Chapter 13: Managing Financial Resources

Business 110
13.1 The Functions of Money

- Money serves three basic functions:
  - *Medium of exchange*: because you can use it to buy the goods and services you want, everyone’s willing to trade things for money.
  - *Measure of value*: it simplifies the exchange process because it’s a means of indicating how much something costs.
  - *Store of value*: people are willing to hold onto it because they’re confident that it will keep its value over time.
13.1 The Functions of Money

- The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below $100,000.
13.1 The Function of Money

Figure 12.3 Management and Financial Accounting

M-1 is sometimes called transactions money because you can use it to buy things. M-2 also includes so-called near money, which is often easy to convert into funds that you can use to make purchases.
13.2 Financial Institutions

- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.

- Those that accept deposits from customers—depository institutions—include **commercial banks**, **savings banks**, and **credit unions**; those that don’t—nondepository institutions—include **finance companies**, **insurance companies**, and **brokerage firms**.

- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
13.2 Financial Institutions

Figure 13.3 Where Our Money Is Deposited

- Commercial banks $13.5 trillion (85%)
- Savings banks $1.5 trillion (10%)
- Credit unions $812 billion (5%)
A bank holds onto only a fraction of the money that it takes in—an amount called its reserves—and lends the rest out to individuals, businesses, and governments. In turn, borrowers put some of these funds back into the banking system, where they become available to other borrowers. The money multiplier effect ensures that the cycle expands the money supply.
13.2 Financial Institutions

Figure 13.4 The Effect of the Money Multiplier
13.3 The Federal Reserve System

- Most large banks are members of the central banking system called the Federal Reserve System (commonly known as “the Fed”).

- The Fed’s goals include price stability, sustainable economic growth, and full employment. It uses *monetary policy* to regulate the money supply and the level of interest rates.
13.3 The Federal Reserve System

• To achieve these goals, the Fed has three tools:

1. it can raise or lower reserve requirements—the percentage of its funds that banks must set aside and can’t lend out;

2. it can raise or lower the discount rate—the rate of interest that the Fed charges member banks to borrow “reserve” funds;

3. it can conduct open market operations—buying or selling government securities on the open market.
13.3 The Federal Reserve System

Figure 13.6 Key Interest Rates, 2002–2011

In 2008 the Fed lowered the discount and federal funds rate drastically to stimulate a weakening economy.
13.4 The Role of the Financial Manager

• If a new business hopes to get funding, it should prepare a financial plan—a document that shows the amount of capital that it needs for a specified period, how and where it will get it, and how and when it will pay it back.

• Common sources of funding for new businesses include personal assets, loans from family and friends, and bank loans.

• Financial institutions offer business loans with different maturities. A short-term loan matures in less than a year, an intermediate loan in one to five years, and a long-term loan after five years or more.
13.4 The Role of the Financial Manager

- Banks also issue **lines of credit** that allow companies to borrow up to a specified amount as the need arises.

- Banks generally require **security** in the form of **collateral**, such as company or personal assets. If the borrower fails to pay the loan when it’s due, the bank can take possession of these assets.

- Existing companies that want to expand often seek funding from private investors. **Angels** are wealthy individuals who are willing to invest in ventures that they believe will succeed. **Venture capitalists**, though willing to invest larger sums of money, often want to cash out more quickly than angels. They generally invest in existing businesses with strong growth potential.
13.4 The Role of the Financial Manager

- Successful companies looking for additional capital might decide to go public, offering an initial sale of stock called an initial public offering (IPO).
13.5 Understanding Securities Markets

- Securities markets provide two functions:

  1. They help companies raise funds by making the initial sale of stock to the public.
  2. They provide a place where investors can trade previously issued stock.

- Stock sold through an IPO is issued through a primary market with the help of an investment banking firm.
13.5 Understanding Securities Markets

• Previously issued securities are traded in a secondary market, where the proceeds from sales go to investors rather than to the issuing companies.

• The best-known exchanges are the New York Stock Exchange, the American Stock Exchange, and the NASDAQ.

• They’re all regulated by the Securities and Exchange Commission (SEC), a government agency that is charged with enforcing securities laws designed to protect the investing public.

• Stock market trends are measured by market indexes, such as the Dow Jones Industrial Average (DJIA), the NASDAQ Composite Index, and Standard & Poor’s Composite Index (S&P 500).
13.5 Understanding Securities Markets

Figure 13.9 DJIA for Ten-Year Period Ended November 2011
13.5 Understanding Securities Markets

Figure 13.10 NASDAQ for Ten-Year Period Ended November 2011
13.5 Understanding Securities Markets

- When the stock market is enjoying a period of large increases in prices, it’s said to be in a **bull market**. When prices are declining, it’s often called a **bear market**.
13.6 Financing the Going Concern

- Companies can raise funds through equity financing—selling stock—or through debt financing—issuing bonds. Each option has its advantages and disadvantages.

- Stock may be common stock or preferred stock.

- Preferred stock is safer than common stock but it doesn’t have the upside potential—namely, the possibility that shareholders will benefit greatly if a company performs very well.

- Unlike common stockholders, however, whose dividends vary according to a company’s profitability, holders of preferred stock receive annual fixed dividends.
Most positions in finance fall into one of these three areas: commercial banking, corporate finance, and the investment industry.

Finance professionals employed in commercial banking help clients obtain personal or business loans. They also invest the bank’s excess funds.

Those employed in corporate finance obtain and manage their employing company’s cash, debt, and investments. They provide financial analysis and advice to management.
13.7 Careers in Finance

- Financial professionals in the investment industry provide financial advice to their clients and help them buy and sell stocks.

- To pursue a career in finance, you’ll need a strong finance education, as well as familiarity with both accounting and finance.