FINANCIAL MARKETS AND FUNDS MANAGEMENT

Multiple choice

1.	D	6.	D	11.	D	16.	D
2.	B	7.	D	12.	C	17.	C
3.	B	8.	A	13.	B	18.	B
4.	C	9.	A	14.	A	19.	C
5.	A	10.	D	15.	B	20.	C

Short answer questions

Question 1

(a) **Financial markets provide a means for the creation and exchange of financial assets. For a business, a financial market provides a means of investing excess funds which can earn a business interest. Alternatively, financial markets can provide a market in which business's in needs of funds can raise these necessary funds by issuing debt or equity securities.**

(b) **Merchant banks operate in the wholesale financial markets in Australia. Although they carry the term 'bank' they are not authorised deposit taking institutions. Merchant banks provide a means for large companies to borrow money or loan excess funds. They also assist companies with the sale of debt or equity securities to the market and can provide mergers and acquisitions advice to companies.**

(c) **Privatisation, which is the sale of government owned businesses to the public, has greatly increased the amount of shares held by ordinary Australians, and the number of people holding shares.**

Globalisation of financial markets around the world mean that the Australian market is now more than ever open to international financial flows. This has also resulted in the Australian market being increasingly influenced by movements and sentiment in overseas markets, particularly the United States'.

(d) **The Reserve Bank of Australia (RBA) has responsibility for monetary policy. By influencing the general level of interest rates in the economy the RBA can influence the level of spending and inflation experienced by the Australian economy. It is at present the most important economic tool used to influence the short term level of economic growth in Australia.**

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The Australian Prudential Regulation Authority (APRA) is responsible for the regulation and supervision of all deposit-taking institutions, insurance companies and superannuation companies within the Australian financial system. It has received much criticism in recent years for its failure to foresee or prevent the collapse of insurer HIH.

Question 2

(a) **Short term - bank overdraft**

Long term - mortgage

(b) **lAdvantage – it is often faster and cheaper to arrange than equity financing.**

Disadvantage – businesses are exposed to the increased cash burden on interest payments if interest rates rise.

(c) **1. How long the funds are required for? If management is aware that the business is about to receive a large cash inflow which could cover the cost then borrowing in the interim is not that risky.**

2. What is the business's finance history? Depending on their credit rating the business may find it hard to obtain the necessary funds from a bank for example and may have to go to a leasing company, which will have a higher rate of interest attached.

3. What tax benefits could be gained? If the business decided to use an operating lease to gain access to the photocopier then it could claim the lease payments back as tax deductions.

(d) **As the head of the finance department believes the cost of the photocopier is financially risky, the business should enter into an operating lease - committing itself to a secured loan on the machine only. This means if they default on their payments all they will lose is the photocopier – a claim will not be made against the rest of the business. Additionally, if features are important to the business, an operating lease will allow the business to gain access to a new machine in a few years with even newer features, as operating leases are usually for periods of time less than the life of the asset – so the time frame of the debt is appropriate. They will also gain a tax benefit from the repayments.**

Question 3

(a) **Gearing is a term used to describe the amount of debt a business has relative to its assets or equity. If a business has a high level of debt it is considered to be 'highly geared'.**

(b) **1. Start-up companies. A new business that has risky prospects will be appealing to venture capitalists as they can add expertise and gain a high return is the business prospers. It would be difficult for a start-up to get traditional financing as it has no credit history.**

2. Business with poor credit histories. Traditional lenders such as banks will be unlikely to lend to these businesses but a venture capitalist may be more willing to accept the risk.

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(c) **Venture capital is a logical choice for Mumbai Ltd. Firstly, the business has made the correct choice in deciding not to increase its debt levels. As it is a risky business in a risky industry at present, its cash flows will likely be erratic meaning it may find it difficult to meet existing debt repayments. Any more debt would also be likely to require an even higher level of interest to be paid.**

Secondly, venture capital is a logical source of equity funds. The business would find it very difficult to float given its high level of debt and risky nature. However, venture capital funds would be willing to take on this extra risk. Additionally, the new owners (venture capitalists) may be able to give extra expertise to the firm's management.

Question 4

(a) **Factoring – by selling its debt to a factoring business the company would receive immediate cash flows from transactions.**

(b) **Banks and finance companies.**

(c) **1. The length of time the funds are need – as the company likes to replace its computer system every two years it should not be considering very long term borrowing facilities.**

2. The immediacy of the required funds – the business needs the equipment urgently so any funding that will take a long time to organise will not be useful.

(d) **Jet Ltd should use debt funding to buy the equipment. As the business is unable to function without the equipment they need immediate funding. Debt financing is far easier and faster to organise than equity financing and can be obtained for exactly two years – it fits the time frame. Although the business has variable cash flows it can put measures into place that will alleviate this position somewhat which will make the cash burden of interest payments not so damaging. The fact that we know they purchase a new system every two years suggests that the company has been in existence for a few years, meaning they will have an established credit history, making debt financing easier to obtain also. As it is a small company, it is likely run by people who are very close to the day-to-day workings of the business, and they may also be unwilling to use equity financing as it would diverge management control.**

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