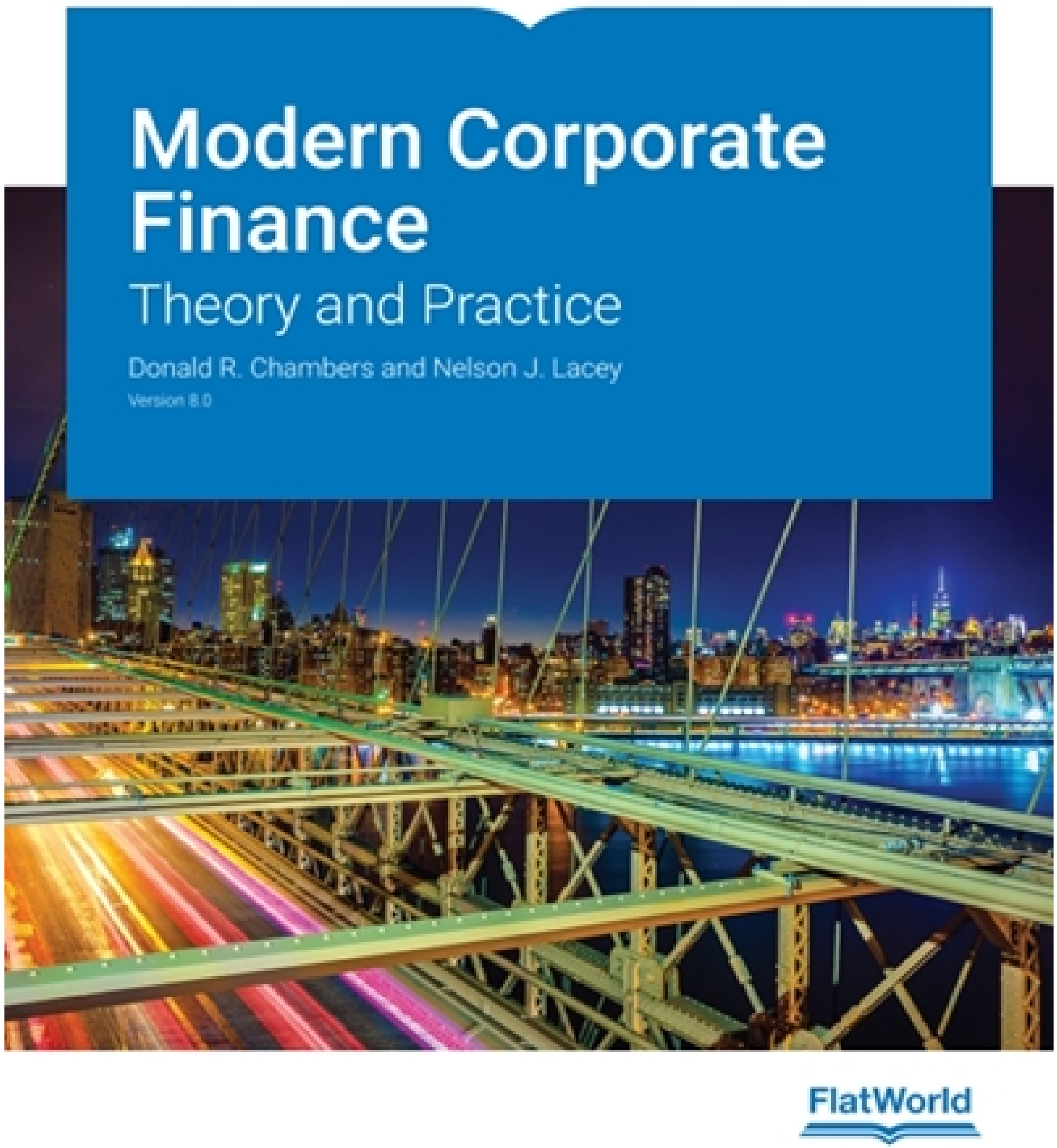
Solutions for Modern Corporate Finance Theory and Practice Version 8 0 8th Edition by Chambers

CLICK HERE TO ACCESS COMPLETE Solutions



Solutions

MODERN CORPORATE FINANCE:

Theory and Practice

Version 8.0

DONALD R. CHAMBERS

NELSON J. LACEY

CHAPTER 2 MARKETS AND CONTRACTS

CHAPTER 2 REVIEW QUESTIONS

R. 1. Market efficiency has vast and important implications for the financial manager. Most importantly, prices in efficient markets are accurate and reflect actual values such that the benefits of investment equal their cost. In other words, in efficient markets, investments are not under or over priced. Financial managers are directed to invest in markets that are not efficient or inefficient such that projects can be found whose benefits are greater than costs.

R. 2. Real assets directly produce or help produce scarce resources, while financial assets are claims on the cash flows of real assets. Common types of tangible real assets include include land, buildings, and equipment, and intangible real assets include trademarks, patents, and human productivity. Common types of financial assets include stocks and bonds issued by corporations.

R. 3. Equity securities, broadly classified as common stock, are claims on the residual cash flows of the corporation. These claims represent a pro–rata right to the firm's residual cash flows. In contrast, debt securities pay fixed claims usually offered at specific intervals in time, say every six months. Debt claims must be paid before any residual cash flow flows through to the equityholders.

R. 4. Auction markets are markets where trades are conducted at centralized locations. The auctioneer serves as a "matchmaker" for buyers and sellers willing to transact at the same price. The New York Stock Exchange is an example of an auction market. In dealer markets, dealers buy and sell securities and hold them in inventory, announcing to willing buyers and sellers that securities will be offered at a certain price. The buyer and seller purchase the securities from the dealer who earns a commission equal to the difference between the bid price and the asked price. The Over–The–Counter market is an example of a dealer market.

R. 5. Agency theory investigates how a group of persons, called the principals, contract with another group of persons, called the agents. In a corporate setting, shareholders are the principals who form contracts with the agents, or the managers, to make decisions on behalf of the shareholders.

R. 6. There are two types of agency costs; (1) the costs of trying to get the agents to do what the principals want, and (2) the lost opportunities caused by conflicts which are too expensive to resolve. Shareholders might choose to incur costs of monitoring managers to insure that, for example, managers do not waste home office supplies foolishly. Shareholders may in certain situations, choose not to incur monitoring costs and instead to bear these expenses as lost opportunities.

R. 7. The primary tool used by shareholders to minimize agency costs is the compensation plan. The compensation plan is the procedure by which the principal and agent have contracted with regard to the basis upon which the agent will be paid. Typical compensation plans are salary and bonus agreements. The best compensation plan is one that links together the desires of the managers with the desires of the shareholders, such as a salary combined with a bonus based upon the performance of the firm's stock.

CHAPTER 2 PROBLEMS

1. b. most liquid   c. moderately liquid   a. least liquid

2. a. F   b. R   c. F   d. R   e. R

3. a. Bigstuff Corporation's shareholders gain and the citizens of the county lose.
   b. Dangerous Products, Inc. shareholders lose while the citizens of West Rochester and the lawyers gain.
   c. Shareholders of Creditor Corporation lose to shareholders of Debtor Corp.
   d. Citizens of United States lose while citizens of Herbanna gain.

4. a. Federal income tax on $125,000 (married filing jointly): $22,250

Amount	Rate	Tax
$20,000	10%	$2,000
$60,000	15%	$9,000
$45,000	25%	$11,250
$125,000		$22,250

b. $22,250 / $125,000 => 17.8%

c. $250. The extra $1,000 will be taxed at 25%.

d. Federal income tax on $10,000 (married filing jointly): $1,000

Amount	Rate	Tax
$10,000	10%	$1,000
$10,000		$1,000

Average and marginal tax rates: 10%

5. a. Federal income tax on $1,100,000 (corporate): $374,000

Amount	Rate	Tax
$50,000	15%	$7,500
$25,000	25%	$6,250
$25,000	34%	$8,500
$235,000	39%	$91,650
$765,000	34%	$260,100
$1,100,000		$374,000

b. \$374,000 / \$1,100,000 => 34.0%

c. \$340. The extra \$1,000 will be taxed at 34%.

d. Federal income tax on \$60,000 (corporate): \$10,000

Amount	Rate	Tax
\$50,000	15%	\$7,500
\$10,000	25%	\$2,500
\$60,000		\$10,000

Average rate, 16.7%, and the marginal tax rate 25%

6. a. (200 shares x \$20 per share) x (102.5%) = \$4,100

   b. (200 shares x \$20 per share) x (97.5%) = \$3,900

   c. \$200 loss

   d. Ebay and Paypal fees would be analogous. Whether you could buy and sell at the same price might depend on how "anxious" each party was and other factors. To buy at a low price, a buyer must be willing to wait for an anxious seller and to take the chance that the price may rise while waiting for an anxious seller. To sell at a high price , a seller must be willing to wait for an anxious buyer and to take the change that the price will fall while waiting.

7. a. 100 shares x \$10.25 per share = \$1,025

   b. 100 shares x \$10.05 per share = \$1,005

   c. \$20 loss

   d. Ebay and Paypal fees would be need to be included. The prices used seem to imply that the investor was an anxious buyer and than was an anxious seller. That is exactly the bahavior that most investors exhibit when they place "market" orders and is how market makers get compensated for their role of providing liquidity.

8. a. 3 additional hours maximize profit.

   b. Offer Nick the salary bonuses in column 3 for producing the additional daily profits shown in column 2 or simply offer Nick the optimum bonus level of \$45 for producing \$230 additional profit each day.

   c. Nick would quit.

   d. No. This problem attempts to focus management of the principal–agent relationship on the compensation scheme. Some management approaches advocate the use of seminars, workshops and retreats in an attempt to get Nick to abandon his self–interest. A compensation scheme based approach attempts to align the self–interests of the parties involved.

9. Probably not. Note that the overall cost savings would be small. However, it is possible that the firm has been able to retain workers at a lower wage because the firm is able to offer non–cash compensation such as free parking, mailing, phone calls and office supplies. There are several important points. First, there is non–cash compensation in addition to cash compensation. Second, sometimes the optimal principal–agent relationship allows certain conflicts to remain unresolved since it is not cost efficient to resolve all conflicts. Finally, it may be noted that there is a tax advantage to certain types of non–cash compensation since it is generally untaxed.

10. a. Jack's analysis may be true – but it does not necessarily imply any level of market inefficiency. It may be possibile to be able to predict some interest rate movements (inflation is somewhat predictable) –– but in order to refute market efficiency, the theory must be capable of earning superior risk adjusted returns. So an interest rate prediction theory would have to predict interest rates better than they are predicted in the marketplace as reflected and contained in current rates.

b. The firms behind investment newsletters can send out millions of junk emails or bulk mailings with different stock picks knowing that some recipients will receive a string of good picks and will be fooled into thinking it was skill. Unless consistent results are demonstrated, the cases of success will be nothing more than statistical flukes. The human mind is surprisingly poor at differentiating between causation and randomness when using casual analysis.

c. As in the previous question regarding stock picks, some argue that fund families generate many, many funds with various risks, eventually closing the "losers" and promoting the "winners" as skill rather than luck. But it could be worse, some people allege that drug companies test high numbers of worthless new drugs in the hopes that some will generate positive test results through being a statistical outlier and not revealing how many drugs were initially tested so that consumers could discern the probabilities that the results were statistical flukes rather than indications of the drug's effectiveness.

d. This would indicate strong level inefficiency of the market for collectibles. In other words, it would argue against the efficiency of the classified ads in that newspaper for collectibles.

CHAPTER 2 DISCUSSION QUESTIONS

1. The key word is "consistently". With tens of millions of active investors and with tens of thousands of professional investment managers it should be expected that some investors will "beat the market" many time periods in a row. Market efficiency merely requires that performance exceeding the market is random rather than consistent. It is useful to note that several of the larger investment companies with "families" of mutual funds contain approaching 100 different funds. There are thousands and thousands of mutual funds. If each mutual fund were assumed to have a 50% (independent) chance of "beating" its market in each year, then out of a group of 4,096 mutual funds the expected number of funds "beating the market" for the last ten consecutive years would be 4!

2. First, there is virtually no net effect of burning a $100 bill on human wealth since human wealth is potential consumption and a $100 bill is a claim on consumption rather than potential consumption itself. The near trivial exception to this point is that the paper, ink and labor involved with producing the $100 bill are lost since currency is useful as a medium of exchange.

   Second, there is a $100 wealth transfer from the owner of the $100 bill (the instructor) to virtually everybody else in society since money becomes more valuable as its supply diminishes. To be precise, the recipients of the wealth transfer are all people who hold claims denominated in dollars in proportion to the size of their claims.

   Finally, we can extend the discussion into monetary policy and inflation by noting that when government increases or decreases the money supply there is an immediate transfer of wealth but (perhaps) no immediate net change in total wealth. However, some people argue that the government can manipulate aggregate economic activity and therefore aggregate wealth by manipulating the money supply.

3. No, technically speaking, a corporation is a set of contracts. To be more precise it is usually useful to identify the specific people involved such as shareholders, creditors, workers and managers.

4. Silver and gold are generally considered real assets since they have value as jewelry and for industrial purposes. The fact that they are used as a medium of exchange does not make them financial assets, per se. However, some people may argue that if silver or gold take on an illusory value as a medium of exchange that departs from its industrial or cosmetic value, then it becomes a financial asset.

5. The point of this question is that there is little or no difference between a communist society and a capitalist society if the income tax rate of the capitalist society reaches 100%. Note that a communist society is where all assets are

owned by the society in general through the government. Further note that the value of any asset is the future consumption that it provides. Broadly defined, we could think of income as including virtually all benefits of consumption and therefore there would be no difference.

The other point of the question is to investigate the idea that income taxation is a partial form of communism and that if we believe that communism is "wrong" then isn't it logical to conclude that any income taxation is wrong? Some of the discussion can be helped using the material from Chapter 3. Note from that chapter that there are two approaches: a contractual rights approach and a societal good approach. For those students who advocate public policy on the basis of societal good or fairness, it is often useful to ask if it would be appropriate to charge tuition on the basis of a student's grade point average since the students who learn more (receive more knowledge) should pay more!

Further discussion questions on this topic inlcude: Upon what basis would students object if the government raised taxes on their income to 100% because the rest of society thought that it was fair? Is it wrong to steal money from a store but OK to shoplift a small item? Is it OK to cheat just a little on taxes but no OK to evade large amounts of taxes?

6. Consumption requires both natural resources and human effort or technology. Thus both types of resources are necessary. For example, a car, a sandwich, a house, a shirt, etc. require raw materials and a combination of intellect and labor. However, the tremendous wealth of one nation as contrasted with another nation, or of one time period as contrasted with another is almost always a difference in human effort and technology rather than natural resources. Were cavemen poor because there wasn't enough oil or ore under the ground or were they poor because they lacked the technology to utilitze the resources?

   As discussed in the next question, virtually all of our wealth today can be attributed to the cumulated wisdom (technology) of people that preceded us.

7. Note that it is virtually impossible to transport a significant amount of drinking water without the help of a material, a device, a tool or an idea created by someone else. Perhaps a leaf, a hollow fruit, a hollow vegetable or a spongue could carry a little water a short distance. But the exercise should cause us to think about the primary source of wealth (the human mind) and the extent to which we live off of the intellect of other people.

COPYRIGHT PAGE:

Published by:

FlatWorld

175 Portland Street

Boston, MA 02114

Chapter 2

Markets and Contracts

1. MARKET EFFICIENCY

Learning Objectives:

- Describe and critique market efficiency
- Compare the weak, semi-strong and strong types of market efficiency
- Discuss inefficient markets and how inefficiency relates to profit opportunities
- Describe liquid assets and the conditions that promote asset liquidity
- Discuss corporate liquidity and distinguish it from asset liquidity

- **Efficient market** – assets traded at prices that equal their values, based upon available information

2. INEFFICIENT MARKETS

- **Inefficient markets** – assets trade at prices that do not reflect all available information

2.1 Liquid Assets

- Can be sold at true value very quickly
- **Illiquid** – costly for buyers to understand fully the information necessary to make a purchase decision
- **Information asymmetries** – discrepancies between the information held by buyer and seller of an asset

2.2 Liquidity and Corporate Finance

- Different meaning when applied to overall corporation
- **Liquid corporation** – sufficient cash, assets near-cash and sources of credit to pay bills and invest in beneficial projects
- **Illiquid corporation** – does not have ability to pay bills or invest wisely in new projects
- **Working capital management** – maximize shareholder wealth via optimal level of liquidity

3. ACQUIRING ASSETS IN THE FINANCIAL SYSTEM

Learning Objectives:

- Distinguish real and financial assets and their roles in a market economy
- Discuss financial intermediation and evaluate its role in asset ownership
- Describe types of financial intermediaries
- Explain the economic roles of real assets and government
- Describe income taxation, marginal tax rates and average tax rates
- Compare the effects of marginal and average tax rates on economic decisions
- Calculate personal and corporate income taxes
- Describe money, inflation, and the effects of inflation on nominal prices

- **Financial system** – means through which individuals acquire assets
- Corporations do not consume or produce resources, people do
- Markets for goods/services allow economic advantages

4. REAL VERSUS FINANCIAL ASSETS

- **Real assets** – directly produce or help to produce scarce resources (e.g. land, buildings, equipment)

- **Financial assets** – represent claims on cash flows from assets; indirect real asset ownership (e.g. stocks, bonds)
- **Intangible assets** – not directly involved in producing resources (e.g. trademarks, patents)
- **Share of stock** – percentage claim on residual value of a firm
- **Bond** – fixed claim on real assets of a corporation
- Financial securities provide greater liquidity than direct ownership of real assets

- Types of financial assets
    - Equity securities
        - **Common stock** – claim on cash flows of corporation and residual earnings, distributed as dividends
        - **Preferred stock** – residual claim with priority (compared to common stock) rights to dividends and other distributions
    - Debt securities
        - **Bonds** – promise fixed return on investment, paid at specific intervals; mortgage bonds have collateral secured by real property
        - **Debentures** – no specific collateral; firm's earning power
- Corporations serve as a conduit between real assets and owners
- Corporations and securities do not by themselves alter total level of wealth
- Indirect ownership provides convenience and liquidity for individuals
- Corporations offer debt claims (fixed securities) and equity claims (residual securities)

5. ASSET OWNERSHIP THROUGH FINANCIAL INTERMEDIARIES

- **Financial intermediaries** – financial institutions (e.g. banks, savings and loans, pension funds) serve as conduit between people and financial assets; enhance liquidity of individual investors by pooling savings of a large number of small investors
- Five types of financial intermediaries
    1. Commercial banks – organized to accept deposits from individuals and make corporate and personal loans; securities used are **demand deposits** (i.e. checking accounts) and certificates of deposit

2. Pension funds – obtain funds from employer and employee retirement contributions and invest funds in financial assets
3. Insurance companies – pool premium payments from individuals into funds used to off-set unpredictable losses; generally invest in common stocks and long-term bonds
4. Investment companies – manage pooled portfolios; types of investment include mutual funds, closed-end funds, open-end funds
5. Investment banks – perform services such as underwriting debt and equity securities for firms, arranging for mergers and other corporate reorganizations, and financial advising; receive fees for underwriting and other services and earn capital gains (or losses) from proprietary trading

5.1 Real Asset Ownership and Governments

- Governments can also act as financial intermediaries
- Governments don't consume or produce, only individuals can consume and/or produce
- Government programs and regulations influence people
- Economic role of government viewed through influence on ownership of real assets; through taxation government alters asset ownership channels; government regulations indirectly alters behavior of businesses

5.2 Taxation

- Government taxation transfers assets from taxpayer to recipients of government spending
- Effects of taxes factored into all financial decisions, whether corporate or personal

5.3 Governments and Money

- Money facilitates transactions; accepted commodity measuring and exchanging wealth
- **Inflation** – economic climate characterized by decline in value of money

- **Deflation -** economic climate characterized by increase in value of money
- **Exchange rate** – measure of change in value of money
- **Consumer price index** – collective index measuring change in value of money through time by monitoring value of common necessities

5.4 Summary of Real Asset Ownership

- Economic value – ultimate value comes from real assets and belongs to individuals
- Financial system includes corporations, financial intermediaries, and governments

6. MARKETS

- Describe and differentiate primary and secondary securities
- Describe and compare primary, secondary, dealer and auction markets
- Compare direct trading markets with brokered trading markets
- Calculate trading costs for dealer and brokered markets
- **Market** – conduit for exchange
- **Financial market** – conduit for financial securities exchange
- **Primary securities** – securities issued and sold to investors for the first time in a **primary market**
- **Secondary securities** – existing financial securities sold in the **secondary market**
- Secondary market increases liquidity of financial securities
- **Dealer market** – dealers buy and sell certain types of securities using their own inventory; buyer pays **offer price** and seller pays **bid price**
- **Auction markets** – conducted at centralized location with auctioneer recording bids and offer prices
- **Direct trading markets** – sellers and buyers trade directly among themselves
- **Brokered trading markets** – buyer and seller employ agent who matches them for a fee

7. CONTRACTING

- Explain the principal-agent relationship and the related use of contracts
- Describe agency costs and identify two major types of agency costs

- Discuss the role of compensation plans in agency relationships
- Solve agent utility maximization problems given a compensation plan

7.1 The Principal–Agent Relationship

- Potential conflict exists between principal desires and agent actions

7.2 Agency Costs

- Two types of agency cost
    1. Costs of getting agents to carry out duties according to principals wishes
    2. Lost opportunities caused by conflicts too expensive to resolve
- Agency theory – minimizing total costs attributable to conflicts within agency relationship

7.3 Agency Relationships and Compensation Plans

- **Compensation plan** – contract between principal and agent stating how agent will be paid
- Shareholders can maximize wealth by selecting managers carefully and offering a well-designed compensation plan
- Executive compensation includes regular (salary plus bonus) and compensation determined by stock price
- shareholders by **maximizing value of shareholder wealth**

END-OF-CHAPTER SUMMARY

- Efficient markets are markets in which prices reflect available information
- Liquidity of an asset is usually related to how difficult it is for buyers to understand information concerning the asset. Liquidity and the costs of information are important

aspects of corporate financial management. Working capital management is the process of providing an optimal level of liquidity in as cost-effective manner as possible.

- Corporate finance occurs within an economic system. The economic system comprises corporations, financial intermediaries, government, and markets that serve as conduits between people and real assets.
- Corporations are conduits between real assets and people via financial assets because they issue financial securities and purchase real assets.
- The existence of financial intermediaries and markets, also part of the financial system, makes it easier and more cost effective for people to own and trade their financial assets, which ultimately represent claims on real assets.
- Governments are also sets of contracts between people with regard to real asset ownership. Taxes are a claim by recipients of government services against taxpayers on the basis of contracts that compromise government.
- The relationship between stockholders and managers is our example of the contracts formed in the financial system. This relationship is known as an agency relationship. The objective of shareholders is often to minimize the total costs – called agency costs – of the inherent conflicts. Compensation plans are a tool for minimizing agency costs.

Modern Corporate Finance: Theory and Practice

- Donald R. Chambers and Nelson J. Lacey
  Adapted by Professor Fahlgren

PUBLISHED BY:
FLATWORLD

FlatWorld

CHAPTER 2

Markets and Contracts

FlatWorld

LEARNING OBJECTIVES

- Describe and critique market efficiency
- Compare the weak, semi-strong and strong types of market efficiency
- Discuss inefficient markets and how inefficiency relates to profit opportunities
- Describe liquid assets and the conditions that promote asset liquidity
- Discuss corporate liquidity and distinguish it from asset liquidity

LEARNING OBJECTIVES (CONTINUED)

- Distinguish real and financial assets and their roles in a market economy
- Discuss financial intermediation and evaluate its role in asset ownership
- Describe types of financial intermediaries
- Explain the economic roles of real assets and government
- Describe income taxation, marginal tax rates and average tax rates

LEARNING OBJECTIVES (CONTINUED)

- Compare the effects of marginal and average tax rates on economic decisions
- Calculate personal and corporate income taxes
- Describe money, inflation, and the effects of inflation on nominal prices
- Describe and differentiate primary and secondary securities
- Describe and compare primary, secondary, dealer and auction markets

LEARNING OBJECTIVES (CONTINUED)

- Compare direct trading markets with brokered trading markets
- Calculate trading costs for dealer and brokered markets
- Explain the principal-agent relationship and the related use of contracts
- Describe agency costs and identify two major types of agency costs
- Discuss the role of compensation plans in agency relationships
- Solve agent utility maximization problems given a compensation plan

SECTION 1

Market Efficiency

MARKET EFFICIENCY

- **Efficient market** – assets traded at prices that equal their values, based upon available information

SECTION 2

Ineffecient Markets

INEFFICIENT MARKETS

- **Inefficient markets** – assets trade at prices that do not reflect all available information

LIQUID ASSETS

Liquid Assets

- Can be sold at true value very quickly
- **Illiquid** – costly for buyers to understand fully the information necessary to make a purchase decision
- **Information asymmetries** – discrepancies between the information held by buyer and seller of an asset

LIQUIDITY AND CORPORATE FINANCE

Liquidity and Corporate Finance

- Different meaning when applied to overall corporation
- **Liquid corporation** – sufficient cash, assets near-cash and sources of credit to pay bills and invest in beneficial projects
- **Illiquid corporation** – does not have ability to pay bills or invest wisely in new projects
- **Working capital management** – maximize shareholder wealth via optimal level of liquidity

SECTION 3

Acquiring Assets in the Financial System

AQUIRING ASSETS IN THE FINANCIAL SYSTEM

- **Financial system** – means through which individuals acquire assets
- Corporations do not consume or produce resources, people do
- Markets for goods/services allow economic advantages

SECTION 4

Real Versus Financial Assets

REAL VERSUS FINANCIAL ASSETS

- **Real assets** – directly produce or help to produce scarce resources (e.g. land, buildings, equipment)
- **Financial assets** – represent claims on cash flows from assets; indirect real asset ownership (e.g. stocks, bonds)
- **Intangible assets** – not directly involved in producing resources (e.g. trademarks, patents)
- **Share of stock** – percentage claim on residual value of a firm
- **Bond** – fixed claim on real assets of a corporation
- Financial securities provide greater liquidity than direct ownership of real assets

TYPES OF FINANCIAL ASSETS

- Equity securities
  - Common stock – claim on cash flows of corporation and residual earnings, distributed as dividends
  - Preferred stock – residual claim with priority (compared to common stock) rights to dividends and other distributions
- Debt securities
  - Bonds – promise fixed return on investment, paid at specific intervals; mortgage bonds have collateral secured by real property
  - Debentures – no specific collateral; firm's earning power

TYPES OF FINANCIAL ASSETS

- Corporations serve as a conduit between real assets and owners
- Corporations and securities do not by themselves alter total level of wealth
- Indirect ownership provides convenience and liquidity for individuals
- Corporations offer debt claims (fixed securities) and equity claims (residual securities)

SECTION 5

Asset Ownership Through Financial Intermediation

FIVE TYPES OF FINANCIAL INTERMEDIARIES

- **Financial intermediaries** – financial institutions (e.g. banks, savings and loans, pension funds) serve as conduit between people and financial assets; enhance liquidity of individual investors by pooling savings of a large number of small investors
- Five types of financial intermediaries
  1. Commercial banks – organized to accept deposits from individuals and make corporate and personal loans; securities used are **demand deposits** (i.e. checking accounts) and certificates of deposit

FIVE TYPES OF FINANCIAL INTERMEDIARIES

- Five types of financial intermediaries (CONTINUED)
  2. Pension funds – obtain funds from employer and employee retirement contributions and invest funds in financial assets
  3. Insurance companies – pool premium payments from individuals into funds used to off-set unpredictable losses; generally invest in common stocks and long-term bonds
  4. Investment companies – manage pooled portfolios; types of investment include mutual funds, closed-end funds, open-end funds

FIVE TYPES OF FINANCIAL INTERMEDIARIES

- Five types of financial intermediaries (CONTINUED)
  5. Investment banks – perform services such as underwriting debt and equity securities for firms, arranging for mergers and other corporate reorganizations, and financial advising; receive fees for underwriting and other services and earn capital gains (or losses) from proprietary trading

REAL ASSET OWNERSHIP AND GOVERNMENTS

- Governments can also act as financial intermediaries
- Governments don’t consume or produce, only individuals can consume and/or produce
- Government programs and regulations influence people
- Economic role of government viewed through influence on ownership of real assets; through taxation government alters asset ownership channels; government regulations indirectly alters behavior of businesses

TAXATION

- Government taxation transfers assets from taxpayer to recipients of government spending
- Effects of taxes factored into all financial decisions, whether corporate or personal

GOVERNMENTS AND MONEY

- Money facilitates transactions; accepted commodity measuring and exchanging wealth
- **Inflation** – economic climate characterized by decline in value of money
- **Deflation** - economic climate characterized by increase in value of money
- **Exchange rate** – measure of change in value of money
- **Consumer price index** – collective index measuring change in value of money through time by monitoring value of common necessities

SUMMARY OF REAL ASSET OWNERSHIP

- Economic value – ultimate value comes from real assets and belongs to individuals
- Financial system includes corporations, financial intermediaries, and governments

SECTION 6

Markets

FlatWorld

MARKETS

- **Market** – conduit for exchange
- **Financial market** – conduit for financial securities exchange
- **Primary securities** – securities issued and sold to investors for the first time in a **primary market**
- **Secondary securities** – existing financial securities sold in the **secondary market**
- Secondary market increases liquidity of financial securities
- **Dealer market** – dealers buy and sell certain types of securities using their own inventory; buyer pays **offer price** and seller pays **bid price**

MARKETS (CONTINUED)

- **Auction markets** – conducted at centralized location with auctioneer recording bids and offer prices
- **Direct trading markets** – sellers and buyers trade directly among themselves
- **Brokered trading markets** – buyer and seller employ agent who matches them for a fee

SECTION 7

Contracting

FlatWorld

PRINCIPAL-AGENT RELATIONSHIP

- Potential conflict exists between principals desires and agent actions

AGENCY COSTS

- Two types of **agency cost**
  1. Costs of getting agents to carry out duties according to principals wishes
  2. Lost opportunities caused by conflicts too expensive to resolve
- **Agency theory** – minimizing total costs attributable to conflicts within agency relationship

AGENCY RELATIONSHIPS AND COMPENSATION PLANS

- **Compensation plan** – contract between principal and agent stating how agent will be paid
- Shareholders can maximize wealth by selecting managers carefully and offering a well-designed compensation plan
- Executive compensation includes regular (salary plus bonus) and compensation determined by stock price

END OF CHAPTER MATERIAL

- Efficient markets are markets in which prices reflect available information.
- Liquidity of an asset is usually related to how difficult it is for buyers to understand information concerning the asset. Liquidity and the costs of information are important aspects of corporate financial management. Working capital management is the process of providing an optimal level of liquidity in as cost-effective manner as possible.

END OF CHAPTER MATERIAL (CONTINUED)

- Corporate finance occurs within an economic system. The economic system comprises corporations, financial intermediaries, government, and markets that serve as conduits between people and real assets.
- Corporations are conduits between real assets and people via financial assets because they issue financial securities and purchase real assets.
- The existence of financial intermediaries and markets, also part of the financial system, makes it easier and more cost effective for people to own and trade their financial assets, which ultimately represent claims on real assets.

FlatWorld

END OF CHAPTER MATERIAL (CONTINUED)

- Governments are also sets of contracts between people with regard to real asset ownership. Taxes are a claim by recipients of government services against taxpayers on the basis of contracts that compromise government.
- The relationship between stockholders and managers is our example of the contracts formed in the financial system. This relationship is known as an agency relationship. The objective of shareholders is often to minimize the total costs – called agency costs – of the inherent conflicts. Compensation plans are a tool for minimizing agency costs.