or a lump sum, but usually monthly.

An ***unfunded*** **defined benefit pension**, no assets are set aside and the benefits are paid for by the employer or other pension sponsor as and when they are paid.

A ***funded*** **plan**, contributions from the employer, and sometimes also from plan members, are invested in a fund towards meeting the benefits.

The terms **retirement plan** or **superannuation** refer to a pension granted upon retirement. Retirement plans may be set up by employers, insurance companies, the government or other institutions such as employer associations or trade unions. Called *retirement plans* in the USA, they are more commonly known as *pension schemes* in the UK and Ireland and *superannuation plans* in Australia. Retirement pensions are typically in the form of a guaranteed annuity.

A pension created by an employer for the benefit of an employee is commonly referred to as an occupational or employer pension. Labor unions, the government, or other organizations may also fund pensions. Occupational pensions are a form of deferred compensation, usually advantageous to employee and employer for tax reasons. Many pensions also contain an insurance aspect, since they often will pay benefits to survivors or disabled beneficiaries, while annuity income insures against the risk of longevity. Other vehicles (certain lottery payouts, for example, or an annuity) may provide a similar stream of payments.

The common use of the term *pension* is to describe the payments a person receives upon retirement, usually under pre-determined legal and/or contractual terms. A recipient of a retirement pension is known as a *pensioner* or *retiree*.

Types of pensions

Employment-based pensions (retirement plans)

A retirement plan is an arrangement to provide people with an income during retirement when they are no longer earning a steady income from employment. Often retirement plans require both the employer and employee to contribute money to a fund during their employment in order to receive defined benefits upon retirement. Funding can be provided in other ways, such as from labor unions, government agencies, or self-funded schemes. Pension plans are therefore a form of "deferred compensation".

Social / state pensions

Many countries have created funds for their citizens and residents to provide income when they retire (or in some cases become disabled). Typically this requires payments throughout the citizen's working life in order to qualify for benefits later on.

For examples, see National Insurance in the UK, or Social Security in the USA.

Disability pensions

Some pension plans will provide for members in the event they suffer a disability. This may take the form of early entry into a retirement plan for a disabled member below the normal retirement age.

Benefits

Retirement plans may be classified as *defined benefit* or *defined contribution* according to how the benefits are determined. A defined benefit plan guarantees a certain payout at retirement, according to a fixed formula which usually depends on the member's salary and the number of years' membership in the plan. A defined contribution plan will provide a payout at retirement that is dependent upon the amount of money contributed and the performance of the investment vehicles utilized.

Some types of retirement plans, such as *cash balance* plans, combine features of both defined benefit and defined contribution plans. They are often referred to as *hybrid* plans. Such plan designs have become increasingly popular in the US since the 1990s. Examples include **Cash Balance** and **Pension Equity** plans.

Defined benefit plans

A traditional defined benefit (DB) plan is a plan in which the benefit on retirement is determined by a set formula, rather than depending on investment returns. In the US, 26 U.S.C. § 414(j) specifies a defined benefit plan to be any pension plan that is not a defined contribution plan (see below) where a defined contribution plan is any plan with individual accounts. A traditional pension plan that *defines* a *benefit* for an employee upon that employee's retirement is a defined benefit plan.

Traditionally, retirement plans have been administered by institutions which exist specifically for that purpose, by large businesses, or, for government workers, by the government itself. A traditional form of defined benefit plan is the *final salary* plan, under which the pension paid is equal to the number of years worked, multiplied by the member's salary at retirement, multiplied by a factor known as the *accrual rate*. The final accrued amount is available as a monthly pension or a lump sum, but usually monthly.

The benefit in a defined benefit pension plan is determined by a formula that can incorporate the employee's pay, years of employment, age at retirement, and other factors. A simple example is a **Dollars Times Service** plan design that provides a certain amount per month based on the time an employee works for a company. For example, a plan offering $100 a month per year of service would provide $3,000 per month to a retiree with 30 years of service. While this type of plan is popular among unionized workers, **Final Average Pay** (FAP) remains the most common type of defined benefit plan offered in the United States. In FAP plans, the average salary over the final years of an employee's career determines the benefit amount.

Inflation Factor

In the United Kingdom, benefits are typically indexed for inflation (known as Retail Prices Index (RPI)) as required by law for registered pension plans. Inflation during an employee's retirement affects the purchasing power of the pension; the higher the inflation rate, the lower the purchasing power of a fixed annual pension. This effect can be mitigated by providing annual increases to the pension at the rate of inflation (usually capped, for instance at 5% in any given year). This method is advantageous for the employee since it stabilizes the purchasing power of pensions to some extent.

If the pension plan allows for early retirement, payments are often reduced to recognize that the retirees will receive the payouts for longer periods of time. In the US, (under the ERISA rules), any reduction factor less than or equal to the actuarial early retirement reduction factor is acceptable.

Many DB plans include early retirement provisions to encourage employees to retire early, before the attainment of normal retirement age (usually age 65). Companies would rather hire younger employees at lower wages. Some of those provisions come in the form of additional *temporary* or *supplemental benefits*, which are payable to a certain age, usually before attaining normal retirement age.

Funding

Defined benefit plans may be either *funded* or *unfunded*.

In an *unfunded* defined benefit pension, no assets are set aside and the benefits are paid for by the employer or other pension sponsor as and when they are paid. Pension arrangements provided by the state in most countries in the world are unfunded, with benefits paid directly from current workers' contributions and taxes. This method of financing is known as *Pay-as-you-go* (PAYGO or PAYG). The social security system in the USA and most European countries are unfunded, having benefits paid directly out of current taxes and social security contributions. In some countries, such as Germany, Austria and Sweden, company run retirement plans are often unfunded.

Criticisms

Traditional defined benefit plan designs (because of their typically flat accrual rate and the decreasing time for interest discounting as people get closer to retirement age) tend to exhibit a J-shaped accrual pattern of benefits, where the present value of benefits grows quite slowly early in an employee's career and accelerates significantly in mid-career: in other words it costs more to fund the pension for older employees than for younger ones (an "age bias"). Defined benefit pensions tend to be less portable than defined contribution plans, even if the plan allows a lump sum cash benefit at termination. Most plans, however, pay their benefits as an annuity, so retirees do not bear the risk of low investment returns on contributions or of outliving their retirement income. The open-ended nature of these risks to the employer is the reason given by many employers for switching from defined benefit to defined contribution plans over recent years. The risks to the employer can sometimes be mitigated by discretionary elements in the benefit structure, for instance in the rate of increase granted on accrued pensions, both before and after retirement.

The age bias, reduced portability and open ended risk make defined benefit plans better suited to large employers with less mobile workforces, such as the public sector (which has open-ended support from taxpayers).

Defined benefit plans are sometimes criticized as being paternalistic as they enable employers or plan trustees to make decisions about the type of benefits and family structures and lifestyles of their employees. However they are typically more valuable than defined contribution plans in most circumstances and for most employees (mainly because the employer tends to pay higher contributions than under defined contribution plans), so such criticism is rarely harsh.

The "cost" of a defined benefit plan is not easily calculated, and requires an actuary or actuarial software. However, even with the best of tools, the cost of a defined benefit plan will always be an estimate based on economic and financial assumptions. These assumptions include the average retirement age and lifespan of the employees, the returns to be earned by the pension plan's investments and any additional taxes or levies, such as those required by the Pension Benefit Guaranty Corporation in the U.S. So, for this arrangement, the benefit is relatively secure but the contribution is uncertain even when estimated by a professional.

Examples

Many countries offer state-sponsored retirement benefits, beyond those provided by employers, which are funded by payroll or other taxes. The United States Social Security system is similar to a defined benefit pension arrangement, albeit one that is constructed differently than a pension offered by a private employer.

Individuals that have worked in the UK and have paid certain levels of national insurance deductions can expect an income from the state pension scheme after their normal retirement. The state pension is currently divided into two parts: the basic state pension, State Second [tier] Pension scheme called S2P. Individuals will qualify for the basic state pension if they have completed sufficient years contribution to their national insurance record. The S2P pension scheme is earnings related and depends on earnings in each year as to how much an individual can expect to receive. It is possible for an individual to forgo the S2P payment from the state, in lieu of a payment made to an appropriate pension scheme of their choice, during their working life. For more details see UK pension provision.

Defined contribution plans

In a defined contribution plan, contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) are credited to the individual's account. On retirement, the member's account is used to provide retirement benefits, sometimes through the purchase of an annuity which then provides a regular income. Defined contribution plans have become widespread all over the world in recent years, and are now the dominant form of plan in the private sector in many countries. For example, the number of defined benefit plans in the US has been steadily declining, as more and more employers see pension contributions as a large expense avoidable by disbanding the defined benefit plan and instead offering a defined contribution plan.

Financing

There are various ways in which a pension may be financed.

Defined contribution pensions, by definition, are **funded**, as the "guarantee" made to employees is that specified (defined) contributions will be made during an individual's working life.

Current challenges

A growing challenge for many nations is population aging. As birth rates drop and life expectancy increases an ever-larger portion of the population is elderly. This leaves fewer workers for each retired person. In almost all developed countries this means that government and public sector pensions could collapse their economies unless pension systems are reformed or taxes are increased. One method of reforming the pension system is to increase the retirement age. Two exceptions are Australia and Canada, where the pension system is forecast to be solvent for the foreseeable future. In Canada, for instance, the annual payments were increased by some 70% in 1998 to achieve this. These two nations also have an advantage from their relative openness to immigration. However, their populations are not growing as fast as the U.S., which supplements a high immigration rate with one of the highest birthrates among Western countries. Thus, the population in the U.S. is not aging to the extent as those in Europe, Australia, or Canada.

Also the condition of the historical data and its development into a secure database can be an expensive and labour intensive endeavor. Currently, the trend to develop on line electronic calculators that replace traditionally complex spreadsheet calculations performed by Actuaries and Analysts is the industry norm in records management.

Another growing challenge is the recent trend of businesses in the United States purposely under-funding their pension schemes in order to push the costs onto the federal government. Bradley Belt, former executive director of the PBGC (the Pension Benefit Guaranty Corporation, the federal agency that insures private-sector defined-benefit pension plans in the event of bankruptcy), testified before a congressional hearing in October 2004, “I am particularly concerned with the temptation, and indeed, growing tendency, to use the pension insurance fund as a means to obtain an interest-free and risk-free loan to enable companies to restructure. Unfortunately, the current calculation appears to be that shifting pension liabilities onto other premium payers or potentially taxpayers is the path of least resistance rather than a last resort.”

Challenges have further been increased by the **credit crunch**. Total funding of US pension plans fell by $303bn in 2008, going from a $86bn surplus at the end of 2007 to a $217bn deficit at the end of 2008.

A mini guide to retirement planning and pensions
How savvy are you?

- Retirement Planning and Pensions are relevant to everyone, regardless of age, gender, health and working situation.
- Being aware of pension options is great - planning for retirement income is even better!
- You can pay into a pension even if you are not working.
- Planning for your income in later life is empowering. The earlier you start, the more choices you have. But doing something about it at any age is better than doing nothing at all.
- You can start a pension at any age. Even babies can have pension schemes opened for them. They won't be able to get their hands on the money until they are 55, but it will be a rich retirement as long as they keep up the payments!
- Pensions are like shoes - they come in different types, carry different names and some are riskier than others. As with footwear, you can have as many pensions as you like.

Pension reform proposals

The government published pension reform proposals in 2006 and early 2007. They include:

- Reducing to 30 years for everyone the number of years of National Insurance Contributions to get a full Basic State Pension. This change will happen from 2010.
- Linking the Basic State Pension to average earnings.
- Raising the State Pension Age for women by 2020.
- Raising the State Pension Age to 66 by 2024.

MODULE 7: FINANCIAL ECONOMICS AND INVESTMENT

Definitions

Financial economics is the branch of economics concerned with "the allocation and deployment of economic resources, both spatially and across time, in an uncertain environment". The questions within financial economics are typically framed in terms of "time, uncertainty, options and information".

- Time: money now is traded for money in the future.
- Uncertainty (or risk): The amount of money to be transferred in the future is uncertain.
- options: one party to the transaction can make a decision at a later time that will affect subsequent transfers of money.
- Information: knowledge of the future can reduce, or possibly eliminate, the uncertainty associated with future monetary value (FMV).

Subject matter

Financial economics is the branch of economics studying the interrelation of financial variables, such as prices, interest rates and shares, as opposed to those concerning the real economy. Financial economics concentrates on influences of real economic variables on financial ones, in contrast to pure finance.

MODULE 8: VALUE BASED FINANCE

A financial management approach in which the primary purpose is owner wealth maximisation. The object of the firm, its systems, strategy, processes, analytical techniques, performance measurements and culture, have as their guiding objective owner wealth maximisation.
A structured approach to measure the performance of an entity's unit managers or products in terms of the net benefit they provide to owners.
The term was used to refer to the more specific concept that planned actions by management and the returns to risk owners should outperform certain bench-marks such as the cost of capital concept. In essence, the idea that risk owners' money should be used to earn a higher return than they could earn themselves by investing in other assets having the same amount of risk. The term in this sense was introduced by Alfred Rappaport in 1986.
Value is a business buzz term, which implies that the ultimate measure of a entity's success is to enrich the risk owners. It became popular during the 1980s, and is particularly associated with former CEO of General Electric, Jack Welch. In March 2009, Welch openly turned his back on the concept, calling shareholder value "the dumbest idea in the world".

Publicly Traded Company

For a publicly traded company, Shareholder Value (SV) is the part of its capitalization that is equity as opposed to long-term debt. In the case of only one type of stock, this would roughly be the number of outstanding shares times current share price. Things like dividends augment shareholder value while issuing of shares (stock options) lower it. This *Shareholder value added* should be compared to average/required increase in value, aka cost of capital.
For a privately held company, the value of the firm after debt must be estimated using one of several valuation methods, such as discounted cash flow or others.

Maximizing shareholder value

This management principle, also known under **value based management**, states that management should first and foremost consider the interests of shareholders in its business decisions. Although this is built into the legal premise of a publicly traded company, this concept is usually highlighted in opposition to alleged examples of CEO's and other management actions which enrich themselves at the expense of shareholders. Examples of this include acquisitions which are dilutive to shareholders, that is, they may cause the combined company to have twice the profits for example but these might have to be split amongst three times the shareholders.

As shareholder value is difficult to influence directly by any manager, it is usually broken down in components, so called **value drivers**. A widely used model comprises 7 drivers of shareholder value, giving some guidance to managers:
- Revenue

- Operating Margin
- Cash Tax Rate
- Incremental Capital Expenditure
- Investment in Working Capital
- Cost of Capital
- Competitive Advantage Period

Looking at some of these elements also makes it clear that short term profit maximisation doesn't necessarily increase shareholder value. Most notably, the competitive advantage period takes care of this: if a business sells sub-standard products to reduce cost and make a quick profit, it damages its reputation and therefore destroys competitive advantage in the future. The same holds true for businesses that neglect research or investment in motivated and well-trained employees. Shareholders, analysts and the media will usually find out about these issues and therefore reduce the price they are prepared to pay for shares of this business. This more detailed concept therefore gets rid of some of the issues (though not all of them) indicated in the next section (criticism).

Based on these 7 components, all functions of a business plan and show how they influence shareholder value. A prominent tool for any department or function to prove its value are so called shareholder value maps that link their activities to one or several of these seven components. So, you can find *HR shareholder value maps*, *R&D shareholder value maps*, etc.

Criticism

The sole concentration on shareholder value has been widely criticized. While shareholder value benefits the owners of a corporation financially, it does not provide a clear measure of social issues like employment, environmental issues, or ethical business practices. A management decision can maximize shareholder value while lowering the welfare of third parties.

It can also disadvantage customers. For example, a company may, in the interests of enhancing shareholder value, cease to provide support for old, or even relatively new, products.

Alternative Definition based upon Criticism: Stakeholder Value

The intrinsic or extrinsic worth of a business measured by a combination of financial success, usefulness to society, and satisfaction of employees, the priorities determined by the makeup of the individuals and entities that together own the shares and direct the company.

However, this concept is difficult to implement in practice because of the difficulty of determining equivalent measures for usefulness to society and satisfaction of employees. To give an example: how much additional "usefulness to society" should shareholders expect if they were to give up $100 million in shareholder return? In response to this criticism, defenders of the shareholder value concept argue that employee satisfaction and usefulness to society will ultimately translate into shareholder value.

Personal Finances

There are four types of people who make up the world of business but it’s the business owners and the investors (not the employees and the self-employed) who can create great wealth by accelerating their cash flow through those assets.

Teachings of Robert Toru Kiyosaki

A large part of Kiyosaki's teachings focus on generating passive income by means of investment opportunities, such as real estate and businesses, with the ultimate goal of being able to support oneself by such investments alone. In tandem with this, Kiyosaki defines "assets" as things that generate cash inflow, such as rental properties or businesses—and "liabilities" as things that use cash, such as houses, cars, and so on. Kiyosaki also argues that financial leverage is critically important in becoming rich.

Kiyosaki stresses what he calls "financial literacy" as the means to obtaining wealth. He says that life skills are often best learned through experience and that there are important lessons not taught in school. He says that formal education is primarily for those seeking to be employees or self-employed individuals, and that this is an "Industrial Age idea." And according to Kiyosaki, in order to obtain financial freedom, one must be either a business owner or an investor, generating passive income.

Kiyosaki speaks often of what he calls "The Cash flow Quadrant," a conceptual tool that aims to describe how all the money in the world is earned. Depicted in a diagram, this concept entails four groupings, split with two lines (one vertical and one horizontal). In each of the four groups there is a letter representing a way in which an individual may earn income. The letters are as follows.

- **E:** Employee — Working for someone else – I have a job.
- **S:** Self-employed or Small business owner — Where a person owns his own job and is his own boss.
- **B:** (Boss) Business owner — Where a person owns a "system" of making money and people work for him, rather than a job to make money.
- **I:** Investor — Spending money in order to receive a larger payout in **-** money works for you.

Cashflow Quadrant: Rich Dad's Guide to Financial Freedom (2000)

Cashflow Quadrant is a personal finance and investing book written with Sharon Lechter, C.P.A. as the sequel to *Rich Dad, Poor Dad*. In it, Kiyosaki discusses what he calls the cashflow quadrant: a grid consisting of the letters "E", "S", "B", and "I." The cashflow quadrant itself is just an illustrative tool to show the difference between Employees, Self Employed/Small Business owners, Business owners (not directly involved in the day-to-day operation of the company), and Investors. Kiyosaki discusses the differences between concepts and ideas characteristic of each quadrant, particularly as they relate to passive income and tax advantages.

***Rich Dad's Guide to Investing: What the Rich Invest in, That the Poor and the Middle Class Do Not!* (2000)**

Rich Dad's Guide to Investing gives the reader a roadmap to becoming the Ultimate Investor, one who uses other peoples' money to create investments that people want to buy into.

Rich Kid, Smart Kid (2001)

Rich Kid, Smart Kid is a retelling of Kiyosaki's views, condensed and clarified to try and help parents better understand and teach their children key financial concepts. It includes a series of activities that a parent can do with their child to make them aware of property, finance and the various ways and places businesses make money.
Rich Dad's Prophecy (2002)
Rich Dad's Prophecy predicts that the market will crash around 2016 when the oldest Baby Boomers start cashing out their 401(k) plans. Individuals whose savings are locked into 401(k) plans will suffer because these retirement plans are not flexible and do not do well in a bear market. Robert Kiyosaki believes this may be his most important book yet.
Why We Want You To Be Rich coauthored by Donald Trump (2007)

Why We Want You To Be Rich is a book written by both Robert Kiyosaki and Donald Trump. It encourages individuals to become financially literate to combat the upcoming problems facing America, such as the shrinking middle class and the entitlement mentality.

Didactic games

Kiyosaki stresses the value of games, particularly *Monopoly*, as tools for learning basic financial strategies such as "trade four green houses for one red hotel." Kiyosaki has created several games to reinforce the information in his books.

"Cashflow 101" is a board game designed by Kiyosaki, which aims to teach the players concepts of investing and making money, it costs $195.

There are two stages to the game. In the first, "the rat race", the player aims to raise his or her character's passive income level to where it exceeds the character's expenses through a variety of investment options. The winner is determined in the second stage, "the fast track." To win, a player must get his character to buy his "dream" or accumulate $50,000 in monthly cash flow.

The game forces the players to do the accounts by themselves. In place of "score cards", there are financial statements. Therefore, players can see more clearly what is happening with their money. It generally shows how assets generate incomes and liabilities affect expenses.

Basic strategies involved in this game are: buying and selling stocks, Cashflow, Appreciation, and leverage.

There are audio/visuals as well.

Criticism and controversy

Kiyosaki's books and teachings have been criticized for focusing on anecdotes and containing little in the way of concrete advice on how readers should proceed. Kiyosaki responds that his material is meant to be more of a motivational tool to get readers thinking about money, rather than a step by step guide to wealth. He also says the books are supposed to be "interesting" to people, which precludes involving a lot of technical material.

There is also disagreement over how blurred the line is between fiction and anecdote in many of his works. Critics believe that Rich Dad is fictional and that Kiyosaki created him as an author surrogate (a literary device).

OBSERVATIONS

- Some people work less, earn more, pay less in taxes, and feel more financially secure than others.
- Most employees go from job to job while others quit their jobs and go on to build business empires?
- *The Cashflow Quadrant* guides readers in finding their own path to financial freedom in a world of ever increasing financial change. It is relevant:
  - for people who are ready to move beyond job security and begin to find their own world of financial freedom.
  - for people who are ready to make deep professional and financial changes in their lives.
  - for people who are ready to move from the Industrial Age to the Information Age.
- Many of the brightest graduates from our universities want to work for college dropouts... dropouts such as Bill Gates of Microsoft, Richard Branson of Virgin Industries, Michael Dell of Dell Computers, Ted Turner of CNN; Dropouts who are today the mega-rich of society.
- Fear, uncertainty and hunger shortens the human emotional fuse, and often we fight with the person who loves us the most.
- Aim at obtaining good grades with good job skills and solid work ethics, but, do no go for job security, aim at attaining financial freedom, by then, you never have to work again for the rest of your life.
- It doesn't take money to make money.
- It also does not take a good formal education to achieve financial freedom.
- It takes a dream, a lot of determination, a willingness to learn quickly, and the ability to use your God-given assets properly and to know which sector of the *CASHFLOW Quadrant* to generate your income from.
- While money is all the same, the way it is earned can be vastly different.
- Being in one quadrant or the other does not necessarily guarantee financial success.

THE CASHFLOW QUADRANT

The letters in each quadrant represent:

E For employee

S for self-employed

B for business owner

I for investor

WHICH QUADRANT DO YOU GENERATE YOUR INCOME FROM?

The *CASHFLOW Quadrant* represents the different methods by which income or money is generated. For example, an employee earns money by holding a job and working for someone else or a company. Self-employed people earn money working for themselves. A business owner owns a business that generates money, and investors earn money from their various investments-in other words, money generating more money.

- Different methods of income generation require different frames of mind, different technical skills, different educational paths, and different types of people. Different people are attracted to different quadrants.

- Each quadrant is different. To generate income from different quadrants requires different skills and a different personality, even if the person found in each quadrant is the same. Changing from quadrant to quadrant is like playing golf in the morning and then attending the ballet at night.

YOU CAN EARN INCOME IN ALL FOUR QUADRANTS

Most of us have the potential to generate income from all four quadrants. Which quadrant you or I choose to earn our primary income from is not so much what we learned in school; <u>it is more about who we are at the core-our core values, strengths, weaknesses and interests. It is these core differences that attract us to or repel us from the four quadrants.</u>

Yet, regardless of what we "do" professionally, we can still work in all four quadrants. For example, a medical doctor could choose to earn income as an "E," an employee, and join the staff of a large hospital, or work for the government in the public-health service, or become a military doctor, or join the staff of an insurance company needing a doctor on its staff.

This same doctor could also decide to earn income as an "S," a self-employed person, and start a private practice, setting up an office, hiring staff and building a private list of clients.

Or the doctor could decide to become a "B" and own a clinic or laboratory and have other doctors on staff. This doctor probably would hire a business manager to run the organization. In this case, the doctor would own the business, but not have to work in it. The doctor also could decide to own a business that has nothing to do with the medical field, while still practicing medicine somewhere else. In this case, the doctor would be earning income as both an "E" and as a "B."

As an "I," the doctor also could generate income from being an investor in someone else's business or in vehicles like the stock market, bond market and real estate.

The important words are "generate income from." It is not so much what we do, but more how we generate income.

DIFFERENT PERSONALITIES AND METHODS OF INCOME GENERATION

More than anything, it is the internal differences of our core values, strengths, weaknesses and interests that affect which quadrant we decide to generate our income from. Some people love being employees, while others hate it. Some people love owning companies, but do not want to run them. Others love owning companies and also love running them. Certain people love investing, while others only see the risk of losing money. Most of us are a little of each of these characters. Being successful in the four quadrants often means redirecting some internal core values.

YOU CAN BE RICH OR POOR IN ALL FOUR QUADRANTS

It also is important to note that you can be rich or poor in all four quadrants. There are people who earn millions and people who go bankrupt in each of the quadrants. Being in one quadrant or the other does not necessarily guarantee financial success.

NOT ALL QUADRANTS ARE EQUAL

By knowing the different features of each quadrant, you'll have a better idea as to which quadrant, or quadrants, might be best for you. For example, one of the many reasons I chose to work predominantly in the "B" and "I" quadrants is because of tax advantages. For most people working on the left side of the *Quadrant*, there are few legal tax breaks available. Yet, legal tax breaks abound on the right side of the *Quadrant*. By working to generate income in the "B" and "I" quadrants, I could acquire money faster and keep that money working for me longer, without losing large chunks to pay taxes.

Business Consultant Robert T Kiyosaki

In his book entitled Rich Dad Poor Dad, Robert Kiyosaki had two dads, one is his biological dad tagged as “poor dad” and one is his friend’s dad tagged as “rich dad.” Both dads taught Robert Kiyosaki how to reach his financial goals and achieve success but with different approaches.

His poor dad spent so much time in school earning him a doctorate degree landing on a high paying job but ended with a lot of bills left unpaid while his rich dad did not finish school but ended up owing a business empire. How did this happen? Just look at the contrasting ideas each dad have:

His poor dad says: “I CAN’T AFFORD IT!” while his rich dad says: “HOW CAN I AFFORD IT?”

His poor dad says: “MONEY IS THE ROOT OF ALL EVIL!” while his rich dad says: “LACK OF MONEY IS THE ROOT OF ALL EVIL!”

By viewing these two contrasting ideas, his poor dad’s brain stopped working when he said those, killing his initiative and promoting negativity while his rich dad’s brain kept on thinking on ways creating initiative and promoting optimism. Which one is best? Of course, undeniably, it’s rich dad’s ideas!

Robert Kiyosaki continued and coined the term RAT RACE. This is the race of our lifetime INCOME and SPEND. We receive our income regularly from our paychecks yet we spend the same to pay bills and satisfy our wants. We are now trapped in this rat race. <u>We live our lives to pay our everyday bills</u>! Now, how can we escape from this rat race trap? By understanding the Cash flow Quadrant.

This is understanding where our income flows. It was divided into two main sections. The <u>left side called “Active Income”</u> and <u>right side called “Passive Income.</u>” What’s <u>the difference</u>? Active Income says “You Work For Money” while Passive Income says “Money Works For You.”

It is then further subdivided into four quadrants. Quadrant 1 is the so-called Employees. Quadrant 2 is the so-called Self-Employed. Qudrant 3 is the so-called Big Business Owners. Quadrant 4 is the so-called Investors.

Quadrant 1 - EMPLOYEES. I do think that most of us belongs here. We have a job. We have to work hard, follow instructions from our bosses and superiors and get paid. We don’t own our time. These are people who love security or tenure. They will work hard to climb up the corporate ladder. The higher they climbed the ladder, the higher they pay is. Sad to say, the higher their pay is, the higher also their taxes. And it's not them getting rich, it's their bosses, it's their company. Time will come, they will get tired. Their body will collapse because of age. And when they stopped working, they will also stop receiving income.

Quadrant 2 - SELF EMPLOYED - They work for themselves. The difference with the employees is that self-employed own their time since they don't have superiors. They can decide for themselves. These are people who loves to be independent. They don't want to work for others, instead they want to work for themselves. These are doctors, lawyers, and small business owners. But still, they are an employee of themselves. And if they stopped working, they will also stop receiving income.

Quadrant 3 - BIG BUSINESS OWNERS - They love delegating tasks. They concentrate their efforts more on activities which produces most profits. They hire people who are more intelligent than them to do the work for them. They have built a solid system and they own it. They have built their resources to make this possible. And so they can leave for vacation and can leave work for some time but still earns money because there were people working for them. Examples of this are the taipans and tycoons and some franchisers (e.g. Nandos, Coca cola, Shell Uganda) who have built a solid business.

Quadrant 4 - INVESTORS - These are people who have built their assets and are not working for money anymore. Instead, the assets they have accumulated works for them providing them constant income even if they don't work. These are people who are called "living on interests". They are living thru the interests of their assets and investments. Money works for them. They have invested their money to have more money. They can differentiate which one is an asset and which one is a liability. Examples of these are investors in the stock market, real estate, etc.

Did you see the difference? The only way to escape from the rat race is by travelling from active income to passive income, from employee or self-employed to becoming a big business owner or investor. And this is the challenge that Robert Kiyosaki left to us readers.

CONCLUSION

"The rich buy assets. The poor only have expenses. The middle class buys liabilities they think are assets. The poor and the middle class work for money. The rich have money work for them."

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