FINANCE (BEGINNERS) SUMMARY 2011

BUSINESSKOOL.COM

BUSINESSKOOL PTY LTD

TABLE OF CONTENTS

SOURCES:

Berk, J. and Demarzo, P. (2009) *Corporate Finance: The Core Plus MyFinanceLab Student Access Kit: International Edition*, Pearson

Peirson et al. (2009) *Business Finance 10th Edition*, McGraw-Hill.

Viney, C. (2007) *Financial Institutions, Instruments and Markets 5th Edition*, McGraw-Hill Irwin

TOPIC 1: THE FINANCIAL SYSTEM

1.1 Function of the Financial System

The fundamental purpose of the financial system is to link the suppliers of funds (savers or "surplus units") with the users of funds (borrowers or "deficit units"). The financial market facilitates the exchange of goods and services by bringing these two parties together. The system is consists of three aspects: institutions, instruments and markets.

1.2 Financial Instruments

A financial instrument is a tool issued by a borrower to raise funds. The instrument acknowledges a financial commitment and entitles the holder to future cash flows. The details of the commitment and future cash flows are unique to the individual instrument. The main types of instruments are:

Equity

Ownership is given in exchange for the funds. Equity holders claim returns through earnings (e.g. dividends) or liquidation (ownership of assets). Shares are an example of a deficit unit (company) using an equity financial instrument to raise funds from a surplus unit (share trader).

"Hybrid" (or quasi-equity) securities – securities which have both equity and debt characteristics – are also included as equity instruments. Examples are preference shares or convertible notes.

Debt

For debt securities, the borrower commits to repaying the principal plus interest payments. An example of a debt security is a loan taken out by a business from a commercial bank to purchase equipment.

Debt instruments vary in time-frame (short, medium or long term). Debt can also be secured or unsecured. Secured debts give the lender a claim to specified assets if the borrower defaults (e.g. household mortgage). Finally, debt can be either negotiable or non-negotiable, referring to whether the debt instrument can be transferred ("on-sold") so that the borrower's obligations become the possession of a third party.

Derivatives

Derivatives are a type of financial instrument whose value is determined by an underlying asset or commodity. These underlying prices or rates can be either physical (wool, corn, oil etc.) or financial (interest rates, currencies etc.).

Financial instruments are used to either limit market exposure (hedge) or to speculate with the goal of making a profit. The four basic types of derivative are forwards, futures, options and swaps.

1.3 Financial Markets

a) Primary and secondary markets: New financial instruments are issued to raise funds in the primary market. The secondary market is these existing instruments are sold and resold, with no effect on the original issuer of the security. The secondary market provides liquidity to financial participants.

b) Direct and intermediated financial flow markets: In direct markets, the lenders and borrowers interact directly. The benefit in this situation is there will exist a greater range of securities and markets (since there is no requirement to standardize), and the costs of intermediation are avoided. The disadvantages associated with the direct model are liquidity issues, the matching of preferences becomes more difficult and search and transaction costs increase. Intermediated cash flows, although more expensive, offer the ability to transform the asset, maturity, credit risk and liquidity to suit the requirements of the borrowers and savers. Economies of scale also arise from the specialization of the industry.

c) Wholesale and retail markets: Wholesale transactions are typically large, involving direct flows between institutional investors and borrowers. Transactions in the retail market are smaller, with financial intermediaries operating with households and small-medium business.

d) Money markets: Wholesale market for short-term securities. It is a highly liquid and deep market, with no specific infrastructure or trading place. It is used by participants seeking to manage their liquidity.

e) Capital markets: Market for longer term (>1year to expiry) securities. This includes debt and equity markets, foreign exchange (FOREX) markets and derivatives. Individuals, businesses, governments and the overseas sector all participate in capital markets.

Definition: The **matching principle** is the idea that assets should be funded by financing of a matching timeframe.

i.e. Short-term assets funded by short-term (money market) liabilities.
Long-term assets funded by long-term (capital market) liabilities

♠♠♠♠