Introduction to Finance Markets Investments and Financial Management 17th edition Melicher Solutions Manual

SKU: 9781119561170-SOLUTIONS

Chapter 1
The Financial Environment

CHAPTER PREVIEW

This first chapter provides an overview of the three areas of finance—institutions and markets, investments, and financial management. We begin by providing clear answers to the following two questions: What is finance? Why study finance? To underscore the importance of studying finance, we briefly discuss how the financial environment changed during the early-part of the twenty-first century. Six principles of finance are identified and discussed: time value of money, risk versus return, diversification of risk, financial markets are efficient, management versus owner objectives, and reputation matters. The basic requirements of an effective financial system need to be understood in order to tie finance into the economy in general. We also discuss the financial functions in the U.S. system: creating and transferring money, accumulating and lending/investing savings, and marketing and transferring financial assets. We then identify financial markets characteristics and describe major types of financial markets. We next follow with a brief discussion of some of the careers available in finance and use this introduction about finance careers to provide the basis for more detailed discussions in later chapters. The chapter concludes with a description of the plan of study for the book.

LEARNING OBJECTIVES

LO 1.1 Define *finance* and describe the three areas of finance.
LO 1.2 Explain why finance should be studied.
LO 1.3 Describe and discuss the six principles of finance.
LO 1.4 Identify the four components of the financial system and describe their roles.
LO 1.5 Describe financial markets characteristics and the four types of financial markets.
LO 1.6 Identify several major career opportunities in finance.
LO 1.7 Describe this textbook's plan of study.

CHAPTER OUTLINE

I. (1.1) WHAT IS FINANCE?
   A. Two Themes

II. (1.2) WHY STUDY FINANCE?

III. (1.3) SIX PRINCIPLES OF FINANCE
   A. Time Value of Money
   B. Risk Versus Return
   C. Diversification of Risk
   D. Financial Markets are Efficient
   E. Management Versus Owner Objectives

Introduction to Finance Markets Investments and Financial Management 17th edition Melicher Solutions Manual

F. Reputation Matters

IV. (1.4) OVERVIEW OF THE FINANCIAL SYSTEM
A. Characteristics and Requirements
B. Financial System Components and Financial Functions
1. Creating Money
2. Transferring Money
3. Accumulating Savings
4. Lending and Investing Savings
5. Marketing Financial Assets
6. Transferring Financial Assets

V. (1.5) FINANCIAL MARKETS: CHARACTERISTICS AND TYPES
A. Money and Capital Markets
B. Primary and Secondary Markets
C. Major Types of Financial Markets

VI. (1.6) CAREERS IN FINANCE

VII. (1.7) THE PLAN OF STUDY

VIII. SUMMARY

LECTURE NOTES

I. (1.1) WHAT IS FINANCE?

Capitalism is an economic system with private ownership of assets, production of goods and services for profit, a price mechanism for allocating resources, and financial markets. The United States is a mixed market capitalistic system. We describe finance in the context of the U.S. economic system.

Finance is the study of how individuals, institutions, governments, and businesses acquire, spend, and manage money and other financial resources. The *financial environment* encompasses the financial system, institutions, markets, and individuals that make the economy operate efficiently.

The three areas of finance within the financial environment and financial system are: institutions and markets, investments, and financial management. **Financial institutions** are intermediaries that help the financial system operate efficiently and help transfer funds from savers to investors. **Financial markets** are physical locations or electronic forums that facilitate the flow of funds. *Investments* involve the marketing of securities, securities analysis, and the management of investment risk. **Financial management** involves financial planning, asset management, and fund raising decisions to enhance the value of firms.

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Within the context of the three areas of finance we cover the themes of small business management and personal financial planning. **Entrepreneurial finance** studies how growth-driven, performance-focused, early-stage firms raise financial capital and manage their operations and assets. **Personal finance** studies how individuals prepare for financial emergencies, protect against premature death and the loss of property, and accumulate wealth over time.

(Use Figure 1.1 and Review Questions 1 through 4 here.)

II. (1.2) WHY STUDY FINANCE?

The first eighteen years of the twenty-first century has been characterized by a volatile economic environment in the U.S. A price bubble for technology stocks (including dot.com start-ups) burst in 2000. A subsequent economic downturn was made worse by the September 11, 2001 terrorist attack. Although there followed a period of economic recovery, a housing price bubble burst in 2006. Debt securities tied to housing prices subsequently fell causing many financial institutions to be pushed to the brink of failure which led to the 2007-08 financial crisis. The economy entered the 2008-09 Great Recession. Although economic recovery was slow, unemployment rates, which exceeded 10 percent in 2009, dropped to the 5 percent level by the end of 2015 and below 4 percent by the end of 2018.

We encourage instructors to spend time at the beginning of the course explaining to, and discussing with, their students about the importance of studying finance. We suggest several reasons why students should study finance.

a. First, as a citizen (of the U.S.A. or another country), you should want to make informed economic decisions. Whatever your financial and economic goals may be, you need to be an informed participant if you wish to "make a difference." The operation of the financial system and the performance of the economy are influenced by policy makers. The citizens elect important policy makers such as the President and Congress who can pass or change laws, and through their decisions impact on the level of economic activity. Thus, it is important that citizens be informed when making political/economic choices.

b. Second, having some knowledge about finance, particularly the financial markets or investments component, should be important to you. An understanding of various aspects of personal finance should help you better manage your existing financial resources, as well as provide the basis for making sound decisions for accumulating wealth over time.

c. Third, to be successful in the business world, it is important to have a basic understanding of business finance in addition to an understanding of macro finance and investments (financial markets). Even if your "business interest" is in a non-

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finance career, you likely will need to interact with finance professionals both within and outside your firm. To do so will require a basic knowledge of the concepts, tools, and applications of business finance.

(Use Review Questions 5 and 6 here.)

III. (1.3) SIX PRINCIPLES OF FINANCE

Finance is founded on six principles. They are:

1. Money has a time value.
2. Higher returns are expected for taking on more risk.
3. Diversification of investments can reduce risk.
4. Financial markets are efficient in pricing securities.
5. Manager and stockholder objectives may differ.
6. Reputation matters.

An individual's reputation reflects his/her ethical behavior which is how an individual treats other legally, fairly, and honestly.

(Use Review Questions 7 and 8 here.)

IV. (1.4) OVERVIEW OF THE FINANCIAL SYSTEM

A **democracy** is a system of government where limited authority and power are granted by law to its people to vote on government policies and issues. The United States of America is a representative democracy where U.S. citizens elect representatives from amongst their peers to participate in formulating government policies and plans and addressing government issues. This system of representative democracy provides the framework for viewing and describing the U.S. financial system in this textbook.

An effective **financial system** is a complex mix of government and policy makers, a monetary system, financial institutions, and financial markets that interact to expedite the flow of financial capital from savings into investment. Basic requirements for an effective financial system include: a monetary system, a savings-investment process, and financial markets. The monetary system must provide an efficient medium for exchanging goods and services. This is accomplished by an efficient system for creating and transferring money. The financial system must also be able to allow capital formation by channeling savings into investment. In addition, markets must exist in which to buy and sell measures of (or claims to) wealth, such as financial assets or real estate.

In a simple economy, such as a self-sufficient farm, a farmer can create capital by building a new barn. Capital formation takes place indirectly in a highly developed economy. For example, individuals may save a portion of their current income which is, in turn, loaned to others who want to purchase equipment.

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The basic financial functions in an effective financial system include: creation of money, transferring money, accumulating savings in financial institutions, lending and investing savings, marketing financial assets, and transferring financial assets.

The functions of finance can be developed in class by asking students to list on the board all financial institutions with which they are familiar. They can then be asked which services they and their families receive from these institutions. It will take some probing and grouping of items to develop the list of functions, but time spent on this significant topic is worth the effort.

(Use Figures 1.2 and 1.3 and Review Questions 9 and 10 here.)

V. (1.5) FINANCIAL MARKETS: CHARACTERISTICS AND TYPES

Financial markets can be classified into: (a) money and capital markets; and (b) primary and secondary markets. **Money markets** are where debt securities with maturities of one year or less are issued and traded. **Capital markets** are where debt instruments or securities with maturities longer than one year and corporate stocks (equity securities) are issued and traded.

Primary markets are where the initial offering or origination of debt and equity securities takes place. **Secondary markets** are physical locations (or electronic forums) where debt (bonds and mortgages) and equity securities are traded.

Debt securities are obligations to repay borrowed funds. Common stocks are ownership shares in corporations.

There are four main types of financial markets—debt securities markets, equity securities markets, derivative securities markets, and foreign exchange markets. **Debt securities markets** are markets where money market securities, bonds, and mortgages are originated and traded. **Equity securities markets** are markets where stocks are initially traded and sold. **Derivative securities markets** are markets for financial instruments or contracts that derive their values from underlying debt or equity securities. **Foreign exchange markets** (or FOREX markets) are electronic markets in which banks and institutional traders buy and sell various currencies on behalf of businesses and other clients.

(Use Review Questions 11 through and 14 here.)

VI. (1.6) CAREERS IN FINANCE

Career opportunities in finance are generally found in the areas of financial management, depository financial institutions, contractual savings and real property organizations, and securities markets and investment firms.

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Entry-level finance job opportunities also exist in government or not-for-profit organizations, as well as with international or global businesses.

(Use Review Question 15 here.)

VII. (1.7) THE PLAN OF STUDY

Part 1 describes the overall financial environment and introduces the three areas of finance—institutions and markets, investments, and financial management. We also discuss how the necessary components (a monetary system, financial institutions, and financial markets) of the financial system interact to make the financial system operate efficiently. Part 2 is concerned with the investments area of finance including the characteristics and valuation of stocks and bonds, as well as the roles and operations of securities markets. Part 3 focuses on the financial management of businesses and includes how the business sector interacts with the financial system.

REVIEW QUESTIONS AND ANSWERS

1. (LO 1.1) *What is finance?*

Capitalism is an economic system with private ownership of assets, production of goods and services for profit, a price mechanism for allocating resources, and financial markets. Finance is described in the context of the U.S. mixed market capitalistic system.

Finance is the study of how individuals, institutions, governments, and businesses acquire, spend, and manage money and other financial resources.

2. (LO 1.1) *What is meant by the term financial environment?*

The *financial environment* encompasses the financial system, institutions, markets, and individuals that make the economy operate efficiently.

3. (LO 1.1) *What are the three areas of finance?*

The three areas of finance within the financial environment and financial system are institutions and markets, investments, and financial management.

Financial institutions are intermediaries that help the financial system operate efficiently and assist the savings-investment process.

Financial markets are physical locations or electronic forums that facilitate the flow of funds.

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Investments involve the marketing of securities, securities analysis, and the management of investment risk.

Financial management involves financial planning, asset management, and fund raising decisions to enhance the value of firms.

4. (LO 1.1) *Briefly describe the terms entrepreneurial finance and personal finance.*

Entrepreneurial finance studies how growth-driven, performance-focused, early-stage firms raise financial capital and manage their operations and assets.

Personal finance studies how individuals prepare for financial emergencies, protect against premature death and the loss of property, and accumulate wealth over time.

5. (LO 1.2) *Briefly describe how the financial environment has changed during the past few years.*

The technology/dot.com stock price bubble burst in 2000. The housing price bubble burst in 2006. Falling housing prices accompanied by falling values of mortgage-backed securities led to the 2007-08 financial crisis and the resulting 2008-09 Great Recession. Economic activity has been slow to recover and unemployment rates remained at high levels at the end of the first decade of the twenty-first century.

6. (LO 1.2) *Identify and briefly describe several reasons for studying finance.*
There are several reasons to study finance.

   a. As a citizen (of the U.S.A. or another country), you should want to make informed economic decisions. Whatever your financial and economic goals may be, you need to be an informed participant if you wish to "make a difference."

   b. Having some knowledge about finance, particularly the financial markets or investments component, should be important to you. An understanding of various aspects of personal finance should help you better manage your existing financial resources, as well as provide the basis for making sound decisions for accumulating wealth over time.

   c. To be successful in the business world, it is important to have a basic understanding of business finance in addition to an understanding of institutions, markets, and investments.

7. (LO 1.3) *What are the six principles of finance?*

The six principles are:
1. Money has a time value.

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2. Higher returns are expected for taking on more risk.
3. Diversification of investments can reduce risk.
4. Financial markets are efficient in pricing securities.
5. Manager and stockholder objectives may differ.
6. Reputation matters.

8. (LO 1.3) *Describe what is meant by ethical behavior.*

Ethical behavior is how an individual or organization treats others legally, fairly, and honestly. Laws and regulations ensure minimum levels of protection and compliance and the difference between unethical and ethical behavior. High ethical behavior occurs when behavior exceeds basic legal or regulatory standards.

9. (LO 1.4) *What are the four major components of an effective financial system?*
A *democracy* is a system of government where limited authority and power are granted by law to its people to vote on government policies and issues. The U. S. is a representative democracy where U.S. citizens elect representatives from amongst their peers to participate in formulating government policies and plans and addressing government issues.

The basic requirements or components of an effective financial system, within the framework of the U.S. being a representative democracy, are:

a. Policy makers. Comprised of the President, Congress, the U.S. Treasury, and the Federal Reserve Board.
b. An efficient monetary system: This requires a unit of account such as the dollar and a convenient means of paying for everything from a pack of chewing gum to a business worth millions.
c. A system for channeling savings into investment: This requires proper legal instruments and financial institutions so that savers are willing and able to transfer savings to those having a demand for them.
d. Financial markets and procedures for transferring claims to wealth: This facilitates the investment process since the owner of funds will invest more readily if claims can be converted into cash when there is a need or desire to do so.

10. (LO 1.4) *Identify and briefly describe the financial functions in the financial system.*
The three components of the financial system are: a monetary system, financial institutions, and financial markets.

a. Monetary system financial functions are: creating money and transferring money.

b. Financial institutions carry out the savings-investment process via the financial functions of accumulating savings and lending/investing savings.

c. Financial markets perform the financial functions of marketing and transferring financial assets.

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11. (LO 1.5) *Briefly describe the differences between money and capital markets.*

Money markets are the markets where debt instruments of one year or less are traded. In contrast, capital markets are markets for debt securities with maturities in excess of one year and corporate stocks.

12. (LO 1.5) *What are the differences between primary and secondary markets?*

Primary securities markets are markets in which the initial offering of debt and equity securities to the public occurs.
Secondary securities markets are markets where the transfer of existing debt and equity securities between investors occurs.

13. (LO 1.5) *How do debt securities and equity securities differ?*

Debt securities are obligations to repay borrowed funds. Common stocks are ownership shares in corporations.

14. (LO 1.5) *Identify the four types of major financial markets.*

The four types of financial markets are debt securities markets, equity securities markets, derivative securities markets, and foreign exchange markets.

Debt securities markets are markets where money market securities, bonds (corporate, financial institution, and government), and mortgages are originated and traded.

Equity securities markets are markets where common stocks are initially sold and traded.

Derivative securities markets are markets for financial contracts (or instruments) that derive their values from underlying debt and equity securities.

Foreign exchange markets are electronic markets in which banks and institutional traders buy and sell various currencies on behalf of businesses and other clients.

15. (LO 1.6) *Indicate some of the career opportunities in finance available to business graduates today.*

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Career opportunities are generally found in the following areas.

a. *Financial management*. Entry-level opportunities (either in the treasurer's department or the controller's department) include cash management analyst, capital expenditures analyst, credit analyst, financial analyst, cost analyst, and tax analyst

b. *Depository financial institutions*. Entry-level job opportunities include loan analyst, bank teller, and investments research analyst.

c. *Contractual savings and real property organizations*. Entry-level opportunities include insurance agent or broker, research analyst, real estate agent or broker, and mortgage analyst.

d. *Securities markets and investment firms*. Entry-level opportunities include stockbroker or account executive, security analyst, investment banking analyst, and financial planner assistant.

Entry-level finance job opportunities are also available in government or not-for-profit organizations. Such jobs may involve management of cash funds, asset acquisition decisions, and borrowing funds. Various entry-level finance job opportunities also are available internationally.

EXERCISES AND ANSWERS

1. Match the following dates with the associated events:

a. *2000* [#4 technology stock bubble]
b. *2001* [# 2 U.S. terrorist attack]
c. *2006* [# 5 housing price bubble]
d. *2007-08* [#3 financial crisis]
e. *2008-09* [#1 great recession]

2. The U.S. financial system is comprised of: (1) policy makers, (2) a monetary system, (3) financial institutions, and (4) financial markets. Indicate which of these components is associated with each of the following "roles":

a. accumulate and lend/invest savings [# 3 financial institutions]
b. create and transfer money [# 2 a monetary system]
c. pass laws and set fiscal and monetary policies [# 1 policy makers]
d. market and facilitate transfer of financial assets [# 4 financial markets]

3. Financial markets may be categorized as: (1) debt securities markets, (2) equity securities markets, (3) derivative securities markets, and (4) foreign exchange markets. Indicate in which of these markets the following securities trade:

a. mortgages [# 1 debt securities markets]

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b. bonds [# 1 debt securities markets]
c. common stocks [# 2 equity securities markets]
d. currencies [# 4 foreign exchange markets]

4. *In business, ethical dilemmas or situations occur frequently. Laws and regulations exist to define unethical behavior. However, the practicing of high quality ethical behavior often goes beyond just meeting laws and regulations. Indicate how you would respond to the following situations.*

   a. *Your boss has just told you that there will be an announcement tomorrow morning that the Federal Drug Administration has approved your firm's marketing of a new breakthrough drug. As a result of this information, you are considering purchasing shares of stock in your firm this afternoon. What would you do?*

      The violation of U.S. laws is both illegal, which could result in prison time, and unethical. U. S. securities laws prohibit officers, employees, and others from taking advantage of "inside" information which when released will impact security prices. This situation seems to violate securities laws and thus you should not purchase shares of stock in your firm prior to the public announcement of this inside information.

   b. *In the past, your firm has been in compliance with regulatory standards relating to product safety. However, you have heard through the "company grapevine" that recently some of your firm's products have failed resulting in injuries to customers. You are considering quitting your job due to personal moral concerns. What would you do?*

      Ethical behavior is how an individual or organization treats others legally, fairly, and honestly. Your firm has been legally in compliance with regulatory standards relating to product safety. At this time injury-related product failures seem to be rumors and product safety regulations do not attempt to ensure there will be no injuries. You probably would want to wait until actual "facts" are known before taking any actions. Ultimately you should decide whether you believe your firm is treating customers fairly and honestly in addition to legally.

5. *Obtain several recent issues of The Wall Street Journal or Bloomberg Businessweek. Identify, read, and be prepared to discuss at least one article relating to one of the six principles of finance.*

The six principles of finance are:

1. Money has a time value.
2. Higher returns are expected for taking on more risk.
3. Diversification of investments can reduce risk.
4. Financial markets are efficient in pricing securities.
5. Manager and stockholder objectives may differ.
6. Reputation matters.

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The instructor will need to identify recent articles from *The Wall Street Journal* and/or *Bloomberg Businessweek* for possible class discussion.

6. *Obtain several recent issues of The Wall Street Journal* or *Bloomberg Businessweek. Identify, read, and be prepared to discuss at least one article relating to one of the four types of financial markets identified in this chapter.*

   The four main types of financial markets are:

   1. debt securities markets,
   2. equity securities markets,
   3. derivative securities markets, and
   4. foreign exchange markets.

   The instructor will need to identify recent articles from *The Wall Street Journal* and/or *Bloomberg Businessweek* for possible class discussion.

7. *Obtain several recent issues of the Wall Street Journal* or *Bloomberg Businessweek. Identify, read, and be prepared to discuss at least one article relating specifically to recent changes in the financial environment.*

   The instructor will need to identify recent articles in *The Wall Street Journal* and/or *Bloomberg Businessweek* for possible class discussion.

8. *Go to the Small Business Administration (SBA) Web site, www.sba.gov, and search for information on starting a new business. Identify and prepare a written summary of the startup basics described on the SBA site.*

   First go to the SBA Web site. Then, click on "Starting Your Business." This will take you to "Startup Basics" involving startup topics, financing, topics, marketing topics, tax topics, and legal topics.

SUGGESTED QUIZ

1. Briefly answer the question: "What is finance?"

2. Identify the six principles of finance.

1. List the three financial system components and their financial functions in an effective financial system.

2. Identify the four main types of financial markets.

3. Describe:

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a. money markets

b. capital markets

c. primary markets

d. secondary markets

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