Washington University of Virginia
BUS 510E ORGANIZATION THEORY
Lecture Notes #7

Organization and Financial Management

Primary References
Ehrhardt, Michael C. and Eugene F. Brigham. *Financial Management: Theory and Practice*, 14th ed. Mason, OH: South-Western Cengage Learning, 2013.

According to Fortune Magazine's annual survey, the global top ten of the most admired companies are: Apple, Berkshire Hathaway, Toyota, Google, Johnson & Johnson, Procter & Gamble, FedEx, Southwest Airlines, General Electric, and Microsoft. Their common attributes were in innovativeness, quality of management, long-term investment value, social responsibility, employee talent, quality of products and services, financial soundness, use of corporate assets, and effectiveness in doing business globally. The main goal of successful companies are identifying, creating, and delivering highly valued products and services to its customers. The key attributes to successful companies lie in skilled people, enough funding, and efficient management of the system.

I. Proprietorship, Partnership, and Corporation

Many companies begin as a proprietorship, which is an unincorporated business owned by an individual, who begins business operations after obtaining business licenses from city, county, or state. Three major advantages of the proprietorship: (1) it is easily and inexpensively formed, (2) it is subject to few government regulations, and (3) its income is not subject to corporate taxation but is taxed as part of the personal income. Three major limitations: (1) it may be difficult to obtain the capital needed for growth, (2) the proprietor has unlimited personal liability for the business debt, and (3) the life of a proprietorship is limited to the life of its founder. In fact, proprietorships are about 80% of all companies, but they hold only about 13% of all sales.

A partnership exists whenever two or more persons or entities associate to conduct a non-corporate business for profit. Partnerships may operate under different degrees of formality, ranging from informal or oral understanding to formal agreements filed with the secretary of the state in which the partnership was formed. Advantages and disadvantages of partnerships are generally similar to those of a proprietorship. Regarding liability, the limited partners can lose only the amount of their investment in the partnership, while the general partners have unlimited liability. In a limited liability partnership (LLP), sometimes called a limited liability company (LLC), potential losses or risks of the company are limited to each partner's investment in LLP.

A corporation is a legal entity created under state laws, and it is separate and distinct from its owners and managers. Three major advantages of the corporation: (1) unlimited life, (2) easy transferability of ownership interest, and (3) limited liability - losses are limited to the actual funds invested. Two major disadvantages of the corporation: (1) Corporate earnings may be subject to double

taxation - their earnings are taxed at the corporate level, and earnings paid out as dividends are taxed again as income to the stockholders, (2) Setting up a corporation involves preparing a *charter*, writing a set of *bylaws*, and filing the many required state and federal reports, which is more complex and time-consuming than creating a proprietorship or a partnership.

PC or PA: Some professionals such as doctors, lawyers, accountants often form a professional corporation (PC) or a professional association (PA), which do not relieve the participants of professional (malpractice) liability, but provide for them to avoid certain types of unlimited liabilities. Owners can establish a corporation but elect to be taxed as if the business were a proprietorship or partnership as a S Corporation. If the corporation continues to grow, it may become successful enough to attract lending from banks, or it may even raise additional funds through an initial public offering (IPO) by selling stocks to the public. The growth of a corporation depends on its interactions with the financial markets.

II. Financial Management in Corporations

A. **The Primary Objective of the Corporation**: Shareholders as the owners of a corporation, elect directors, who hire managers to run the corporation. Therefore, the primary objective of management is to maximize stockholder wealth, represented by the market price of the firm's common stock. In general, maximization of intrinsic stock value benefits society because of following reasons. (1) To a large extent, the owners of stock are society, so that the rise of stock prices increases wealth of society and improves the quality of life for citizens. (2) Consumer benefit: Stock price maximization requires efficient, low-cost businesses that produce high-quality goods and services at the lowest possible cost. (3) Employees benefit: In general, companies that successfully increase stock prices also grow and add more employees, thus benefiting society. Managerial actions to maximize shareholder wealth are based on a company's ability to generate cash flows now and in the future since (1) any financial asset, including a company's stock, is valuable only to the extent that it generates cash flows; (2) the timing of cash flows matters - cash received sooner is better; (3) investors are adverse to risk, so all else equal, they will pay more for a stock whose cash flows are relatively certain than for one whose cash flows are more risky. Free cash flows (FCF) depend on three factors: sales revenues, operating costs and taxes, and required new investments in operating capital.

FCF = Sales revenues - Operating costs - Operating taxes - Required new investments

B. **Financial Management in Corporations**: Finance in corporations is one of organizational subsystems, among which manning and funding are two most important factors. Financial managers must decide how to finance the firm, and must choose the mix of debt and equity that should be used and specific types of debt and equity securities that should be issued. They must also decide what percentage of current earnings should be retained and reinvested rather than paid out as dividends. Along with these financing decisions, the general level of interest rates in the economy, the risk of the firm's operations, and stock market investors' overall attitude toward risk determine the rate of return that is required to satisfy a firm's investors. The rate of return required by investors is called the weighted average cost of capital (WACC).

Therefore, a firm's fundamental value is positively related to its free cash flows, and negatively related to its weighted average cost of capital. In other words, financial managers should maximize firm's free cash flows and should minimize the average cost of capital in order to maximize stockholder wealth.

III. Capital Allocation Process

There are three ways of capital allocation process from savers to business users.

(1) Direct transfer: A business sells its securities directly to savers. The business delivers its securities to savers who provide money to the business.

(2) Indirect transfer through investment bankers: savers purchases business securities through investment bankers such as Goldman Sachs, which underwrites the issue. An underwriter serves as a middleman and facilitates the issuance of securities. The company sells its stocks or bonds to the investment bank, which in turn sells these same securities to savers.

(3) Indirect transfer through a financial intermediary: A financial intermediary such as a bank or mutual fund obtains funds from savers in exchange for its own securities. The intermediary then uses this money to purchase and then hold business securities.

There are three important characteristics of the capital allocation process. (1) New financial securities are created. (2) financial institutions are often involved. (3) Allocation between providers and users of funds occurs in financial markets.

IV. Financial Securities

Financial securities are simply pieces of paper with contractual provisions that entitle their owners to specific rights and claims on specific cash flows or values.

Debt or Bond: Debt instruments typically have specified payments and a specified maturity. For example, an Alcoa bond might promise to pay 10% interest for 30 years, at which time it promises to make a $1,000 principal payment. If the debt matures in less than a year, it is a money market security. Investors pay the present discount value of the debt amount based on the announced interest rate.

Equity or Stocks: Stock holders are entitled to the cash flows generated by the company. Because the stock has no maturity date, it is a capital market security.

Derivatives are securities which values depend on (are derived from) the values of some other traded assets. For example, options and futures are two important types of derivatives, and their values depend on the prices of other assets. An option on Alcoa stock or a futures contract to buy pork bellies are examples of derivatives. Some securities (preferred stocks) are a mix of debt, equity, and derivatives.

In the securitization process, the mortgage-backed bonds causes the global financial crisis. While the mortgagees can make their payments to the banks, Fannie Mae takes the mortgages into a very large pool, and sells the mortgage-backed bonds to investors. Home owners pay their mortgages to the banks which forwarded the payments to Fannie Mae. Fannie Mae uses the funds to pay interest on the bonds it issued, to pay dividends on its stock, and to buy additional mortgages from banks. Notice that the mortgage risk has been shifted from Fannie Mae to the investors who now own the mortgage-backed bonds issued by Fannie Mae. If banks pay 5% for deposit and charge 8% for loans, both banks and Fannie Mae gain 3% of interest margin from home mortgage loans. However, there have been serious risks if home owners fail to pay their payments. Nobody knows when massive default would happen as the economy goes down and unemployment goes up. If this is the case, Fannie Mae cannot collect mortgage payments, and investors cannot receive interest payments for the mortgage-backed-bonds.

V. The Cost of Money

For debt, the cost of money is the interest rate; and for equity, the cost of money is the cost of equity consisting of the dividends and capital gains of stock holders. The major factors affecting the cost of money are:

(1) production opportunities turning capital into benefits,
(2) time preferences for consumption that is to save and invest now and consume later,
(3) risk - higher risk requires more cost or higher interest rate, and
(4) inflation leads to a higher cost of money.

Economic Conditions and Policies affecting the Cost of Money:

(1) Federal Reserve Policies: In the period of depression, the expansionary policy reduces the interest rate; while in the period of inflation pressure, the contraction policies raises the interest rate.

(2) Budget Deficits or Surpluses: To finance budget deficits, the government borrows by issuing new securities, which leads to lower security prices and higher interest rates. If the government prints money to finance deficits, that caused inflation.

(3) Business Activities: In recessions, consumer demand slow, keeping companies from increasing prices, which reduces price inflation. Companies also cut back on hiring, which reduces wage inflation. Less disposable income causes consumers to reduce their purchases and reducing consumer demand for loans. Fed tries to stimulate the economy by driving down interest rates.

(4) Trade Deficit or Surplus: Trade deficits are financed by debt, and increased borrowing drives up interest rates. International investors are willing to hold U.S. debt if and only if the risk-adjusted rate paid on this debt is competitive with interest rates in other countries. U.S. trade deficit was 701.4 billion dollars in 2007, 695.5 in 2008, and 378.6 in 2009.[1]

(5) Foreign Country Risk: Country risk is associated with changes in tax rates, regulations, currency conversion, and exchange rates. Country risk also includes the risk that (1) property will be expropriated without adequate compensation; (2) the host country will impose new stipulations concerning local production, sourcing, or hiring practices; and (3) there might be damage or destruction of facilities due to internal strife.

(6) Exchange Rate Risk: If U.S. investors purchase a Japanese bond, interest will probably be paid in Japanese yen, which must then be converted to dollars if the investor wants to spend his or her money in the United States. If the yen weakens relative to the dollars, then the yen will buy fewer dollars. If the yen strengthens, the opposite will happen.

[1] http://www.tradingeconomics.com/Economics/Balance-of-Trade.aspx?Symbol=USD.

VI. Financial Institutions

(a) Investment Banks and Brokerage Activities

Investment banking houses help companies raise capital. They underwrite security offerings; which means they (1) advise corporations regarding the design and pricing of new securities, (2) buy this securities from the issuing corporation, and (3) resell them to investors. Although the securities are sold twice, this process is really one primary market transaction, with the investment banker acting as a facilitator to help transfer capital from savers to businesses. In addition to security offering, investment banks also provide consulting and advisory services, such as merger and acquisition (M&A) analysis and investment management for wealthy individuals. Large brokerage operations were made by Goldman Sachs, Merrill Lynch of the Bank of America, JP Morgan, and others.

(b) Deposit-taking Financial Intermediaries

Some financial institutions take deposits from savers and then lend most of the deposited money to borrowers. (1) Savings and Loan Associations (S&Ls): They originally accepted deposits from many small savers and then loaned this money to home buyers and consumers. Mutual savings banks (MSBs) are similar to S&Ls, but they operate primarily in the northeastern states. Today, most S&Ls and MSBs have been acquired by banks. (2) Credit Unions: they are cooperative associations whose members have a common bond, such as being employees of the same firm or living in the same geographic area. Credit unions are often the cheapest source of funds available to individual borrowers. (3) Commercial Banks raise funds from depositors and by issuing stock and bonds to investors. Someone might deposit money in a checking account, and can write checks, use a debit card, and even receive interest on the deposits. The Federal Deposit Insurance Corporation (FDIC) guarantees banks up to $250,000 each account.

(c) Investment funds

At some financial institutions, savers have an ownership interest in a pool of funds rather than owning a deposit account. (1) Mutual funds are corporations that accept money from savers and then use these funds to buy financial instruments. They pool funds allowing them to reduce risks by diversification and achieve economies of scale in analyzing securities, managing portfolios, and buying or selling securities. Money market funds invest in short-term, low-risk securities, such as Treasury bills and commercial paper. Many of these funds offer interest-bearing checking accounts with rates that are greater than those offered by banks, so many people invest in mutual funds as an alternative to depositing money in a bank. No FDIC insurance is required. (2) Hedge Funds raise money from investors and engage in a variety of investment activities. Unlike typical mutual funds, hedge funds are limited to institutional investors and a relatively small number of high-net-worth individuals. Hedge funds are less regulated than mutual funds. They lost huge money during 2007-8 when large numbers of sub-prime mortgages defaulted. (3) Private Equity Funds are similar to hedge funds in that they are limited to a relatively small number of large investors, but they differ in that they own stock (equity) in other companies and often control those companies, whereas hedge funds usually own many different types of securities. Because the company's stock is not traded in the public markets, it is called "private equity."

(d) Life Insurance Companies and Pension Funds

Life insurance companies take premiums, invest funds in stocks, bonds, real estate, and mortgages, and then make payments to beneficiaries. Traditional pension funds are retirement plans funded by corporations or government agencies. Pension funds invest primarily in bonds, stocks, mortgages, hedge funds, private equity, and real estates. Many companies are switching from traditional plans to self-directed plans, partly because this shifts the risk from the company to the employees.

(e) Regulation of Financial Institutions

With the exception of investment banks, hedge funds, and private equity funds, financial institutions have been heavily regulated to ensure their safety and thus protect investors and depositors. They are a prohibition on nationwide branch banking, restrictions on the types of assets the institutions could buy, ceilings on the interest rates they could pay, and limitations on the types of services they could provide – tended to impede the free flow of capital and thus hurt the efficiency of our capital markets. However, deregulation of the 1970s and 1990s blurred the boundary of banking services. The U. S. Congress passed and President signed the financial reform bill to prevent financial crisis.

VII. Financial Markets

(a) Physical asset markets (tangible or real asset markets) are those for such products as wheat, autos, real estate, computers, and machinery. The markets also deal with stocks, bonds, notes, mortgages, derivatives, and other financial instruments.
(b) Spot markets and futures markets are markets where assets are being brought or sold for on-the-spot delivery or for delivery at some future date.
(c) Money markets are the markets for short-term, highly liquid debt securities, while capital markets are the markets for corporate stocks and debt maturing more than a year in the future.
(d) Mortgage markets deal with loans on residential, agricultural, commercial, and industrial real estate, while consumer credit markets involve loans for autos, appliances, education, vacations, and so on.
(e) World, national, regional, and local markets also exit. Thus, depending on an organization's size and scope of operations, it may be able to borrow or lend all around the world, or it may be confined to a strictly local market.
(f) Primary markets are the markets in which corporations raise new capital. If Microsoft were to sell a new issue of common stock to raise capital, this would be a primary market transaction. The IPO is a subset of the primary market. Secondary markets are markets in which existing, already outstanding securities are traded among investors.
(g) Private markets, where transactions are worked out directly between two parties, are differentiated from public markets, where standardized contracts are traded on organized exchanges.

VIII. Trading Procedures in Financial Markets

(a) Physical Location and Electronic Network: A huge volume of trading occurs in the secondary markets, which can be either a physical location exchange or a computer or telephone network. For example, the New York Stock Exchange (NYSE), the Chicago Board of Trade (CBOT trades futures and options), and the Tokyo Stock Exchange are all physical location exchanges. In contrast, Nasdaq, which trades a number of U.S. stocks, is a network of linked computers. Other network examples are the markets for U.S. treasury bonds and foreign exchange, which are conducted via telephone and/or computer networks. In these electronic markets, the traders never see one another.
(b) Matching Orders - Auctions, Dealers, and ECNs: The second dimension is the way orders from sellers and buyers are matched. This can occur through an open outcry auction system, through dealers, or by automated order matching, such as at the CBOT. In a dealer market, there are market makers who keep an inventory of the stock. The third method of matching order is through an electronic communications network (ECN). Participants in an ECN post their orders to buy and sell, and the ECN automatically matches order. There are limits on the price and/or the duration of the order like the next two hours.

I X. Stock Markets

Stock market transactions are divided by three distinct types: initial public offerings, seasoned equity offerings, and secondary market transactions. Whenever stock is offered to the public for the first time, the company is said to be going public. This primary market transaction is called the initial public offering (IPO). If a company later decides to sell additional shares to raise new equity capital, this is still a primary market, but it is called a seasoned equity offering. Outstanding shares of established publicly owned companies are traded in the secondary market. The two leading U.S. stock markets today are the New York Stock Exchange and the Nasdaq stock market.

(a) The New York Stock Exchange (NYSE)

Before March of 2006, the New York Stock Exchange (NYSE) was a privately held firm owned by its members. It then merged with Archipelago, a publicly traded company that was one of the world's largest ECNs. The NYSE Group, Inc. was publicly traded under the ticker symbol NYX. In 2007 The NYSE Group merged with Euronext, a European company that operates stock exchanges in Paris, Amsterdam, Brussels, and Lisbon. The combined company is called NYSE Euronext. The NYSE still has over 300 member organizations, which are corporations, partnerships, or LLCs. Membership prices were as high as $4 million in 2005. Trading licenses are now leased by member organizations from the exchange, with an annual fee of $40,000 for 2009. The NYSE has leased most of its 1,500 available trading licenses. Most of the larger investment banking houses operate brokerage departments and are members of the NYSE with leased trading rights.

(b) The Nasdaq Stock Market

The National Association of Securities Dealers (NASD) is a self-regulatory body that licenses brokers and oversees trading practices. The computerized network used by the NASD is known as the NASD Automated Quotation System, or Nasdaq. Nasdaq lists about 4,000 stocks, although not all trade through the same Nasdaq system. Nasdaq also operates the Nasdaq OTC Bulletin Board, which lists quotes for stocks that are registered with the Securities and Exchange Commission (SEC) but are not listed on any exchange, usually because the company is too small or not sufficiently profitable. Finally, Nasdaq operates the Pink Sheets, which provide quotes on companies that are not registered with the SEC. Liquidity of stocks is the ability to trade quickly at a net price that is close to the security's recent price. Nasdaq has more than 400 dealers, most of whom make markets in a large number of stocks. Stocks listed on the OTC Bulletin Board or the Pink Sheets have much less liquidity.

(c) Competition in the Secondary Markets

There is intense competition between the NYSE, Nasdaq, and other international stock exchanges – they all want the larger, more profitable companies to list on their exchange. Since most of the largest U.S. companies trade on the NYSE, the market capitalization of NYSE-traded stocks is much higher than for stocks traded on Nasdaq (about $15.7 trillion versus $4.o trillion at the end of 2007). For comparison, the market capitalizations for global exchanges are $4.3 trillion in Tokyo, $3.9 trillion in London, $3.7 trillion in Shanghai, $2.7 trillion in Hong Kong, $2.1 Trillion in Germany, and $1.8 trillion in Bombay.

(d) Stock Market Returns

During the period 1968-2008, the average annual return for the stock market, as measured by total returns (dividends plus capital gains) on the S&P 500 index, was about 10.6%, but this average does not reflect the considerable annual variation. When you invest overseas, you face two risks: that foreign stocks will decrease in their local markets, and that the currencies in which you will be paid will fall relative to the dollar.

X. The Global Economic Crisis

The Globalization of Mortgage market Securitization

(1) Home Purchase
(2) Mortgage Origination
(3) Securitization and Re-securitization: In exchange for cash, the originator sold the mortgage to a securitizing firm. For example, Merill Lynch's investment banking operation was a major player in securitizing loans. It would bundle large numbers of mortgages into pools and then create new securities that has claims on the pools' cash flows. The slices of the pool were "tranches." Some of the tranches were themselves re-combined and then re-divided into securities called "collateralized debt obligations (CDOs)," some of which were themselves combined and subdivided into other securities, commonly called CDOs–squared. However, the process did not change the total amount of risk embedded in the mortgages, and each time a new security was created or rated, fees were being earned by the investment banks and rating agencies.
(4) The Investors: In exchange for cash, the securitizing firms sold the newly created securities to individual investors, hedge funds, college endowments, insurance companies, and other financial institutions, including pension funds. Mortgage payments go from home purchasers to investors through financial institutions making the mortgage-backed securities. A wave of mortgage defaults can easily break the chain of fund flows, resulting investors to lose money.

The Dark Side of Securitization: The Sub-Prime Mortgage Meltdown

(1) Regulators Approved Sub-Prime Standards: Until the early 1990s, regulators did not permit a non-qualifying mortgage to be securitized, so most originators mandated that borrowers meet certain requirements, including having at least a certain minimum level of income relative to the mortgage payments and a minimum down payment relative to the size of the mortgage. But in the mid-1990s, Washington politicians wanted to extend home ownership to groups that traditionally had difficulty obtaining mortgages. To accomplish this, regulations were relaxed so that non-qualifying mortgages could be securitized. Such loans are commonly called sub-prime or Alt-A mortgages.
(2) The Fed Helped Fuel the Real Estate Bubble: With more people able to get a mortgage, the demand for home increased. The Fed also slashed interest rates to historic lows after 9/11 attack to prevent a recession, and these low interest rates made mortgage payments lower, which made home ownership seem even more affordable, again contributing to an increase in the demand for housing. The combination of lower mortgage qualifications and lower interest rates caused house prices to skyrocket: the Fed contributed to an artificial bubble in real estate.
(3) Home Buyers Wanted more for Less: First, most sub-prime borrowers chose an adjustable rate mortgage (ARM) with an interest rate based on a short-term rate, such as that on 1-year Treasury bonds, to which the lender added a couple of percentage points. Because the Fed had pushed short-term rates so low, the initial rates on ARMs were very low. Many borrowers chose ARMs, but their mortgage payments rose rapidly when interest rates rose.
(4) Mortgage Brokers didn't Care:
(5) Real Estate Appraisers Were Lax: The relaxed regulations didn't require the mortgage broker to verify the borrower's income, so these loans were called "liar loans" because the borrowers could overstate their income. Many real estate appraisers simply assumed that house prices would keep going up, so they were willing to appraise houses at unrealistically high values. If the

borrowers defaulted, the value of the house turned out to be less than the remaining loan balance, causing a loss for the lender.

(6) Originators and Securitizers Wanted Quantity, not Quality:

(7) Rating Agencies Were Lax: Rating agencies were paid to investigate the details of each bond and to assign a rating which reflected the security's risk. Since the investment bank wanted a high rating, the rating agency got paid to help design securities that would qualify for a high rating, and high ratings led to continued business for the raters.

(8) Insurance Wasn't Insurance: To provide a higher rating and make these mortgage-backed securities look even more attractive to investors, the issuers would frequently purchases a type of insurance policy on the security called a credit default swap. However, it was impossible to tell how much risk any of the players had taken on, making it impossible to know whether or not counterparties like AIG would be able to fulfill their obligations in the event of a CDO default.

(9) Rocket Scientists Had Poor Rearview Mirrors: The experts looked at the high growth rates of recent real estate prices, which caused models to calculate very high CDO prices, at least until the real estate market crumbled.

(10) Investors Wanted More for Less: In the early 2000s, low-rated debt (including mortgage-backed securities), hedge funds, and private equity funds produced great rates of return. Investors focused primarily on returns and largely ignored risk.

(11) In 2006, many of the option ARMs began to reset, borrowers began to default, and home prices first leveled off and then began to fall. Things got worse in 2007 and 2008, and by early 2009, almost 1 out of 10 mortgages was in default or foreclosure, resulting in displaced families and virtual ghost towns of new subdivisions. As homeowners defaulted on their mortgages, so did the CDOs backed by the mortgages. That brought down the counterparties like AIG who had insured the CDOs via credit default swaps. The investors who owned mortgage-backed securities became stuck with pieces of worthless papers.

From Sub-Prime Meltdown to Liquidity Crisis to Economic Crisis

By the sub-prime meltdown, financial institutions were the first to fall. Many originating firms had not sold all of their sub-prime mortgages, and they failed. Securitizing firms also crashed, partly because they kept some of the new securities they created. For example, Fannie Mae and Freddie Mac had huge losses on their portfolio assets, causing them to be virtually taken over by the Federal Housing Finance Agency in 2008. Many investment banks had losses in credit default swaps. Lehman Brothers was forced into bankruptcy, Bear Stearns was sold to JP Morgan Chase, and Merrill Lynch was sold to Bank of America with huge losses. Citi Group sold Smith Barney to Morgan Stanley, Wells Fargo absorbed Wachobia Bank, and so on.

Bank began hoarding cash rather than lending it. The Fed requires banks to keep 10% of the funds they raise from depositors on reserve. Banks use the other 90% to make loans of to buy securities. However, at the end of 2008, banks held over $770 billion in excess reserves compared to $75 billion in required reserves. This hoarding may have reduced the banks' risk, but it deprived the economy of a much needed capital. Consequently, there had been a reduction in construction, manufacturing, retailing, and consumption, all of which caused job losses in 2008 and 2009. In short, this had led to a serious recession in the United States and most of the develop0ed world, a recession that brings back memories of the Great Depression of the 1930s.

QUESTIONS OF THE WEEK

1. Describe advantages and limitations of business ownerships: proprietorship, partnership, corporation, professional corporation or association, and S-corporation

Ownership	Advantages	Limitations
Proprietorship		
Partnership		
Corporation		
Professional Corporation Professional Association		
S-Corporation		

2. If you expect that your company would be optimistic or pessimistic in the future, which way of finance, either debt (bonds) or equity (stocks), would you like to choose, and why?

Finance	Optimistic future	Pessimistic future
Debt (bond) finance		
Equity (stock) finance		

3. The primary objective of the corporation is to maximize stockholders' wealth, represented by the market price of the firm's common stock. In general, maximization of intrinsic stock value benefits society. Explain why high prices of stock benefit society.

(a) Quality of life
(b) Consumer benefit
(c) Employee benefit

4. Managerial actions to maximize shareholders' wealth are based on a company's ability to generate cash flows now and in the future. Free Cash Flow (FCF) depends on three factors as follows. Explain.

FCF = Sales revenues - Operating costs - Operating taxes - Required new investments

5. Economic conditions affect the cost of money. Explain why in terms of followings:

(a) Federal Reserve policies
(b) Budget deficit or surplus
(c) Business activities
(d) Trade deficit or surplus
(e) Foreign country risk
(f) Exchange rate risk

6. Explain activities of following financial institutions:

(a) Investment banks
(b) Deposit-taking financial intermediaries
(c) Investment funds
(d) Life insurance companies
(e) Pension funds

7. Stock market transactions are divided by three distinct types - initial public offering, seasoned equity offering, and secondary market transactions. The two leading U.S. stock markets today are the New York Stock Exchange (NYSE) and the Nasdaq Stock Market. Explain how stocks are traded in them (trading procedures) ?

(a) New York Stock Exchange
(b) Nasdaq Stock Market

8. Explain the major reasons of the financial crisis of 2007-2008, the Obama's stimulus package, and the financial reform act passed the U.S. Congress on July 16, 2010.

(a) Major reasons of financial crisis of 2007-2008
(b) President Obama's stimulus package
(c) Financial reform act of 2010 signed by President Obama

(End of Lecture Notes #7)