

Chapter 1

An Introduction to Finance

Synopsis

The purpose of this chapter is to introduce the reader to the field of finance, describing the areas of finance, the environment in which decisions are made, and the financial aspects of the 2007-2008 economic crisis. We focus on this financial crisis because it has helped reshape the financial industry and had spill-over effects in other industries as well. We refer to this financial crisis throughout this book because this crisis provides unique examples of regulatory response, financial decision making under difficult conditions, and opportunities afforded by changing economic environments.

In the appendix, we focus on career opportunities in the field of finance, relating these careers to the primary fields in finance: investments, financial management, and institutions. We also provide information on certifications and career designations in the field of finance.

Learning Outcomes

- LO 1.1 Define finance and explain the types of decisions made in finance.
- LO 1.2 Identify the basic types of financial instruments and explain how they are traded.
- LO 1.3 Explain the significance of the global financial system and the global economy to business entities and a country's economy.

Chapter Outline

1.1 What is finance?

- A. The three primary areas of finance
- B. The role of financial intermediaries

1.2 Financial instruments and markets

- A. Financial instruments
- B. Financial markets
- C. Regulation
- D. Deregulation of the financial services industry

1.3 The global financial crisis

- A. The global financial community
- B. The foundation for the crisis
- C. The financial crisis
- D. What is to come

E. Lessons for financial managers

Appendix 1A Careers in Finance

- 1A.1 Financial officers
- 1A.2 Entry-level and mid-career financial positions
- 1A.3 Professional designations

Discussion Questions for Special Features

Feature	Learning Outcome	Discussion Questions
<i>Opening vignette</i>	1.3	<i>After reading the entire chapter</i> 1. What is the “economic medicine” that Buffett refers to? 2. Buffett’s letter ends on a hopeful, upbeat note. Why would he be optimistic about the crisis?
<i>Global Perspective: Equity markets</i>	1.3	1. What is the significance of market capitalization in describing equity markets? 2. Do you expect the U.S. stock markets to continue their dominance of the global stock markets in terms of the value of equity-listed on markets?
<i>Finance in the News: It’s Greek to Me</i>	1.3	1. What are the implications of a sovereign nation having its debt downgraded? 2. How does a debt downgrade affect a country’s recovery? 3. Why do rating agencies focus on the economic policies of a nation in evaluating sovereign debt?
<i>Ethics: Subprime loans and more</i>	1.1; 1.2	1. What are the costs, direct or indirect, of this type of fraud to other consumers? 2. In the process of securitization, which we discussed earlier in this chapter, where are the opportunities for fraud on the part of one or more parties?
<i>Lessons learned: The benefit of being nimble</i>	1.1; 1.2	1. How may the build-up of cash affect the profitability of a company? Can too much cash be “too much of a good thing”? Why? 2. If a company does not take advantage of borrowing in the low-interest environment, what are the competitive and financial implications for the company?

Concept Review Questions

1.1 What is Finance?

1. Finance is the study of how and under what terms funds are allocated between those with excess fund and those who need funds.
2. Financial institutions, investments, financial management
3. A market intermediary facilitates trades, whereas a financial intermediary changes the nature of the securities (e.g., a bank accepts deposits, which are short-term, and grants mortgages, which are long term).

1.2 Financial instruments and markets

1. A debt is an obligation that will be repaid at a future point in time, whereas equity is an ownership interest that does not mature.
2. The primary market is where cash is raised by issuers of securities; the secondary market is where investors trade securities that have already been issued.
3. The Securities and Exchange Commission oversees brokers, markets and self-regulatory organizations.

1.3 The global financial crisis

1. Global markets are important because the markets are interconnected. Consider the recent experiences with Greece and Spain.
2. The subprime mortgage was a debt instrument created by originators (lenders), who then sold these to dealers, who subsequently packaged these in pools and sold interests in these pools. Essentially, subprime mortgages were the fuel that stoked the crisis.

Answers to Multiple Choice Questions

1. B
2. D
3. A
4. C
5. B
6. B
7. C
8. C
9. B
10. A

Solutions to Practice Problems and Questions

1.1 What is Finance?

11. Business finance, investments, and financial institutions. See Figure 1-1.
12. Financial managers use accounting information to measure performance and to help plan and budget for future periods.
13. The market intermediary assists providers of funds and those needing funds getting together, hence facilitating the flow of funds.
14. Examples: bank; credit union; pension fund

1.2 Financial instruments and markets

15. Issuance of new debt (borrowing) and initial public offering (new equity).
16. Examples: Corporate bond, municipal bond, debenture, commercial paper, bank loan.
17. A note typically has a maturity between one and ten years, and a bond has a maturity of more than ten years. [Another distinguishing feature, to be discussed later in the text, is that a bond has an indenture agreement, whereas a note does not.]
18. The common stock owners stand last in line in terms of rights to income and assets. The creditors are paid first, and then the preferred stock owners. The common stock owners get what (if anything) is left over.
19. Secondary markets are markets that involve trading among investors. By having an efficient secondary market, issuers will find a ready market of investors for any primary offerings of securities.
20. The securities markets are self-regulated through FINRA. In addition, the SEC monitors the markets and market participants, and the securities laws provide the framework.
- 21.

		<i>Number of shares outstanding</i>	<i>Market price per share</i>	<i>Market capitalization</i>
A.	Company A	1,000,000	\$5	\$5,000,000
B.	Company B	10,000,000	\$10	\$100,000,000
C.	Company C	5,000,000	\$20	\$100,000,000
D.	Company D	3,500,000	\$25	87500000
E.	Company E	300,000,000	\$13	\$3,900,000,000

22.

	<i>Primary</i>	<i>Secondary</i>
A.		☒
B.		☒
C.		☒
D.	☒	
E.	☒	
F.		☒

23.

	<i>Money market security</i>	<i>Capital market security</i>
A.	☒	
B.		☒
C.		☒
D.		☒
E.	☒	
F.		☒
G.		☒

24. Market capitalization = $\$8 \times 5 \text{ million} = \mathbf{\$40 \text{ million}}$

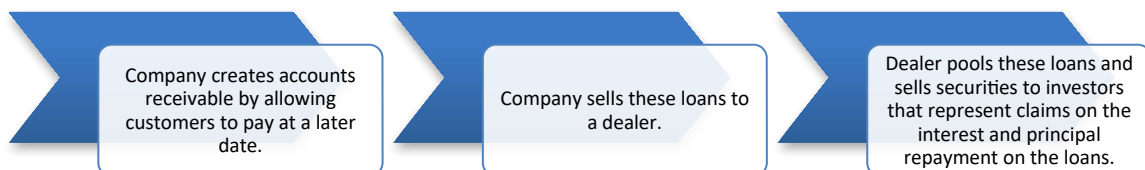
25.

- A. Initial public offering
 B. Market capitalization = $\$31.02 \times 515,000,000 = \mathbf{\$15.9753 \text{ billion}}$

1.3 The global financial crisis

26. A subprime mortgage is a loan secured by a home that is granted to a borrower that does not have prime (i.e., high quality) credit worthiness.

27.



28. Granting loans to persons who are not likely to be able to satisfy the obligations of the loan results in:

- Financial strain for the borrowers, who become even less credit worthy, with ramifications for many years to come (poor credit scores).
- Lender has bad debts, which create losses. These losses reduce the value of the equity interest in the banks, and also risk the stability of the institution. In cases of large lenders, there may be systemic risk implications.