



Module 1

The Financial System and the Economy

Introduction

The topic of finance means different things to different people. For that reason we start this course with an overview of what finance is about and how it relates to other disciplines you have learned about during your studies and work experience. This module is meant to provide you with a big picture view of finance and the financial systems currently in place.

In simple terms, the study of finance is focused on money and money management through investment and financing decisions. For different types of organisations this means very different activities, as not all companies will use the same tools and means of determining their financial needs depending on the size and depth of their operations. Money management in a small organisation is often focused on cash flow management. The goal in these smaller organisations is to ensure that excess cash is invested to earn maximum return with a reasonable level of risk and to have capital resources in place when there is a deficit of cash. In larger organisations, cash flow management is also an area of concern. However, many other items must be dealt with as well, such as how to raise capital required for investments and ongoing operations, what is the right level of risk and reward, what type of insurance/hedging arrangements should be in place, and how to evaluate capital projects. Small firms face these same problems. The difference is the tools available to finance their operations; for example, public offerings of equity shares, corporate bonds and debentures would not be options available to the smaller organisation.

In this course we will learn about the key areas of finance and the decisions that a financial manager faces. We will also learn about the systems in place that allow for the easier flow of funds between corporations, individuals and governments. It is important for non-financial managers to have this knowledge for many reasons, not the least of which is that you will at some point be submitting project requests to a financial manager or management board and/or part of a team that will be evaluating projects.

Upon completion of this unit you will be able to:



Outcomes

- *explain* what the study of finance means
- *identify* the various business forms and their implications for obtaining financing
- *identify* agency problems and the steps that companies can take to overcome them
- *describe* the role of a financial manager and how it relates to other areas in an organisation.
- *explain* why wealth maximisation as opposed to profit maximisation should be the goal of the firm
- *describe* the relationship between financial institutions, regulators, and markets.



Terminology

Sole proprietorship:	It is a business owned and operated by one person.
Partnership:	A partnership involves two or more people operating a business together.
Corporation:	A corporation is a legal entity created by law.
Accounting:	The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.
Finance:	A branch of economics concerned with resource allocation as well as resource management, acquisition and investment.
Economics:	A study of choices made by people who are faced with scarcity.
Agency relationship:	The relationship between organisation management and shareholders is described as an agency relationship.
Financial institutions:	Intermediaries that allow for the movement of funds from investors to borrows whether individuals, governments, or businesses.
Financial regulations:	A form of regulation or supervision, which subjects financial institutions to certain



requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system.

Financial market:	A market where financial securities like stocks and bonds and commodities like valuable metals are exchanged at efficient market prices.
Capital market:	A market in which individuals and institutions trade financial securities.
Money market:	A segment of the financial market in which financial instruments with high liquidity and very short maturities are traded.
Derivatives market:	A security whose price is dependent upon or derived from one or more underlying assets.
Primary market:	A market for issuing new securities.
Secondary market:	A market where investors purchase securities or assets from other investors, rather than from issuing companies themselves.

Forms of a Business Organisation

Before we get too deep into the area of Finance we should review the legal forms of business. There are three basic legal structures an organisation can take: a sole proprietorship, a partnership, and a corporation. An entrepreneur will have to look into the following issues before their decision to start a new business and in making the choice for their desired form of business.

1. Your vision regarding the size and nature of your business.
2. The level of control you wish to have.
3. The level of “structure” you are willing to deal with.
4. The business’s vulnerability to lawsuits.
5. Tax implications of the different ownership structures.
6. Expected profit (or loss) of the business.
7. Whether or not you need to re-invest earnings into the business.
8. Your need for access to cash out of the business for yourself.
9. The risks of your personal assets from business liabilities.
10. Are their partners and/or investors that will be part of the business.

Sole proprietorship

The sole proprietorship is the simplest form a business can take. It is a business owned and operated by one person. The profits from the business are generated for this person's benefit alone. This organisation is very easy to set up. Depending on the city/state you are doing business in there is very little required in the way of registration and administration for this type of business. A sole proprietor would have anywhere from no employees to a few employees. Most of the capital required to operate this business would be generated from the personal resources of the owner and any personal borrowings he/she can access. The main disadvantage of this type of organisation is that the owner has unlimited liability which means that his/her total wealth can be accessed to satisfy claims against the proprietorship. Another key disadvantage is that you have limited access to resources.

Advantages of a sole proprietorship

1. Easiest and least expensive form of ownership to organise.
2. Sole proprietors are in complete control, within the law, to make all decisions.
3. Sole proprietors receive all income generated by the business to keep or reinvest.
4. Profits from the business flow-through directly to the owner's personal tax return.
5. The business is easy to dissolve, if desired.

Disadvantages of sole proprietorship

1. Unlimited liability and legally responsible for all debts against the business.
2. Business and personal assets are 100 per cent at risk.
3. Has limited ability to raise investment funds.
4. Limited to using funds from personal savings or consumer loans.
5. Have a hard time attracting high-calibre employees, or those that are motivated by the opportunity to own a part of the business.
6. Employee benefits such as owner's medical insurance premiums are not directly deductible from business income (partially deductible as an adjustment to income).

Partnership

A partnership involves two or more people operating a business together. This type of organisation is also easy to form. It is often based on a written partnership agreement, which establishes how the partnership will be run,



how the profits will be shared, and other operational matters. In a general partnership, regardless of what share each partner has in the partnership, they are each responsible for all the debts of the partnership. As was the case with the sole proprietorship, the personal wealth of each partner can be accessed to satisfy claims against the partnership.

Other forms of partnerships exist which allow partners limited liability. A limited partnership is made up of general partner(s) and limited partner(s). The general partner(s), of whom there must be at least one, are responsible for all the liabilities of the partnership. The limited partner(s) enjoy liability protection similar to that of a corporation with one difference being that the limited partner cannot be involved in the management of the partnership.

Advantages of a partnership

1. Partnerships are relatively easy to establish; however time should be invested in developing the partnership agreement.
2. With more than one owner, the ability to raise funds may be increased.
3. The profits from the business flow directly through to the partners' personal taxes.
4. Prospective employees may be attracted to the business if given the incentive to become a partner.

Disadvantages of a partnership

1. Partners are jointly and individually liable for the actions of the other partners.
2. Profits must be shared with others.
3. Since decisions are shared, disagreements can occur.
4. Some employee benefits are not deductible from business income on tax returns.
5. The partnership has a limited life; it may end upon a partner's withdrawal or death.

Types of partnerships that should be considered

General partnership

Partners divide responsibility for management and liability, as well as the shares of profit or loss according to their internal agreement. Equal shares are assumed unless there is a written agreement that states differently.

Limited partnership and partnership with limited liability

“Limited” means that most of the partners have limited liability (to the extent of their investment) as well as limited input regarding management decisions,

which generally encourages investors for short term projects, or for investing in capital assets. This form of ownership is not often used for operating retail or service businesses. Forming a limited partnership is more complex and formal than that of a general partnership.

Joint venture

Acts like a general partnership, but is clearly for a limited period of time or a single project. If the partners in a joint venture repeat the activity, they will be recognised as an ongoing partnership and will have to file as such, and distribute accumulated partnership assets upon dissolution of the entity.

Corporations

A corporation is a legal entity created by law. A corporation is therefore distinct from its owners unlike a partnership and a sole proprietorship. Owners of a corporation are issued shares in that corporation and their liability is limited to the amount invested in the company to purchase those shares, for example, they have limited personal liability. It is important to note that for many small corporations lenders will require personal guarantees from the key owners, thereby eliminating this protection from liability.

There is more administration involved with a corporation, as the entity must comply with the regulations of the state in which it is incorporated. Owners receive profits from the corporation when and if dividends are declared and can realise profits on the sale of their shares in the corporation. Of course, owners may also incur a loss on the sale of their shares depending on the perceived value of the shares at the time of sale.

Advantages of a corporation

1. Shareholders have limited liability for the corporation's debts or judgments against the corporation.
2. Generally, shareholders can only be held accountable for their investment in stock of the company. (Note, however, that officers can be held personally liable for their actions, such as the failure to withhold and pay employment taxes.)
3. Corporations can raise additional funds through the sale of stock.
4. A corporation may deduct the cost of benefits it provides to officers and employees.
5. Can elect S corporation status if certain requirements are met. This election enables the company to be taxed similar to a partnership.

Disadvantages of a corporation

1. The process of incorporation requires more time and money than other forms of organisation.
2. Corporations are monitored by federal, state and some local agencies, and as a result may have more paperwork to comply with regulations.



3. Incorporating may result in higher overall taxes. Dividends paid to shareholders are not deductible from business income, thus this income can be taxed twice.

Limited liability company (LLC)

The LLC is a relatively new type of hybrid business structure that is now permissible in most western countries. It is designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership.

The owners are members, and the duration of the LLC is usually determined when the organisation papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration. LLCs must not have more than two of the four characteristics that define corporations: Limited liability to the extent of assets; continuity of life; centralisation of management; and free transferability of ownership interests.

Summary – Forms of business

Advantages and disadvantages of each form of business organisation

	Sole Proprietorship	Partnership	Corporation
Advantages	Simple to create	Simple to create	Limited liability of owners
	Owner has full control over operations	Allows for the sharing of skills among partners	Ease of transfer of ownership
	Owner receives all profits	Increased access to financing over sole proprietorship due to increased number of owners	Increased access to financing
	Business information is kept confidential, owner is not required to share information	Better decisions making	Can have tax advantages

	Sole Proprietorship	Partnership	Corporation
	Easy to dissolve	Sharing risks	Separate legal entity
	Easy to transfer ownership		
Disadvantages	Unlimited liability of the owner	Unlimited liability of each partner	More expensive to create than partnerships or sole proprietorships
		Difficult to transfer ownership	Ownership is more difficult to transfer. More ongoing administration and regulatory reporting
	Life of the organisation is limited to the life of the owner	A partnership ceases upon the death of any of the partners	May be subject to higher taxes than other business forms
	Limited access to financing May have a hard time attracting high-calibre employees	Limited capital Divided authority	Owners do not control the organisation. Lengthy decision-making process

Role of the financial manager

Many of you may have asked yourself in the past what functions a financial manager performs. The specific duties will vary from one organisation to the next. In general terms, a financial manager is responsible for financial analysis, financial planning and control, working capital management, financing and investment decisions. As these responsibilities concern every area of the organisation, it is important for the financial manager to have a clear understanding of the organisation and what is occurring throughout it. This understanding will allow the manager to make rational decisions and effective planning.



Here we take an example of financial decision-making and aspects of this process that are the areas a finance manager will have to look into for financial decisions. Today a typical farming operation spends and takes in several hundred thousand dollars a year, and receipts of more than a million dollars are not uncommon. The irregular nature of farm income and expenditures, and the use of capital intensive production technologies have made having enough financing at the right time critical to the success of a farm business. The use of capital and credit presents the modern farmer with a number of decisions to make.

1. How much to invest?
2. Where to obtain capital?
3. What mix of equity and debt to use?
4. What credit rates and terms to negotiate?
5. How much financial risk to take?

Making good financial decisions is often the difference between a prosperous, growing farm business and one that is constantly wondering how to pay the next bill.

Finance, economics and accounting

Accounting

Accounting is an art of recording, classifying, summarising and interpreting financial events and transactions in a significant manner and in terms of money.

It is not easy to provide a concise definition of accounting since the word has a broad application within businesses and applications.

The American Accounting Association defines accounting as:

“the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information”.

Finance

All the accounting information is ultimately used by the finance department for its review and future decision-making e.g. Cash budgeting and Capital Budgeting.

The term finance is defined as:

A branch of economics concerned with resource allocation as well as resource management, acquisition and investment. Simply, finance

deals with matters related to money and the money and capital markets.

Economics

It is a social science that deals with the production, distribution, and consumption of goods and services and with the theory and management of economies or economic systems.

Adam Smith wrote a book in 1776 titled *Wealth of Nations*. In his book he discussed the word “wealth” through its four aspects: production of wealth, exchange of wealth, distribution of wealth and consumption of wealth. Therefore, it can be said according to Adam Smith:

“Economics is a science of wealth.” Wealth means goods and services transacted with the help of money.

Economics is a study of choices made by people who are faced with scarcity. Economics has two divisions, microeconomics and macroeconomics. Microeconomics is study focusing at the firm level, while macroeconomics focuses more at the policy and regulatory levels. Economics uses assumptions to simplify a situation; the ceteris paribus i.e. (“Other things remain constant” assumption). Many economic decisions are based on certain assumptions. When the assumptions don’t hold then the specific decision may also be affected.

Major types of economics are:

1. Microeconomics
2. Macroeconomics.

Comparison

Finance and accounting

What is exact difference between accounts and finance?

Finance means the study of different ways in which individuals, businesses and organisations raise and allocate monetary resources and use the same for business purposes keeping the risks involved in mind.

The activity of finance is the application of a set of techniques that individuals and organisations use to manage their financial affairs, particularly the differences between income and expenditure and the risks of their investments. There are different categories in which finance could be distributed, like personal finance, public finance and corporate finance.

Accounting, on the other hand, is the measurement, disclosure or provision of assurance about financial information that helps managers, investors, tax authorities and other decision-makers make resource-allocation decisions.



Financial accounting is one branch of accounting and historically has involved processes by which financial information about a business is recorded, classified, summarised, interpreted and communicated. There are different categories in which accounting can be distributed, like cost accounting, financial accounting, internal and external accounting.

The finance and accounting managers work closely together and in smaller firms the two roles are often performed by one manager. While some of the same skills are required for the manager of both areas they have a different focus. The finance manager is interested in cash flows whereas the accounting manager is concerned with accrual basis of financial reporting. The reason for this difference lies in the fact that the accounting manager must report on the company's financial performance. This means the preparation of financial statements created using generally accepted accounting principles.

The financial manager is concerned with ensuring that the organisation can satisfy its financial obligations as they come due. In other words, that the company has enough cash to make timely payments on any debts or other amounts owing. If payments cannot be made as they come due, there can be severe implications for the company. Therefore the account managers in an organisation will be more interested in reading the latest financial statement, and the financial management personnel would be more interested in the bank statement.

The financial manager will often use information generating from the accounting system or the same source data as the accounting system uses. However, the financial manager will use the information to a different end. One example of the different use of information is information on outstanding obligations to suppliers. The accounts department will want to know what invoices have not been paid or recorded at the end of a reporting period to ensure that all expenses and payable amounts are recorded in the proper period, so these invoices can be accrued. The financial manager will be interested in the unpaid invoices as he/she would need to know when payment is due for cash-flow projection purposes.

Finance and economics

As with accounting, there is some overlap with economics and finance. The financial manager must have a clear understanding of economics as changes to the economic environment will have impacts to the organisation's ability to raise funds, the cost of those funds, or return on investments. In the role of investor and borrower, it is a key requisite that the finance manager must have a clear understanding of the current state of the economy both locally and internationally. No longer can we be concerned only with our local economy. The world is becoming a smaller place all the time and events in foreign countries can have a significant impact on interest rates, exchange rates and the general level of consumer confidence. Therefore it is the role of

financial managers to assess the implications of events/conditions in their current decisions and analysis.

Economics provides a structure from decision-making in such areas as risk analysis, pricing theory through supply and demand relationships, comparative return analysis and other important issues. While the micro economic part will assist in explaining the economic theory behind what happens at the firm level, the macroeconomics part provides explanations relating to the industry and the economy at large. Economics provides a broad picture of the economic environment in which corporations must continuously make decisions.

While a financial manager needs to understand the institutional structure of a central bank, the commercial banking and other financial institutions systems, and their relationship between the various sectors of the economy, the economist may not need to know a lot of the operations of these institutions, but rather the impact of macroeconomic variables such as gross domestic product, industrial production, disposable income, unemployment, inflation, interest rates and taxes and how they affect the decisions of the financial manager.

Goals of an organisation

Following are the characteristics of any successful business goals

1. Measurable
2. Achievable
3. Relevant
4. Specific.

The goals of an organisation should be the same as the goals of its owners. In smaller organisations it is easier to discuss specific goals with the owners because there are fewer owners and their goals are likely to be consistent. In larger organisations understanding the goals of each shareholder would be an unrealistic expectation of any manager. Therefore, a general objective of owners must be defined. The most basic objective of any owner (assuming it is a for-profit organisation) is to earn profit on their investment over the long term. While this sounds relatively simple, the question is then asked: how is this measured? Again you may say well this is straightforward; if the company has income, this basic objective is satisfied. A common measure for profit is earnings per share (EPS). Under the assumption that we want to maximise profits for each owner, we should make decisions based on whether they maximise earnings per share or not.

Let us look at an example of what decision would result if we used EPS as our decision criteria. Our organisation, Finance Co, must decide between two investments. Each investment will have the following impact on EPS for the next four years:



	EPS for Year 1	EPS for Year 2	EPS for Year 3	EPS for Year 4	Total
Investment 1	\$2.5	\$1.5	\$1.7	\$2.0	\$7.7
Investment 2	1.5	1.8	2.0	2.0	7.3

If we were using profit maximisation as our indicator of owners' objectives, we would place our funds in Investment One because it has the higher total increase in EPS over the four-year period, for example, an EPS of \$7.7 on Investment 1 versus \$7.3 on Investment Two. Would this be the correct investment choice? The answer based on the above information is that we do not really know because there are other factors that we have not considered. There is the risk level of each of the investments, the possibility of earnings beyond the four-year horizon we are looking at, and the nature of the investment itself and how it fits with our current investment portfolio. These demonstrate why profit maximisation should not be the basis of sound financial decisions.

Profit maximisation

Profit maximisation does not take into account certain key factors that must be considered when making financial decisions. The three key factors are timing of returns between alternatives, the risk of each alternative, and funds generating to shareholders. Timing of returns is important as you can invest your earnings when received to generate further revenue for your organisation. In the above example, if we just looked at year 1, you would prefer Investment One because it generates a higher profit in year 1. Your investment would earn an extra \$1 (2.5 – 1.5) under this investment alternative, which should then increase your profits in year 2.

Risk of investments should always be considered as any investment contains an element of risk. If you are deciding between two investments it is important to know the risk associated with each. In other words, you want to know what the likelihood is that I will get the \$7.7 increase in EPS under Investment One vs. the likelihood of getting the \$7.3 under Investment Two. As a simplified example, if you were given the following probabilities for each investment your decision may be different depending on your risk tolerance:

Investment One: 25 per cent chance of receiving \$7.7 EPS and a 75 per cent chance that you would only receive \$2.5 EPS over the four-year period.

Investment Two: 75 per cent chance of receiving \$7.3 EPS and a 25 per cent chance that you would only receive \$3 EPS over the four-year period.

Your investment decision could be quite different as you may not be willing to invest in something with only a 25 per cent chance of earning the higher

EPS. The relative risk of each investment is one that should be considered when making financial decisions and is one that is ignored if you use earnings per share as your decision criteria.

Profits generated by a company do not always equate to more money in the shareholders' pockets. Shareholders earn money in two ways. The first is the receipt of cash dividends from the shares and the second is capital gains realised from the sale of their shares. If earning per share increases, there is no guarantee that a dividend will be declared. The money generating from these investments could be retained within the organisation for a variety of reasons. Also, an increase in EPS does not equate to an increase in stock price. Stock prices are based on expectations for the future. Past EPS does not necessarily mean that the future will see the same high profits. Therefore, an increase to EPS does not necessarily correspond to an increase in funds to shareholders.

What then should the financial manager use as a measuring stick for owners' objectives? The answer is maximisation of shareholder wealth.

Maximisation of shareholder wealth

How is wealth measured? From the point of view of the corporation, it is measured by share price. Using this as a guide, financial managers would make their investment decisions and dividend decisions based on whether an action will increase the share price of their organisation's stock or not. Any decisions that do not increase share price are rejected. Those decisions that increase share price are accepted. The skill of the financial managers must lie in their ability to identify investments and financing that will increase the share price.

Agency theory

Agency theory, developed in the 1970s, focuses on the way the central management of a firm manages its relations and enters into contractual arrangements with its divisional managers. The conditions under which subordinate agents work with corporate managers may directly influence the behaviour of the firm. Issues such as remuneration, accounting techniques or risk-taking are among the major concerns of both parties in this relationship.

Agency theory is the branch of financial economics that looks at conflicts of interest between people with different interests in the same assets. This most importantly means the conflicts between:

1. Shareholders and managers of companies, shareholders and bond holders.
2. Agency theory explains, among other things, why: companies so often make acquisitions that are bad for shareholders.



3. Convertible bonds are used and bonds are sometimes sold with warrants.

One particularly important agency issue is the conflict between the interests of shareholders and debt holders. In particular, following a more risky, but higher return strategy, benefits the shareholders to the disadvantage of the debt holders. It can easily be seen why debt holders lose out: a more risky strategy increases the risk of default on debt, but debt holders, being entitled to a fixed return, will not benefit from higher returns. Shareholders will benefit from the higher returns (if they improve), however if the risk goes bad, shareholders will, thanks to limited liability, share a sufficiently bad loss with debt holders. This conflict can be addressed by the use of debt covenants, or by providing debt holders with a hedge against such action by the shareholders by issuing convertible debt or debt bundled with warrants.

Agency problem and control

The relationship between organisation management and shareholders is described as an agency relationship. The management team is the agent, hired to act on behalf of the shareholders. This relationship exists due to the fact that in large corporations the shareholders are largely dispersed and therefore not involved in the daily operations of the organisation. A potential problem exists as the corporation is concerned with maximising shareholder wealth and managers also want to maximise their personal wealth as well. If there is a conflict between these two goals then managers may choose their own goals over the goal of shareholder wealth maximisation. In other words, managers may act in their best interest over the interest of the owners of the organisation. This conflict of goals is referred to as “agency cost”.

The term agency cost comes from the impact of this conflict. For example, the management may make decisions that they benefit from but that cost the shareholders with no corresponding increase in share price. Therefore, management must be monitored to ensure they act in the best interest of shareholders. There are two ways of reducing the potential negative impact of the agency problem. The first is to ensure the management objectives do not conflict with shareholder objectives. The second is to use the ultimate control of the firm – the board of directors can vote to remove a manager who is not acting in the best interest of the shareholders.

Compensating management in a manner that aligns their goals with those of the shareholders is an effective and widely used means of ensuring management attempts to meet shareholder objectives. Often companies will use the granting of stock options to management as a part of their compensation programme. The price that shares can be purchased at will be based on the share price at the time the option is awarded. If the share price increases subsequently then management will gain wealth and shareholders will gain wealth. Another type of incentive plan is to have a bonus paid in cash or shares based on specified results. The measures of these results would be key ratios that show an increase in shareholder value.

Ultimately, shareholders control the company through voting at shareholder meetings and the election of the board of directors. The board of directors is responsible for ensuring the organisation is properly managed. The board of directors can therefore hire and fire management. If management is proven not to be performing their agency functions in the best interest of the owners then the board of directors can terminate, at a cost, their employment. It should also be noted that poorly managed companies are often selected as takeover targets. A manager acting in his or her own best interest is just one example of a poorly managed company. Therefore, the current shareholders of an organisation can sell their shares to a new shareholder who will take control of the company and replace the existing management team with managers of their choice.

The principle agent problem between managers and shareholders

One problem in assuming that businesses set price and output to maximise profits is that decision-taking, where there is a separation between ownership and control, can be difficult to monitor. How do the owners of a business know that managers making the key day-to-day decisions are operating to maximise shareholder value?

This lack of information is known as the principal-agent problem. In other words, one person, the principal, hires an agent (e.g. a sales or finance manager) to perform tasks on their behalf but they cannot ensure that the agent performs them in precisely the way the principal would like. The decisions and the performance of the agent are impossible and or expensive to monitor and the incentives of the agent may differ from those of the principal.

Examples of the principle-agent problem that have hit the financial headlines include the management of financial assets on behalf of investors and the management of companies on behalf of shareholders.

Various strategies are available for coping with the principal agent problem.

1. Rapid expansion of employee share-ownership schemes.
2. Offsetting the principal agent problem is the introduction of other variants of performance- related pay or long-term employment contracts for senior management.

Financial institutions, markets and regulation

The financial market facilitates the needs of investors, those with surplus capital, and borrowers, those needing capital. There are three methods of facilitating the transfer of funds from investors to borrowers. The first is through financial institutions, the second is the financial markets and the third is private placements.



Financial institutions

Financial institutions are intermediaries that allow for the movement of funds from investors to borrowers whether individuals, governments, or businesses. Examples of financial institutions in a country like Canada are chartered banks, credit unions, investment dealers, insurance companies, pension funds and mutual funds. The various types of financial institutions operate within regulatory guidelines specific to their type. Financial institutions consolidate the savings of individuals to lend to those customers with borrowing needs and/or to invest directly in revenue-producing assets.

Financial institutions are those organisations involved in providing various types of financial services to their customers. The financial institutions are controlled and supervised by the rules and regulations delineated by government authorities.

Examples of financial institutions are:

- banks
- stock brokerage firms
- non-banking financial institutions
- building societies
- asset management firms
- credit unions
- insurance companies.

Some financial institutions also function as mediators in share markets and debt security markets. There the principal function of financial institutions is to collect funds from the investors and direct the funds to various financial services providers in search for those funds.

Financial institutions deal with various financial activities associated with bonds, debentures, stocks, loans, risk diversification, insurance, hedging, retirement planning, investment, portfolio management and many other related functions. With the help of their functions, the financial institutions transfer money or funds to various tiers of economy and thus play a significant role in acting upon the domestic and the international economic scenario.

For carrying out their business operations, financial institutions implement different types of economic models. They assist clients and investors to maximise their profits by rendering appropriate guidance. Financial institutions also impart a wide range of educational programmes to investors on the fundamentals of investment and the valuation of stock, bonds, assets, foreign exchanges and commodities.

Financial institutions can be both private and public in nature. The most common forms of financial institutions can be categorised into the following types:

- business finance company
- mortgage finance company
- car finance company
- personal finance company
- personal loan finance company
- home finance company
- corporate finance company.

Thus, it can be concluded that a financial institution is one which performs the collection of funds from private investors and public investors and utilises those funds in financial assets. The functions of financial institutions are not limited to a particular country, instead they have also become popular in abroad due to the growing impact of globalisation.

Financial regulations

Financial regulation is a form of regulation or supervision, which subjects financial institutions to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system. This may be handled by either a government or non-government organisation.

Aims

The specific aims of financial regulators are usually:

- To enforce applicable laws
- To prosecute cases of market misconduct, such as insider trading
- To license providers of financial services
- To protect clients, and investigate complaints
- To maintain confidence in the financial system.

Financial markets

Financial market is nothing but a tool which is used to raise capital. Just like any other tool, it can be beneficial and can be harmful, too. So, the ultimate outcome solely lies in the hands of the people who use it to serve their purpose.

The term “financial market” is used to describe the place where investors provide their surplus capital to those in need of capital. This may be done directly, such as a person borrowing from a friend, or financial



intermediaries, such as banks, mutual funds, life companies, may facilitate this process. Similar to financial institutions, financial markets allow for the suppliers and demanders of funds to deal with each other. The main difference between financial markets and financial institutions is that in financial markets the investor knows with whom their funds are being invested or to whom they are being loaned.

Financial market is the market where financial securities like stocks and bonds and commodities like valuable metals are exchanged at efficient market prices. By efficient market prices we mean the unbiased price that reflects belief at collective speculation of all investors about the future prospect. The trading of stocks and bonds in the financial market can take place directly between buyers and sellers or by the medium of stock exchanges. Financial markets can be domestic or international.

Financial markets are generally described as having two parts: an equity market and a debt or bond market. The bond market is often further stratified to include short-term bonds (money market) and long-term bonds. Similarly, equity markets are often stratified by type of equity such as common stock or preferred stock.

Types of financial markets

Following are different types of financial markets:

Capital market

It is important to remember that the capital markets deal with both shares and long-term debt. Bonds are issued by both corporations and governments, normally have terms from 10 to 30 years, and have a face value of \$1,000. Shares are issued by corporations and include both common and preferred shares. Sale and purchases of stocks and bonds occur through security exchanges, which we commonly refer to as the stock market. This common name is slightly misleading as stock markets deal in both stock and debt instruments. There are two types of exchanges, the over-the-counter exchange and the organised exchange.

The over-the-counter (OTC) exchange deals in securities and debt instruments that are not listed on an organised exchange. People who trade in these markets are called dealers and are connected electronically to facilitate their transactions. The prices at which securities are traded are based on either competitive bids or negotiated price. The bid price is what a purchaser is willing to pay for a security. An ask price is what a seller is willing to receive for a security. A dealer makes money by the difference between the bid and the ask price by purchasing at the ask price and selling at the bid price. The OTC is both a primary and secondary market, i.e., it can deal in new and previously issued securities.

The organised exchange is a tangible organisation where previously issued securities are sold. One of the better-known organised exchanges is the New York Stock Exchange. For companies to be listed on a stock exchange they must apply and meet the requirements set by each exchange they are attempting to be listed on. To complete a transaction on the exchange, individuals and/or companies must be a member of the exchange, commonly referred to as holding a seat on the exchange. Transactions are completed through buy and sell orders. Buy orders are an order to purchase shares therefore the trader is attempting to find the lowest price to purchase at. A sell order is an order to sell securities therefore the goal of the trader is to obtain the highest price for the security.

Capital market consists of a primary market and secondary market. In a primary market newly issued bonds and stocks are exchanged and in a secondary market buying and selling of already existing bonds and stocks take place. So, the capital market can be divided into bond and stock market. Bond market provides financing by bond issuance and bond trading. Stock market provides financing by shares or stock issuance and share trading. As a whole, capital markets facilitate raising of capital.

Products of capital market

Fixed Income Treasuries

- Bonds
- Federal Agency Securities
- Municipal Securities
- Corporate Bonds.

Equities

- Preferred Stock
- Common Stock.

Money market

Money market facilitates short-term debt financing and capital.

Products of money market include:

- Treasury Bills
- Negotiable certificates of deposit
- Commercial Paper
- Repurchase Agreements
- Bankers Acceptance
- Eurodollar/Rupee.



Derivatives market

Derivatives market provides instruments which help in controlling financial risk.

Products of derivative market are:

- Options
- Future and forward contracts.

Foreign exchange market

Foreign exchange market facilitates the foreign exchange trading of international investment.

Insurance market

Insurance market helps in relocation of various risks. The derivative market and insurance market are the same in nature and functionality.

Contribution of financial markets

Financial markets are essential for fund raising. Through financial markets borrowers can find suitable lenders. Banks also help in the process of financing by working as intermediaries. They use the money, which is saved and deposited by a group of people; for giving loans to another group of people who need it. Generally, banks provide financing in the form of loans and mortgages. Except banks' other intermediaries in the financial market can be insurance companies and mutual funds. But more complicated transactions of financial markets take place in stock exchanges. In stock exchanges, a company can buy others companies' shares or can sell their own shares to raise funds or they can buy their own shares existing in the market.

Basis of financial market

Basis of financial markets are the borrowers and lenders.

Borrowers on the financial markets can be individuals, private companies, public corporations, government and other local authorities like municipalities. Individuals generally take short-term or long-term mortgage loans from banks to buy any property. Private companies take short-term or long-term loans for expansion of business or for improvement of the business infrastructure. Public corporations like railway companies and postal services also borrow from financial markets to collect required money. Government also borrows from financial market to bridge the gap between government revenue and spending. Local authorities like municipalities sometimes borrow in their own name and sometimes government borrows in behalf of them from the financial markets.

Lenders in the financial market are actually the investors. Their invested money is used to finance the requirements of borrowers. So, there are various types of investments which generate lending activities. Some of these types of investments are depositing money in savings bank account, paying premiums to insurance companies, investing in shares of different companies, investing in government bonds and investing in pension funds and mutual funds.

Types of financial assets

Major types of financial assets	
	DIRECT INVESTMENT
Nonmarketable	<ul style="list-style-type: none"> • Savings deposits • Certificates of deposit • Money market deposit accounts • Saving bonds
Money market	<ul style="list-style-type: none"> • Treasury bills • Negotiable certificates of deposit • Commercial paper • Eurodollars/Rupee • Repurchase agreements • Bankers' acceptances • Fixed income treasuries
Capital Market	<ul style="list-style-type: none"> • Federal Agencies Securities • Municipals • Corporate bonds
Derivatives market	<ul style="list-style-type: none"> • Equities • Preferred stock • Common stock
	INDIRECT INVESTMENT
Investment companies	<ul style="list-style-type: none"> • Unit investment trust • Open end • Money market mutual fund • Stock, bond, and income funds • Exchange-rated funds

This summary table gives different types of financial assets which are traded in different financial markets. For details are adapted from websites of Karachi stock exchange, New York Stock Exchange, in the United States of America, Canadian stock exchange and different books on fundamentals of corporate finance.

Primary vs. secondary markets

Financial markets are further split into primary and secondary markets.



Primary market

The primary market, also called the new issue market, is the market for issuing new securities. Many companies, especially small and medium scale, enter the primary market to raise money from the public to expand their businesses. They sell their securities to the public through an initial public offering. The securities can be directly bought from the shareholders, which is not the case for the secondary market. The primary market is a market for new capitals that will be traded over a longer period. In the primary market, securities are issued on an exchange basis. The underwriters, that is, the investment banks, play an important role in this market: they set the initial price range for a particular share and then supervise the selling of that share.

Investors can obtain news of upcoming shares only on the primary market. The issuing firm collects money, which is then used to finance its operations or expand business, by selling its shares. Before selling a security on the primary market, the firm must fulfill all the requirements regarding the exchange. After trading in the primary market the security will then enter the secondary market, where numerous trades happen every day. The primary market accelerates the process of capital formation in a country's economy. The primary market categorically excludes several other new long-term finance sources, such as loans from financial institutions. Many companies have entered the primary market to earn profit by converting its capital, which is basically a private capital, into a public one, releasing securities to the public. This phenomenon is known as "public issue" or "going public".

There are three methods through which securities can be issued on the primary market: rights issue, initial public offer (IPO), and preferential issue. A company's new offering is placed on the primary market through an initial public offering.

Secondary market

Secondary market is the market where, unlike the primary market, an investor can buy a security directly from another investor in lieu of the issuer. It is also referred as "after market". The securities initially are issued in the primary market, then they enter into the secondary market. In other words, secondary market is where any type of used goods are available. In the secondary market shares are maneuvered from one investor to other, that is, one investor buys an asset from another investor instead of an issuing corporation. So, the secondary market should be liquid.

The secondary market has an important role behind the developments of an efficient capital market. Secondary markets connect investors' favouritism for liquidity with the capital users' wish of using their capital for a longer period. For example, in a traditional partnership, a partner cannot access the other partner's investment but only his or her investment in that partnership, even on an emergency basis. Then he or she may break the ownership of

equity into parts and sell their respective proportion to another investor. This kind of trading is facilitated only by the secondary market.

Example of secondary market:

In the New York Stock Exchange, in the United States of America, all the securities belong to the secondary market.

The Canadian Security Exchanges

How exchanges are organised and regulated will vary in each country. What follows is an overview of the Canadian exchanges.

Toronto Stock Exchange (TSX)

Toronto is Canada's most senior exchange with the most stringent listing requirements and the largest dollar volume of activity. All of Canada's major public companies are listed on the TSX. Many of these same companies are also listed on US exchanges such as the NYSE. The purpose of these multiple listings is to increase the market for the securities of the companies concerned.

The Venture Division of the Toronto Stock Exchange (formerly the Canadian Venture Exchange or CDNX)

The market for junior companies had its operations split between Calgary and Vancouver. Listing criteria for the Venture Division are less stringent than the TSX. Companies are listed as either tier one, two or three. Listing requirements are the most stringent for tier one and lowest for tier three, which replaces the over-the-counter (OTC) market operated by the Canadian Dealer Network. Tier 3 of the TSX Venture exchange is analogous to the well-known NASDAQ market, which is the system used in the US OTC market.

In Canada, securities are regulated on a provincial basis. This is quite different from the United States, where the Securities and Exchange Commission (SEC) is a national body which regulates securities. Each province has its own securities legislation, the enforcement of which is the responsibility of a provincial securities commission (e.g., the Ontario Securities Commission [OSC] is responsible for enforcing the Ontario Securities Act). In practice, the Ontario Securities Commission takes a leading role.

In the United States there have been significant efforts to tighten regulation in the light of the Enron, WorldCom, and similar disasters.

Module summary



Summary

In this module you learned:

- The role of the financial manager is to maximise the value of the organisation, which means maximising profits to the shareholders. The key measures of success are dividends and the share price. If the share price increases over time, the company is seen as having an increased value for the shareholder. Similarly if share prices remain constant, but dividends are paid as expected, shareholders wealth may also be maximised.
- As conflict can exist between personal goals of a manager and the goals of the owners of an organisation, companies are faced with an agency problem. Thus companies incur cost to reduce the impact of any such problems.
- Financial intermediaries exist to facilitate the exchange of funds from investors to borrowers.
- Financial markets are composed of money markets and capital markets. Money markets deal in securities that have a maturity of less than one year. Capital markets deal in securities that have a greater than one year maturity and shares which do not have a maturity.
- Capital markets are further segregated into primary and secondary markets. Primary markets handle the initial issue of a security and the secondary markets deal with subsequent resales.
- Sales of securities can occur in the over-the-counter (OTC) market, which deals with securities not listed on organised exchanges, or through organised exchanges.
- Organised exchanges are commonly referred to as stock markets yet they deal in both stocks and debt securities.
- Regulations for stock exchanges will vary from one country to another; however, some form of regulation will exist for an organised exchange.

Assignment



Assignment

1. Discuss the rationality for incorporating corporate governance function as a finance function.
2. Compare and contrast between profit maximisation and shareholder wealth maximisation.
3. What are the costs and benefits of the three major business organisational forms?
4. Comment on the following statement “Sooner or later, all successful private companies that are organised as proprietorships or partnerships must be corporations.”
5. Discuss how the market efficiency level can be enhanced with the presence of a secondary market (for example, stock exchange market).
6. Discuss how the stock price fluctuations in the secondary market matter to the manager of a company.



Assessment



Assessment

1. Which of the following legal forms of organisation is most expensive to organise?
 - a. Sole proprietorships.
 - b. Partnerships.
 - c. Corporations.
 - d. Limited partnerships.
2. A major weakness of a partnership is:
 - a. limited liability.
 - b. difficulty liquidating or transferring ownership.
 - c. access to capital markets.
 - d. low organisational costs.
3. The financial manager is interested in the cash inflows and outflows of the firm, rather than the accounting data, in order to ensure:
 - a. profitability.
 - b. the ability to pay dividends.
 - c. the ability to acquire new assets.
 - d. solvency.
4. The wealth of the owners of a corporation is represented by:
 - a. profits.
 - b. earnings per share.
 - c. share price.
 - d. cash flow.
5. The conflict between the goals of a firm's owners and the goals of its non-owner managers is:
 - a. the agency problem.
 - b. incompatibility.
 - c. serious only when profits decline.
 - d. of little importance in most large U.S. firms.
6. Most money market transactions are made in:
 - a. common stock.
 - b. marketable securities.

- c. stocks and bonds.
 - d. preferred stock.
7. The over-the-counter market is:
- a. the New York Stock Exchange.
 - b. an organised stock exchange.
 - c. a place where securities are bought and sold.
 - d. an intangible market for unlisted securities.
8. The two key financial markets are:
- a. primary market and secondary market.
 - b. primary market and money market.
 - c. money market and capital market.
 - d. capital market and secondary market.
9. All of the following are examples of organised stock exchanges EXCEPT:
- a. the New York Stock Exchange.
 - b. the American Stock Exchange.
 - c. the Pacific Stock Exchange.
 - d. the over-the-counter exchange.
10. Primary and secondary markets are:
- a. markets for short-term and long-term securities, respectively.
 - b. markets for initial public offerings and resale, respectively.
 - c. markets for institutions and individuals, respectively.
- markets for corporations and sole proprietorships, respectively.



Answer Key to Assessment Questions

1. d
2. b
3. d
4. c
5. a
6. b
7. d
8. c
9. d
10. b

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