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GB550-01 Financial Management

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1. **Why is corporate finance important to all managers?**

Corporate finance is important to managers because of the establishment of corporate strategies, planning for the financing for business operations, compare analysis of alternate ways to raise or receive money, and the selection of the most reliable option to raise monies for the business.

1. **Describe the organizational forms a company might have as it evolves from a start-up to a major corporation. List the advantages and disadvantages of each form.**
2. Sole proprietorship

This type of business is operated solely by one individual. There is no distinction business the business entity and the owner of the business. The sole proprietor enjoys all the profits and it is easy to form. At the same time, he/she is liable for all the risks and has unlimited liability.

1. Partnership

A partnership firm is a business established by one or more persons. All the profits and losses are divided per the partnership agreement. Partnerships are also easy to form and have unlimited liability.

1. Corporation

A corporation is a company of group of people authorized to act as a single person (legally a person) and is recognized as such in law. Advantages consist of a corporation’s shareholders not being liable for and debts incurred or judgments against the corporation. Some disadvantages would include be subject to higher taxes since the government taxes profits at the corporate level and again at the individual level.

1. **How do corporations go public and continue to grow? What are agency problems? What is corporate governance?**

A corporation goes public by issuing shares of stock to the public through Initial Public Offering (IPO). It can also issue additional stocks or debt securities when capital is needed.

Agency problems are when the company’s managers working on behalf of the shareholders work for their own benefit and not in the interest of the shareholders.

Corporate governance refers to a set of rules and regulations established by the government to control the actions of corporations.

1. **What should be the primary objective of managers?**

The primary objective of managers should be stockholders’ wealth maximization

1. **Do firms have any responsibility to society at large?**

Every firm has a responsibility to adhere to ethical and moral obligations. They need to provide a safe and healthy environment to produce quality products without harming individuals or the environment.

1. **Is stock price maximization good or bad for society?**

Stock prices generally increase when the quality of a product increases and when firms are producing the products that consumers want.

1. **Should firms behave ethically?**

Yes. If firms do not behave ethically to increase profits legal issues could prevail and the image of the firm would be negative.

1. **What three aspects of cash flows affect the value of any investment?**

The three aspects of cash flows affecting the value of investments are:

1. Amount of cash flows expected
2. The timing of the cash flows
3. Risk involved with obtaining the cash flows
4. **What are free cash flows?**

Free cash flows refer to the amount of cash available after disbursements to stockholders and creditors and paying the taxes and acquiring the needed cash available to continue the operation of the firm.

1. **What is the weighted average cost of capital?**

Weighted average cost of capital is the average rate of return a company expects to compensate all its different investors. The weights are the fraction of each financing source in the company's target capital structure.

1. **How do free cash flows and the weighted average of capital interact to determine a firm’s value?**

Divide the free cash flow by the weighted average cost of capital to determine the value of the firm.

1. **Who are the providers (savers) and users (borrowers) of capital? How is capital transferred between savers and borrowers?**

The savers or providers are households or individuals that can directly transfer funds to a non- financial corporations or businesses that are borrowers through financial markets. However, many borrowers use investment banking houses to raise capital.

Capital is transferred between savers and borrowers by:

Direct Transfers: of money and securities, occur when a business sells its stocks or bonds directly to savers, without going through any type of financial institution.  
  
-Indirect Transfers: (primary market transaction) through an investment bank such as Morgan Stanley, which underwrites the issue. the securities and the savers money passes through the investment bank.  
  
-Indirect Transfers: Through financial intermediary such as a bank, insurance company, or a mutual fund. the intermediary obtains funds from savers in exchange for its securities. Then the intermediary uses this money to buy and hold businesses' securities, while the savers hold the intermediary's securities.   
  
example: saver deposits dollar in a bank, receives a CD, then bank lends the money to a business the form of a mortgage loan.

1. **What do we call the cost that a borrower must pay to use debt capital?** Interestrate

**What two components make up the cost of using equity capital?** Cost of using equity is dividends plus capital gains

**What are the four most fundamental factors that affect the cost of money, or the general level of interest rates in the economy?** Production opportunities, time preferences, expected inflation, and risk

1. **What are some economic conditions that affect the cost of money?**

Some of the economic conditions that affect the cost of money are federal policy, fiscal and foreign trade deficits, and a specific country’s risk

1. **What are financial securities? Describe some financial instruments?**

Financial securities are pieces of paper with contractual provisions that entitle their owners to specific rights and claims on specific cash flows or values. These may include T-Bills, negotiable CDs, municipal bonds, corporate bonds, and preferred or common stocks.

1. **List some financial institutions.**

Some financial institutions are credit unions, pension funds, commercial banks, mutual savings, savings and loan, and insurance companies.

1. **What are some different types of markets?**

Some of the types of markets are capital markets (including stock markets and bond markets), commodity markets, money markets, futures markets, insurance markets, and foreign exchange markets.

1. **Along what two dimensions can we classify trading procedures?**

Trading procedures can be classified across two dimensions: location and method of matching orders.

1. **What are the differences between market orders and limit orders?**

Market orders go to the market and are executed at the best available price but are not guaranteed. Limit orders are when the buyer sets a maximum or minimum price to a buy and sell order respectively. If the market never reaches the limit price, the order is not executed.

1. **Explain the differences among dealer-broker networks, alternative trading systems, and registered stock exchanges.**

Registered stock exchange must display pre-trade quotes. Dealer-broker networks and alternative trading systems do not require pre-trade information. An alternative trading system is one that is not regulated as an [exchange](https://www.investopedia.com/terms/e/exchange.asp) but is a venue for matching the buy and sell orders of its subscribers.

1. **Briefly explain mortgage securitization and how it contributed to the global economic crisis.**

Mortgages are converted into securities by financial institutions that buy mortgages from mortgage brokers. These securities have their collateral as the expected cash flow from the mortgage.

The global problems arose when some US companies lent money for houses to people without the ability to continue mortgage payments (it was called trailer park lending) on the promise that the mortgage could be renewed at favorable interest rates (less than rent) and falsely inflated the values of the properties thus increasing the debt of the customer. They then securitized the lending, but the value was much less than they claimed and when the property values fell, people defaulted as the debt was more than the value of their property and the banks who had purchased the parcels in good faith found that they were sat on useless paper (assets were much less than the expected value). This reduced the value of their balance sheets and reduced their liquidity which led to distrust in the financial community as no-one knew which bank was sat on reduced value assets. The lending lines between banks were based on good faith but these were cancelled as no bank wanted to be pulled under due to the failure of another. This created a situation where credit disappeared from the system, so the banks could not lend to their own customers.