



# Financial Markets Relevant to Business Needs

## Matching terms

Definitions	Terms
The markets where financial products are first issued. They are issued by companies for the purpose of raising equity or debt.	Primary Markets
Markets which trade funds and debt instruments that have a maturity of up to twelve months.	Money Markets
Markets which are concerned with the buying and selling of debt and equity instruments that have a maturity greater than twelve months.	Capital Markets
Markets where previously issued or “old” financial products are bought and sold	Secondary Markets
Banks which provide financial services, including the provision of capital, to large companies. They are inaccessible to small companies and individuals.	Merchant Banks
A measure of the amount of income which a company makes. The two most common forms are gross profits, which is the sales revenue less cost of goods sold, and net profit, which is gross profit minus all further expenses.	Profitability
Institutions such as the Reserve Bank of Australia and the Australian Securities Investment Commission which control and supervise the behaviour of institutions in financial markets	Regulators
A unit of ownership in a business	Share
A situation where one company (lessor) purchases a product, and then leases it to another (the lessee) for a fee per period.	Leasing

## True or False

1. True
2. True
3. False
4. False
5. False
6. True
7. False
8. True
9. True
10. True

## Multiple Choice

- 1 D Participants in financial markets
- 2 C Participants in financial markets
- 3 C Participants in financial markets
- 4 C ASX as a market
- 5 B Trends in financial markets
- 6 A Trends in financial markets
- 7 C Sources of funds
- 8 B Sources of funds
- 9 B External sources of funds
- 10 A Comparison of debt and equity financing
- 11 B Financial considerations
- 12 A Debt financing
- 13 D Comparison of debt and equity financing
- 14 D Financial considerations
- 15 D Comparison of debt and equity financing

## Short Answer Questions

### Question 1

- (a) Any of the following:
- Increased technology, which significantly improves efficiency in financial transactions.
  - Privatisation of government owned institutions, such as Telstra, Qantas and the CBA.
  - Globalisation of economies has made transactions easier between nations
  - Compulsory Superannuation initiated by the government in the 1980s.
  - Financial Deregulation in the 1980s removed many restrictions on the finance industry.
- (b) Any two of the following:
- Banks: The most common type, banks take deposits from those with excess funds and provide loans, mortgages, credit cards and overdrafts to those who require funds.
  - Finance Companies: Similar to banks, however finance companies don't rely on deposits but rather issue short term financial securities and re-loan these at higher interest rates.
  - Insurance companies: Provide guarantees for its customers in the form of promising to cover asset losses resulting from theft, accident, or other unforeseen events.
  - Merchant Banks: Banks which deal exclusively with big companies and governments, providing them with capital as well as other financial services.
  - Superannuation/mutual funds: A fund which receives superannuation payments from individuals and in exchange for a fee, invests these in a variety of financial assets.
  - Companies: Ordinary companies invest their profits in the markets, and larger companies will issue debt or equity to the public.
  - Stockbrokers: Serve as intermediaries in the purchase and sale of company stocks, performing transactions on their client's behalf.
  - Government: Regulates the sharemarket, banks, and corporate operations via the Reserve Bank (RBA), Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) respectively.

- (c) A company, provided it meets basic Australian Stock Exchange (ASX) requirements, can issue securities to the general public by listing on the ASX. It would offer a prospectus to the public detailing the issue of the shares, and soon after the shares would be listed and commence trade on the share market. Money with which the shares were purchased would then go towards the company's equity, and subsequently spent on the firm's expansion.
- (d) A primary market is one where initial funds are raised by a company either by issuing debt or shares. With shares, after an initial offering, investors will purchase a number of shares in the company, with the proceeds from this going directly to the company for use in its operations.

Conversely, a secondary market is one where shares are traded from one owner to another with no effect whatsoever on the amount of funds the company itself possesses. These are the most common transactions taking place on the ASX.

### Question 2

- (a) Any two of the following:
  - Banks: A bank can provide Disco Fashion with a mortgage which utilises her current properties as collateral (security) for the finance provided. A short term loan may also be an option.
  - Finance Companies: Similar to banks, they too provide finance. They are more commonly used for leases, which may be a viable option for Disco Fashion.
  - Merchant Banks: Given Disco Fashion is a public company, it can obtain funding from a merchant bank in the form of a loan.
- (b) Any two of the following:
  - The length of time for which the funds are required. For example, short term financing will be a poor choice for Disco Fashion's acquisition of retail premises, which are intended to be used for the long term.
  - Tax Benefits: Some forms of financing, for example leasing, carried tax-deductible status and thus has benefits which other forms of finance don't have.
  - The state of the economy: If the economy is entering a downward trend, it means the company may experience slower revenues and thus have difficulty in meeting debt repayments.
  - Solvency which is the ability to meet debt obligations: The company must be sure that in future it will have sufficient funds to repay debts as they fall due.
  - Ease with which finance can be obtained: If the company's credit history is poor, it will have difficulty obtaining some forms of finance, and will likely have to resort to more expensive forms.
- (c) (i) A form of debt financing obtained from banks and finance companies. They are generally long-term in nature and are repaid in periodical instalments. They are secured against a firm's assets or property.
  - (ii) A form of equity funding, retained profits encompasses the income which the company has made in profits in past years and decided to reinvest rather than distribute to owners in the form of dividends. It is generally cheaper than debt financing and easier to arrange.
  - (iii) Provided by governments or other institutions, grants tend to be one-off payments which the firm has no obligation to repay. They are often given as an incentive to produce certain products, especially with regard to research and development.

- (d) Any two of the following:
- Owner's Equity: Disco may choose to draw on funds from current owners or from outsiders in exchange for ownership rights. It can achieve this via the selling of shares to private investors who gain a right to future profits in the form of dividends.
  - Retained Profits: Disco made a profit of \$150,000 in the previous financial year. Disco must decide between distributing the profits as dividends to equity holders or retaining them for reinvestment into the company. If reinvested, the profit can provide relatively cheap, adequate funding for the expansion.
  - Mortgage: A form of long term loan, a mortgage will allow Disco to make small periodical repayments of borrowed funds, which may prove cheap if interest rates are low. The newly purchased premises themselves may be used as security for the loan, if not the firm's other assets.
  - Leasing: An arrangement where Disco obtains a right to occupy the premises and to use the furniture and equipment, however doesn't purchase them outright. Rather, it makes small, regular payments to the lessor, i.e. the owner of the premises and equipment. Leasing also carries significant tax advantages.

### Question 3

- (a) Gearing is a term used to describe the level of debt relative to equity a firm is utilising. For example, if it is highly geared, it means that it has a high proportion of debt borrowing relative to equity.
- (b) Advantage: Any one of:
- Can be organised in a short period of time
  - Equity's ownership stake isn't diluted as it would with new shareholders
  - Provides greater incentive to ensure sufficient cash flow
  - The repayments are tax deductible
- Disadvantage: Any one of:
- Business is more likely to become insolvent and thus liquidated.
  - Lending organizations place covenants (restrictions on how the firm is allowed to operate) which may impair the way a firm operates.
  - Taking on extra debt funding gives the impression the company has cash flow issues and hence leads to a fall in the confidence of shareholders.
  - The company is exposed to interest rate risk.
- (c) Record Technology has several financial considerations to make with regard to choosing financing. Firstly, it must decide how long it wished to use the funds for, given that there are significant differences between short and long term funding. It must ensure that it can meet any debt repayments it faces in the future so that it does not default on payments and make contingency plans if it experiences future trouble meeting repayments. Also, its credit history must allow for it to obtain the chosen form of finance.

Finally, it must consider the current and future state of the economy, given that this is what influences the interest rates set by financial institutions which the company ultimately borrows from.

- (d) Address present financial position: Record technology must examine the present state of its finances by utilising bank statements, invoices, etc and via both the balance sheet and revenue statement.

Determine financial elements of the plan: The company must now determine what its financial objectives are, and then prepare budgets which demonstrate how the objectives are to be met.

Maintain Record Systems: Record Technology must, once objectives are ascertained, ensure it has sufficient information for itself and stakeholders as to the performance of its financial plans.

Interpretation: The last stage of the cycle, the financial reports which the company has prepared over the period are interpreted. The company should use benchmarks, for example predicted performance, average performance of the industry, ratio analysis to determine whether the objectives have been met and if the company is performing adequately.