BASIC of FINANCE THEORITICAL

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“BASIC OF FINANCE - TEORITICAL’

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PREFACE

This e-book is available exclusively for students and lecturers who are studying and teaching courses on finance either at the polytechnics and other tertiary institutions. This book is suitable for students and lecturers in order to obtain an overview of initial and basic knowledge involving finance.

This book contains two main topics involving the initial and basic topics in the field of finance. Readers initially will be introduced with an understanding of the basic concepts of finance and the financial system.

It is hoped that this book will help readers to get a clearer understanding of basic knowledge in the field of finance. This book will hopefully also be able to help especially the students to face the learning environment and enhance the interest of the students to be involved in the finance field in the future.

Finally, we would like to express our warm appreciation to many parties who have provide us with strong encouragement and very helpful assistance.

THANK YOU

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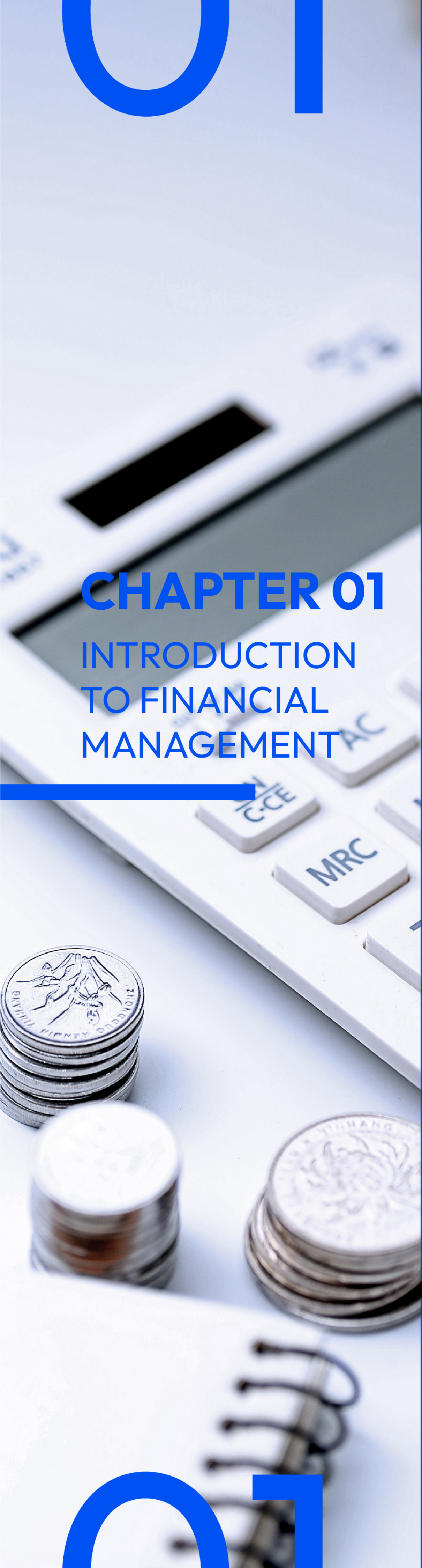


CHAPTER 01

INTRODUCTION TO FINANCIAL MANAGEMENT

INTRODUCTION

Financial decision-making involves all aspects of our lives, from basic decisions on household spending to a complex dealing of big businesses or of a corporation. There are financial implications in almost all business decisions, and even non-financial executives must know enough finance to be able execute their duties effectively and efficiently. The understanding and comprehension of financial decision-making tools and their relationships with other business functions are essential to aid decision makers in obtaining the optimal investment that could provide minimum risk and maximum return to the firm.

DEFINITION

- Financial management can be defined as a process involved in an attempt to obtain and allocate financial resources effectively and efficiently to achieve the firms goal; that is to maximize the shareholder's wealth by maximizing the share price.
- Finance can be defined as application of fundamental finance economy relating to financial problems.
- Finance can also be defined as a process which involves money exchange between business entities, individuals as well as government whereby money is passed from one to another via finance activities and investment.
- Finance is art and science of handling money and involves assessing value and deciding the best outcome.

FINANCIAL ACTIVITIES ARE CATEGORIZED UNDER THREE MAIN AREAS WHICH ARE CLOSELY RELATED TO EACH OTHER:

a. Money trade and capital

- This area revolves around activities carried out by finance institution including banks, insurance company, (trust company) and etc.
- It stresses more on the factors inflicting the changes on interest rate; rules abided by finance institutions and types of short term and long term fund instruments.

b. Investment

- This area involves security analysis highlighting more on the functions of brokerage house.
- It provides the guidelines to manage investment portfolio either by individual investor or institutional investor.

c. Finance management

- This area is the broadest area of all.
- It is very important for all business types and covers all the finance entities including banks and other finance institutions.
- This is area will be stressed and discussed thoroughly in this subject.

IMPORTANCE OF FINANCE

- The knowledge can assist in planning, problem solving as well as decision making.
- Runs smoothly the department operations.

THE ROLE AND THE IMPORTANCE OF FINANCE MANAGER

Finance management applies the principles of organizational finance in creating and sustaining the value integrated via decision making process as well as efficient resource management. All decisions pertaining to finance management depends on basic concept and finance principle.

They are split up into FIVE (5) main areas which are:

a. Financial analysis and planning

The financial manager will monitor the financial position of the company. He should interact with other executive for future planning and development of the company. A financial manager needs to encourage production managers to consider conservation and efficiency to improve gross profit margins.

b. Investment decision

A successful company usually grows rapid. An increase in sales requires investment in buildings, equipment and inventory. A financial manager will assist in determining the optimum growth rate of sales, and also determines the mix and types of assets to be acquired. He will determine the optimum level of each current assets type, and fixed assets to be purchased. This is important because it can influence the success of the company in achieving its objectives.

c. Financing decisions

A financial manager will determine the best mix financing between short-term financing and long-term financing, or in the form of loans or equity financing. Then he will choose between the various sources of financing available in line with the company objectives.

d. Monitoring and controlling

A financial manager should interact with other executives to ensure that the company operates efficiently. All managers should be aware that all business decisions have financial impications.

e. Involvement in financial market

All actions and decisions of a company will be influenced and affected by the market. Therefore, a financial manager should be involved in money and capital market transactions, the source of funds available and securities, to ensure attainment of stability and profit growth, as well as the maximum rate of return on investment and minimum losses.

INVESTMENT DECISION

- Most important decision
- Determine the amount of assets demanded by the firm.
- Decision making on resource fund.
  - Decision on the investment capital
    - Not routine, big amount.
    - E.g: Purchases of machines
  - Decision on net working capital investment.
    - More routine
    - Daily operated
    - Eg: Inventory selection, AR

FINANCING/ EXPENDITURE DECISION

- Finance manager should be able to expect finance necessities of an organization.
- Decision to raise company's fund to cater to investment expenditure.
- Involves:
  - Financial resource
    - Loan
    - Long/short term
      Capital
      Ordinary stock/ prefered Stock @ retained earning
  - Financing mix – partly using debt and equity

ASSET MANAGEMENT DECISION

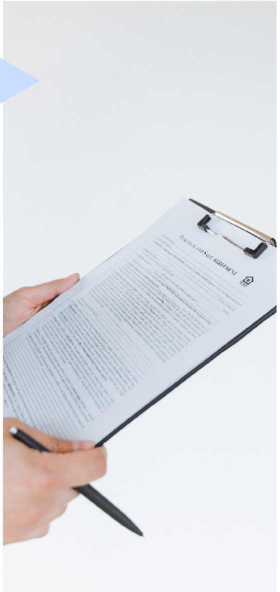
- After assets are bought the expenditure is determined, they need to be managed resourcefully and efficiently.
- Finance manager will take into account the management of existing assets.
- Efficient management on available and existing assets will give benefit in return besides lessening the risk of LIQUIDITY.

THE ROLE OF FINANCE MANAGER

The main role of a finance manager is to raise and search out funds as well as utilize them wisely in accordance with the goals set by the firm. Amongst the specific activities handled by a finance manager are:

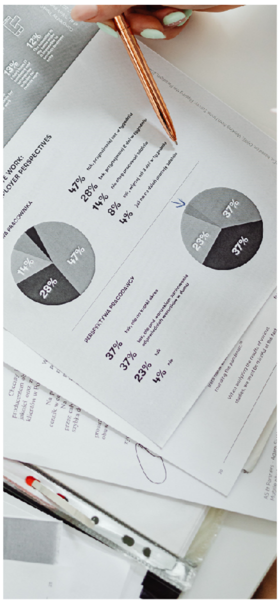
Responsible in company's planning and expectations.

Finance manager will be dealing and keeping into contacts with the other executives in the company to sketch out planning which drives the direction of the company in the future.



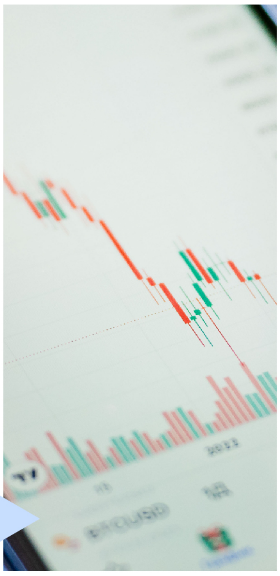
Deciding on investment and expenditure

Finance manager will decide on optimizing the sale growth rate as well as in the matter of purchasing certain assets. This will also include the ideal and best ways to cater for the investment expenditure of those assets.



Set the standard and control

Finance manager will be dealing with the other executives in order to optimize the company's operational system. This is because, as mentioned earlier, all the decisions in business have their own financial implications.



Carrying out trade in finance market

Finance manager will directly be involved in all trading sequences that deal with finance market and capital.

If all the responsibility and duties are well implemented, a finance manager is expected to be able to assist the company in achieving the company goals.

COMPANY GOALS

In finance, the goal of the firm is always described as "maximization of shareholder wealth". But generally there are two goals:

a. Profit Maximization

b. Maximization of shareholder wealth

PROFIT MAXIMIZATION

- A short term aim needs to be achieved in time of one year.
- Highlighting more on the efficiency of the capital resource use.
- To ensure that this specific aim can maximize the profit gained, finance manager should implement ways to maximize the profit without taking into consideration the effects and consequences of the actions in the future time.

WEAKNESS

- **Only for short term and not holistic.**
  a. E.g.: Company ABC earns RM 30 million and decides on increasing its earning up to RM 50 million;
  b. Procedure: Finance manager decides on cutting down the expenditure for R&D and not to fix the major defect on machines.
  c. Implication: The goods become outdated and less competitive or the machines defect even worse or may eventually turn unfeasible.

- **Not stressing on the time the return is gained.**
  a. Def: The time the return is gained.
  b. How fast a firm gains a return from the asset investment
  c. The value of money changes by time, but as far as the aim to maximize the profit is concerned, the time the return is ready to be harvested is disregarded by all means.

	Return/ Earning (RM)	
	Project X	Project Y
Year 1	RM250,000	Nil
Year 2	Nil	RM250,000

  d. On one perspective, maximizing the profit for both projects is seemingly equal.
  e. The truth is actually the reverse, because project X can be invested again on the second year and the return may be bigger.

- **Not stressing on the time the return is gained.**
  a. Risk is defined as the possibility that something unpleasant would occur or the probability that the actual results would differ from the expected results.
  b. E.g.: The estimated return for two products. Which product should be choosing?

Year	Product X	Product Y
1	RM12,500	RM11,500
2	RM12,500	RM11,500
3	RM12,500	RM11,500
Total	**RM37,500**	**RM 34,500**

c. The objective of maximizing the profit. Finance manager will decide on product X but disregard the risk. However, if product X is riskier than product Y, then the decision is not as straightforward as the figures seem to indicate, because of the trade-off between risk and return. Shareholders would expect higher return from a riskier investment to compensate for the comparatively higher level of risk in making product X.

MAXIMIZATION OF SHAREHOLDER WEALTH

- The goal of the firm is to maximize the wealth of the owners for whom it is being operated.
- Maximizing shareholder's wealth means maximizing the total market value (or market price) of the existing shareholders common stock.
- Stresses on the time the return is gained, the amount of the return and its risk.
- Finance manager must be consistent with the share holders' request.
- It is actually a result of slight alteration based on the aim to maximize the profit by stressing on more complex actual environment.
- As the aim is formed, it will affect the overall monetary decision that is about to take effect.
- The main thing focused here is the effects of each decision made on the price of the company's ordinary share price; taking into account the risk factor, time and other factors relevant to the owner of the company, which are the share holders of the company.
- Therefore, the aim to maximize the profit gained by the share holders is a more realistic aim due to the fact that the company's sake is taken into highlight.

DIFFERENCE OF OBJECTIVES MAXIMIZES THE PROFIT AND OBJECTIVE TO MAXIMIZATION OF SHARE HOLDER WEALTH

Objective To Maximize the Profit	Objective To Maximize Shareholder Wealth
1. Profit • A result of after reduced- cost and expenditure. • The firm can achieve maximum profit without achieving maximum shareloders wealth.	1. The wealth/riches of shareholder • The value of ordinary stock market held by the share holders. • In order to maximize shareholder's wealth, the firm has to maximize its profit first.

2. Achievable in short term • Can manipulate the sale and costs by either increasing or decreasing the variables involved.	2. The firm should to meet the short term objective and stresses on long term objective. E.g: should have growth in earning and dividends, profit increment and maintaining its financial stability then only the share price will rise up when the demand for the firms shares also increase.
3. Stresses on the amount of profit gained and not when is it gained. Hence its does not considerthe timing of the returns. It does not matter how late the profits are received as long as the amount are huge.	3. Stresses on the principle of current financial value (value of money). The earlier the cash is received the better, fot the money can be invested in another project so as to increase earnings. This will lead to an overall increase in the company earnings.
4. Ignore the risk and uncertainty involved in any investment.	4. Decision is made after assessing the risk involved in any investment. High risk high return and low risk low return.
5. Increase in profit does not mean an increasein cash flows. This is because the computation of profit includes non-cash items such as depreciation and amortization.	5. Increase in shareholders wealth is related to an increase in cash flows increase, dividends can be paid, payment for expansion be made and so on.

FIVE (5) BASIC PRINCIPLES OF FINANCE

01 Money Has Time Value

Money received today is worth more than a money received in future. Conversely, a money received in the future is worth less than a money received today. We can invest the money we have today to earn interest so that at the end of one year we will have more money from today.

02 The Risk-Return Trade-Off

People won't take on additional risk unless they expect to be compensated with additional return. The trade off which an investor faces between risk and return while considering investment decisions is called the risk return trade off.

Higher risk is associated with greater probability of higher return and lower risk with a greater probability of smaller return. This trade off which an investor faces between risk and return while considering investment decisions is called the risk return trade off. The risk return trade off won't take on additional risk unless they expect to be compensated with additional return. Investment alternatives have different amounts of risk and expected returns. The more risk an investment has, the higher ist expected return will be. For example, if Amar deposits all his money in a saving bank account, he will earn a low return i.e. the interest rate paid by bank and the money is safe in bank. However, if he invests in equities, he faces the risk of losing a major part of his capital along with a chance to get a much higher return than compared to a saving deposit in a bank.

03 Cash Flows Are the Source of Value

Profit is an accounting concept designed to measure a business performance over an interval of time. Cash flow is the amount of cash that can actually be taken out of the businesses over this same interval. Cash flows represent actual money that can be spent and cash flows determine an investment value.

Profits are different. To determine a company accounting profit, its accountants have to make a judgement about how the business costs and revenues are allocated to each time period. In fact, a firm can show a profit on paper even when it is generating no cash at all.

04 Market Price Reflect Information

Investors respond to new information by buying and selling their investments. The speed with which investors act and the way that prices respond to the information determine the efficiency of the market. The price of financial claims traded in the public financial markets respond rapidly to the release of new information. Thus when earnings reports come out, price adjust immediately to the new information, moving upward if the information is better than expected and downward if it is worse than expected. In efficient market such as in developed countries, this process take place very quickly. As a result, its hard to profit from trading on publicly released information. Consequently, managers can expect their companys share prices to respond quickly to the decisions they make. Good decisions wll result in higher stock prices. Bad decisions will result in lower stock prices.

05 Individual Respond to Incentive

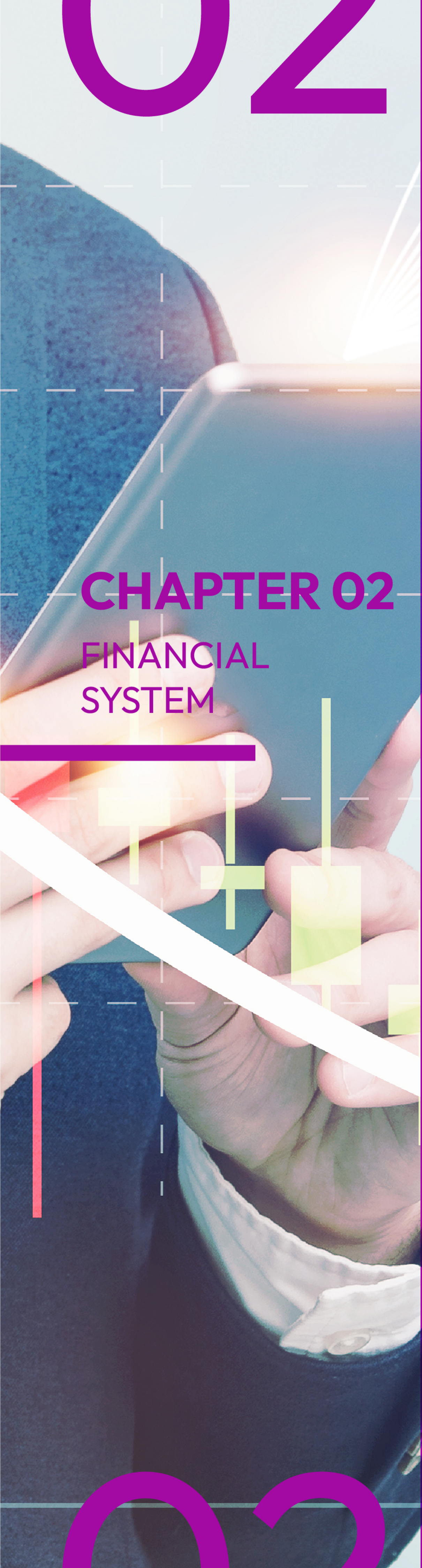
An incentive is something that motivates an individual to perform an action. Perhaps the most notable incentive in economics is price. Price acts as a signal to suppliers to produce and to consumers to buy. For example, a sale is nothing more than a store providing an incentive to potential customers to buy. The lowering of the price makes the purchase a better idea for some customers; the sale seeks to persuade individuals to change their actions (namely, to buy the product). Similarly, the increase in price acts as an incentive to suppliers to produce more of a good. If suppliers think they can sell their products for more, they will be more inclined to produce more. The price acts, therefore, as an incentive to customers to buy and suppliers to produce.

TYPES OF INCENTIVES

Incentives come in many other forms, however. Broadly, most incentives can be grouped into one of four categories:

a. Remunerative incentives:	b. Moral incentives:
The incentive comes in the form of some sort of material reward – especially money – in exchange for acting in a particular way. Wages, prices, and bribery are all examples of remunerative incentives. This is the type of incentive that is typically associated with economics.	This occurs when a certain choice is widely regarded as the right thing to do, or as particularly admirable, or where the failure to act in a certain way is condemned as indecent. Societies and cultures are two main sources of moral incentives.
c. Coercive incentives:	**d. Natural Incentives:**
The incentive is a promise of some sort of punishment if the wrong decision is made. For example, the promise of impris-onment is a coercive incentive for people to not steal.	Things such as curiosity, mental or physical exercise, admiration, fear, anger, pain, joy, or the pursuit of truth, or the control over things in the world or people or oneself cause individuals to make certain decisions.

Economics is mainly concerned with remunerative incentives, though, when discussing government regulations, coercive incentives often come into play. By manipulating incentives, individuals (and businesses and government) hope to encourage some behaviors and discourage others.



CHAPTER 02
FINANCIAL SYSTEM

INTRODUCTION TO FINANCIAL INSTITUTIONS

A financial institution (FI) is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange. Financial institutions encompass a broad range of business operations within the financial services sector including banks, trust companies, insurance companies, brokerage firms, and investment dealers.

The difference between financial intermediaries and financial institutions is that the financial institution is an establishment that conducts financial transactions such as investments, loans and deposits while financial intermediaries function is to move funds from parties with excess capital to parties needing funds. The process creates efficient markets and lowers the cost of conducting business.

FINANCIAL INTERMEDIARIES

Financial intermediaries are generally classified into two broad groups- (a) banks, and (b) non-bank financial intermediaries (NBFIs). Non-bank financial intermediaries are thus a heterogeneous group of financial institutions other than commercial banks.

A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund or pension fund, finance companies, insurance companies and investment company. Financial intermediaries offer a number of benefits to the average consumer, including safety, liquidity, and economies of scale involved in banking and asset management.

Among the function of financial intermediaries is to move funds from parties with excess capital to parties needing funds. The process creates efficient markets and lowers the cost of conducting business. For example, a financial advisor connects with clients through purchasing insurance, stocks, bonds, real estate, and other assets. Banks connect borrowers and lenders by providing capital from other financial institutions and from the Federal Reserve. Insurance companies collect premiums for policies and provide policy benefits. A pension fund collects funds on behalf of members and distributes payments to pensioners.

Among the benefits of financial intermediaries is through a financial intermediary, savers can pool their funds, enabling them to make large investments, which in turn benefits the entity in which they are investing. At the same time, financial intermediaries pool risk by spreading funds across a diverse range of investments and loans. Loans benefit households and countries by enabling them to spend more money than they have at the current time.

Financial intermediaries also provide the benefit of reducing costs on several fronts. For instance, they have access to economies of scale to expertly evaluate the credit profile of potential borrowers and keep records and profiles cost-effectively. Last, they reduce the costs of the many financial transactions an individual investor would otherwise have to make if the financial intermediary did not exist.

NON FINANCIAL INTERMEDIARIES

Non-bank financial intermediaries (NBFIs) comprise a mixed bag of institutions, ranging from leasing, factoring, and venture capital companies to various types of contractual savings and institutional investors (pension funds, insurance companies, and mutual funds). The common characteristic of these institutions is that they mobilize savings and facilitate the financing of different activities, but they do not accept deposits from the public.

NBFIs play an important dual role in the financial system. They complement the role of commercial banks by filling gaps in their range of services. But they also compete with commercial banks and force them to be more efficient and responsive to the needs of their customers. Most NBFIs are also actively involved in the securities markets and in the mobilization and allocation of long-term financial resources. The state of development of NBFIs is usually a good indicator of the state of development of the financial system.

Their growth has been much faster than that of commercial banks. The main reason for this is that, in comparison to commercial banks, NBFIs pay higher interest rates to the depositors and charge lower interest rates from the borrowers. Non-Banking Financial Intermediaries are such institutions as savings and loan associations, life insurance companies, benefit funds, common trust funds, pension funds and government lending agencies.

In spite of certain similarities, the commercial banks basically differ from nonbank financial intermediaries on the following grounds:

i. Bank is a financial institution whose liabilities (i.e., deposits) are widely accepted as a means of payment in the settlement of debt. Non-bank financial intermediaries, on the other hand, are those institutions whose liabilities are not accepted as means of payment for the settlement of debt.

ii. Commercial banks have the ability to generate multiple expansion of credit. The non-bank intermediaries do not have such ability. They simply mobilize savings for investment.

iii. Commercial banks raise funds costlessly because no interest is paid on demand deposits. Nonbank intermediaries, on the other hand, have to pay higher interest to attract more funds.

iv. People deposit money in the banks for safety, convenience and liquidity considerations. However, they invest their savings in the nonbank intermediaries with the motive of earning extra income.

v. Banks form a homogeneous group, while nonbank intermediaries form a heterogeneous group in the financial structure of the economy.

vi. Bank generally deals with short-term loans in the money market, whereas the nonbank intermediaries mostly deal with all types of loans i.e., short-term, medium-term and long-term loans.

CENTRAL BANK/ REGULATORS

A central bank is an independent national authority that conducts monetary policy, regulates banks, and provides financial services including economic research. Its goals are to stabilize the nation's currency, keep unemployment low, and prevent inflation.

Most central banks are governed by a board consisting of its member banks. The country's chief elected official appoints the director. The national legislative body approves him or her. That keeps the central bank aligned with the nation's long-term policy goals. At the same time, it's free of political influence in its day-to-day operations.

In Malaysia, Bank Negara Malaysia (the Central Bank of Malaysia), is a statutory body which started operations on 26 January 1959. Bank Negara Malaysia is governed by the Central Bank of Malaysia Act 2009. The role of Bank Negara Malaysia is to promote monetary and financial stability. This is aimed at providing a conducive environment for the sustainable growth of the Malaysian economy.

Among the major role of the Bank is the prudent conduct of monetary policy, which has seen generally low and stable inflation for decades and thereby, preserving the purchasing power of the ringgit. The Bank is also responsible for bringing about financial system stability and fostering a sound and progressive financial sector. There is now in place a well diversified, comprehensive and resilient financial sector, that is able to meet the increasingly sophisticated needs of consumers and businesses, and which has become a growth driver in the economy.

The Bank also plays a significant developmental role, including development of financial system infrastructure with major emphasis placed on building the nation's efficient and secured payment systems as well as the necessary institutions (including Securities Commission, KLSE, now known as Bursa Malaysia and Credit Guarantee Corporation) which are important towards building a comprehensive, robust and resilient financial system.

The Bank actively promotes financial inclusion, which has led to improved access to financial services for all economic sectors and segments of society, thereby supporting balanced economic growth.

Other important roles of the Bank are being a banker and adviser to the Government, playing an active role in advising on macroeconomic policies and managing the public debt. It is also the sole authority in issuing currency as well as managing the country's international reserves.

TYPES OF FINANCIAL MARKET

Financial markets represent forums that facilitate the flow of funds among investors, firms, government units and agencies. They provide a meeting place where suppliers and demanders of loans and investments can transact business directly. Among the roles of financial markets is:

a. Primary Market

A primary market is defined as a market where new securities are bought and sold for the first time. In this market, the issuer is directly involved in the transaction and receives the proceeds from the sale of securities. Once the securities begin to trade among individuals, businesess, government, financial institutions, savers and investors they become part of secondary market.

b. Secondary Market

The secondary market is defined as a market in which existing securities are traded among investors. The issuer of the securities is not involved in the transactions and does not receive the proceeds from the sale. Examples of secondary markets include Bursa Malaysia (formerly Kuala Lumpur Stock Exchange), The Malaysian Exchange of Securities Dealing and Automated Quatation (MESDAQ) and Malaysia Derivatives Exchange Berhad (MDEX).

Simply put, primary market is the market where the newly started company issued shares to the public for the first time through IPO (initial public offering). Secondary market is the market where the second hand securities are sold (security Commodity Markets).

c. Debt Market

The market where funds are borrowed and lent is known as debt market. Arrangements are made in such a way that the borrowers agree to pay the lender the original amount of the loan plus some specified amount of interest.

This market is also known as a fixed-income market as it deals with the fixed payments on interest and principal. Generally, it can be categorized further into short-term and long-term debt markets. In Malaysia, short term debt market refers to the notes payable such as letter of credit issued by financial institutions for corporate short term capital and marketable securities. On the other hand, long term debt market refers to the long term loans provided by the financial institutions to the companies and bonds issued by the corporate or government institutions.

d. Equity Market

A market where ownership of securities is issued and subscribed is known as equity market. An example of a secondary equity market for shares is the Bursa Malaysia. This market also known as the variables income market as it deals with variable payment on dividend and share prices.

e. Derivative Market

In finance, a derivative is a contract that derives its value from the performance of an underlying entity. Examples of derivatives are futures, options and swaps. Such derivatives are issued and traded in derivative market, such Bursa Malaysia Derivative Market. Derivatives are contracts between two parties that specify conditions (especially the dates, resulting values and definitions of the underlying variables, the parties' contractual obligations, and the notional amount) under which payments are to be made between the parties. Derivatives can be used for a number of purposes, including to reduce the risks (Hedging) faced by firm or it can be used for speculation purpose. There are two groups of derivative contracts:

i Over-The-Counter (OTC) derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. Products such as swaps are almost always traded in this way. The OTC derivative market is the largest market for derivatives.

ii Exchange-Traded Derivatives (ETD) are those derivatives instruments that are traded via specialized derivatives exchanges or other exchanges. A derivatives exchange is a market where individuals trade standardized contracts that have been defined by the exchange. A derivatives exchange acts as an intermediary to all related transactions, and takes initial margin from both sides of the trade to act as a guarantee. The examples of derivatives exchanges (by number of transactions) are the Korea Exchange and Eurex.

f. Spot Market

The spot market is where financial instruments, such as commodities, currencies and securities, are traded for immediate delivery. Delivery is the exchange of cash for the financial instrument.

The spot market is a commodity or security market where goods, both perishable and non-perishable are sold for money and delivered immediately or within a short span of time. Contracts traded on a spot market are also in effect instantly. The spot market is also recognized as the cash market or physical market. The purchases are settled in cash at the current prices fixed by the market as opposed to the price at the time of distribution. The price quoted for a purchase or sale on the spot market is called the spot price.

For example, if you wish to purchase Company XYZ shares and own them immediately, you would go to the cash market on which the shares are traded (the New York Stock Exchange, for example). If you wanted to buy gold on the spot market, you could go to a coin dealer and exchange cash for gold.

The foreign exchange (FOREX) market is one of the largest spot markets in the world. People and companies all over the world are constantly exchanging one currency for another as transactions occur all over the globe.

g. Future Market

A futures market is an auction market in which participants buy and sell commodity and futures contracts for delivery on a specified future date. Futures are exchange-traded derivatives contracts that lock in future delivery of a commodity or security at a price set today. To understand the futures market, we first need to understand the concept of a "futures contract." This is an investment product built around buying and selling commodities at a later date. Literally, a futures contract is an agreement to buy or sell some commodity (usually) on a given date for a given price. A commodity is a raw, physical product such as wood, corn, gold, pork bellies or any other unprocessed material.

Futures markets allow commodities producers and consumers to engage in “hedging” in order to limit the risk of losing money as commodity prices change. For example, Bill and Susan make the same deal (1,000 pounds of coffee on Sept. 1 for $1 per pound), but this time they aren't investors. Susan owns a coffee farm and Bill runs a chain of restaurants.

Each of them wants to secure the best price they can on coffee, but just as importantly they want to secure the most stable price they can. Susan wants to avoid the risk that next September the price of coffee will collapse, leaving her with a warehouse full of near-worthless product. Bill wants to avoid the opposite risk, that next September the price of coffee will skyrocket, pushing up his costs and erasing his profit margin.

In this case they will use a futures contract to "hedge," protecting themselves against future price swings. Susan takes the risk that she'll miss out on potential gains if the price soars, and Bill accepts that he might overpay if the price collapses, but both are confident that they'll receive a price they can accept.

MONEY MARKETS AND CAPITAL MARKETS DEFINITION

a. **Money market** is a market for dealing with the financial assets and securities which have a maturity period of up to one year. In other words, it's a market for purely short-term funds. The money market is a component of the economy which provides short-term funds. The money market deals in short-term loans, generally for a period of less than or equal to 365 days. The money market is important for businesses because it allows companies with a temporary cash surplus to invest in short-term securities; conversely, companies with a temporary cash shortfall can sell securities or borrow funds on a short-term basis.

b. A **capital market** is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long-term securities which have a maturity period of above one year. It comprised of the equity market and the bond market. The equity market provides opportunity for corporations to raise fund through the issuing of stocks and listed in the Malaysian Securities Exchange Berhad. The bond market is a market where corporations may be able to raise fund through the issuance of private debt securities (PDS). It also a place where the public sector can raise funds by issuing government securities.

MONEY MARKET INSTRUMENTS

The money market is the arena in which financial institutions make available to a broad range of borrowers and investors the opportunity to buy and sell various forms of short-term securities. The short-term debts and securities sold on the money markets—which are known as money market instruments—have maturities ranging from one day to one year and are extremely liquid. Treasury bills, short dated government securities, banker's acceptance, negotiable certificates of deposits, certificates of deposit (CDs), commercial paper and repurchase agreements are examples of instruments. The suppliers of funds for money market instruments are institutions and individuals with a preference for the highest liquidity and the lowest risk.

- Commercial paper – Short term instruments promissory notes issued by company at discount to face value and redeemed at face value
- Repurchase agreements – Short-term loans—normally for less than one week and frequently for one day—arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.
- Treasury bills – Short-term debt obligations of a national government that are issued to mature in three to twelve months
- A certificate of deposit (CD) is a time deposit, a financial product commonly sold by banks. CDs differ from savings accounts in that the CD has a specific, fixed term (often one, three, or six months, or one to five years) and usually, a fixed interest rate and issued at discount on face value.

CAPITAL MARKET INSTRUMENTS

Capital markets refer to the places where savings and investments are moved between suppliers of capital and those who are in need of capital. Capital markets consist of the primary market, where new securities are issued and sold, and the secondary market, where already-issued securities are traded between investors. The most common capital markets are the stock market (secondary market) and the bond market.

The instruments traded (media of exchange) in the capital market are:

a. Debt Instruments (Bond)

A debt instrument is used by either companies or governments to generate funds for capital-intensive projects. It can have obtained either through the primary or secondary market. The relationship in this form of instrument ownership is that of a borrower – creditor and thus, does not necessarily imply ownership in the business of the borrower. The contract is for a specific duration and interest is paid at specified periods as stated in the trust deed* (contract agreement). The principal sum invested, is therefore repaid at the expiration of the contract period with interest either paid quarterly, semi-annually or annually. The interest stated in the trust deed may be either fixed or flexible. The tenure of this category ranges from 3 to 25 years. Investment in this instrument is, most times, risk-free and therefore yields lower returns when compared to other instruments traded in the capital market. Investors in this category get top priority in the event of liquidation of a company.

When the instrument is issued by:

- The Federal Government, it is called a Sovereign Bond;
- A state government it is called a State Bond;
- A local government, it is called a Municipal Bond; and
- A corporate body (Company), it is called a Debenture, Industrial Loan or Corporate Bond

b. Equities (also called Common Stock)

This instrument is issued by companies only and can also be obtained either in the primary market or the secondary market. Investment in this form of business translates to ownership of the business as the contract stands in perpetuity unless sold to another investor in the secondary market. The investor therefore possesses certain rights and privileges (such as to vote and hold position) in the company. Whereas the investor in debts may be entitled to interest which must be paid, the equity holder receives dividends which may or may not be declared.

The risk factor in this instrument is high and thus yields a higher return (when successful). Holders of this instrument however rank bottom on the scale of preference in the event of liquidation of a company as they are considered owners of the company.

c. Preference Shares

This instrument is issued by corporate bodies and the investors rank second (after bond holders) on the scale of preference when a company goes under. The instrument possesses the characteristics of equity in the sense that when the authorised share capital and paid up capital are being calculated, they are added to equity capital to arrive at the total. Preference shares can also be treated as a debt instrument as they do not confer voting rights on its holders and have a dividend payment that is structured like interest (coupon) paid for bonds issues.

INTRODUCTION TO ISLAMIC FINANCE

Islamic finance refers to how businesses and individuals raise capital in accordance with Sharia, or Islamic law. It also refers to the types of investments that are permissible under this form of law. Sharia (also known as "Shariah" or "Shari'a") is an Islamic religious law that governs not only religious rituals but also aspects of day-to-day life in Islam. Guided by Islamic economics, it prohibits riba (collection and payment of interest), usury, trading in financial risk and haram (unlawful) business ventures.

The concept of risk sharing is central to Islamic banking and finance. It is essential to understand the role of risk-sharing in raising capital. At the same time, Islamic finance demands the avoidance of riba (usury) and gharar (ambiguity or deception).

Islamic law views lending with interest payments as a relationship that favors the lender, who charges interest at the borrower's expense. Islamic law considers money as a measuring tool for value and not an asset in itself. Therefore, it requires that one should not be able to receive income from money alone. Interest is deemed riba, and such practice is proscribed under Islamic law. It is haram, which means prohibited, as it is considered usurious and exploitative. By contrast, Islamic banking exists to further the socio-economic goals of an Islamic community.

Accordingly, Sharia-compliant finance (halal, which means permitted) consists of banking in which the financial institution shares in the profit and loss of the enterprise it underwrites. Of equal importance is the concept of gharar. In a financial context, gharar refers to the ambiguity and deception that come from the sale of items whose existence is uncertain. Examples of gharar would be forms of insurance. That could include the purchase of premiums to insure against something that may or may not occur. Derivatives used to hedge against possible outcomes are another type of gharar.

The equity financing of companies is permissible, as long as those companies are not engaged in restricted businesses. Prohibited activities include producing alcohol, gambling, and making pornography.

PRINCIPLES USED IN ISLAMIC FINANCE

Some of the principles and terms used in Islamic Finance are discussed below:

Mudarabah (Joint Venture)

Mudarabah is a form of partnership where one of the contracting parties, the rabb-al-mal (the financier), provides a specified amount of capital and acts like a sleeping or dormant partner, while the other party, called the mudarib (entrepreneur), provides the entrepreneurship and management for carrying on any venture, with the objective of earning profits. The mudarib is required to act with prudence and in good faith, and is responsible for losses incurred due to his willful negligence. He is expected to employ and manage the capital in such a manner as to generate optimum profits for the business without violating the values of Islam. The Mudarabah agreement can also be consummated between several financiers and entrepreneurs.

The Mudarabah agreement could be formal or informal, and written or oral. However, in view of the Quran's emphasis on the writing and formalizing of loan agreements, it would be preferable for all Mudarabah agreements to be in writing, to avoid any misunderstanding.

Musharakah (Joint Venture)

Musharakah is a joint enterprise or partnership structure in Islamic finance in which partners share in the profits and losses of an enterprise. Since Islamic law (Sharia) does not permit profiting from interest in lending, musharakah allows for the financier of a project or company to achieve a return in the form of a portion of the actual profits according to a predetermined ratio. However, unlike a traditional creditor, the financier also will share in any losses should they occur, also on a pro rata basis. Musharakah is a type of shirkah al-amwal (or partnership), which in Arabic means "sharing."

The following table lists the differences between Musharakah and Mudarabah:

Attribute	Musharakah	Mudarabah
Investment	All partners invest	Rabb-ul-mal is the investor
Managing	All partners can participate	It is the duty of the mudarib
Loss sharing	All partners have to share the loss	To be borne by Rabb-ul-mal
Liability	Usually partners have unlimited liability	The liability of the Rabb-ul-mal is limited by the capital he or she has invested

Some of the principles and terms used in Islamic Finance are discussed below:

Murabahah (Asset Based, Commonly Used for Cost Plus Financing)	This is a contract that effects a sale and purchase transaction for the financing of an asset. The cost and profit margin (mark-up) are made known and agreed upon by all parties involved at the beginning. The settlement for the purchase can be settled either on a deferred lump sum basis or on an installment basis, and is specified in the agreement.
Bai-al-Salam	This is a contract whereby payment is made in cash at point of contract but delivery of asset purchased is deferred to a pre-determined date.
Istisna (Manufacturing Contract)	This is a purchase order contract of assets whereby a buyer places an order to purchase an asset to be delivered in the future. The buyer requires the seller or a contractor to construct the asset and deliver in the future according to the specifications given in the sale and purchase contract. Both parties decide on the sale and purchase prices and the settlement can be delayed or arranged based on a schedule of work completed.
Ijarah (Leasing or Rent)	This is a manfaah (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to a client at an agreed rental-fee and predetermined lease period as agreed in aqd (contract). The ownership of the leased equipment usually remains in the hand of a lessor.
Takaful (Islamic Insurance)	This is an Arabic word that means mutual help and co-operation. This is the principle under which Islamic insurance companies are structured. Unlike insurance, the money from premium cannot be invested in interest bearing instruments and organizations that are not halal. Takaful is based on concept of mutual co-operation, responsibility, protection and assistance between groups of participants. It is similar to co-operative scheme wherein members contribute sums of money to a pool. Losses are divided and liabilities spread according to the community pooling system.
Sukuk (Islamic Bond)	Sukuk is the plural of Sakk or participation securities, investment certificates. In general terms, it is known as the Islamic equivalent of bonds or tradable certificates. Sukuk are tradable, like conventional bonds. They are usually asset backed and represent proportionate beneficial ownership in the underlying asset. Sukuks can be based on principles of Musharakah, Ijarah, etc.

ETHICAL ASPECTS IN ISLAMIC FINANCE

Islamic scholars have examined verses from the holy Quran and the Sunnah and have long established the basic principles, which govern the rights and obligations of participants in a financial system. While some differences in interpretation remain, these are some of the most broadly agreed precepts.

a. Freedom to Contract Within Permitted Commodities/ Activities

Trade is considered to be permissible and legal, but a contract is not valid if it involves an element of coercion or force. Further exchange, trade and investment is permitted only when undertaken in permissible commodities or property or activities. For example, trade is not permissible in alcohol-related businesses and casinos. Even trade in stocks or ownership interests in companies dealing with or producing these commodities is not permissible.

b. Freedom from Riba

While riba is commonly understood as interest, in Arabic it means 'to excess' or 'increase'. Aside from loans, all forms of contracts and transactions must be free from riba. As riba means 'excess', the prohibition of riba implies that there is no reward for time preference alone. Reward, returns or benefits must always accompany liability or risk.

c. Freedom from Al Gharar (Excessive Uncertainty and Ambiguity)

All forms of contracts and transactions must be free from excessive gharar (or uncertainty). One of the implications is that one cannot trade in objects that are not in possession (i.e. selling things one has not bought, or pay –offs upon the happening of some events that are difficult to predict. Freedom from gharar also means that the contract does not have ambiquity about terms. Further to this al-qimar (gambling) and al-maysir (unearned income) are also prohibited.

An Islamic businessman or business unit is required to assume risk after making a proper assessment of risk with the help of information. However, in absence of relevant information, or conditions of excessive uncertainty, any risk taken is similar to a game of chance. This is forbidden in Islamic law.

d. Freedom from Price Manipulation

Islam approves of a free market where prices are determined by forces of demand and supply. There should be no interference in the price formation process, even by the regulators. However, it may be noted here that while price control and fixation is generally considered as unIslamic, some scholars are of the view that it is permissible. However, it is permissible only in the context of correcting cases of market anomalies caused by impairment of the conditions of free competition.

e. Entitilement to Equal, Adequate and Accurate Information

Islam attaches great importance to the role of accurate information in the market. Release of misleasding information or concealing vital information (ghish) is a violation of Islamic ethical norms.

ISLAMIC FINANCE INDUSTRY

The Islamic finance market is a new but fast-growing development in banking, insurance and the capital markets.

a. Islamic Banking

Islamic banking in Malaysia began in September 1963 when Perbadanan Wang Simpanan Bakal-Bakal Haji (PWSBH) was established. PWSBH was set up as an institution for Muslims to save for their Hajj (pilgrimage to Mecca) expenses. In 1969, PWSBH merged with Pejabat Urusan Haji to form Lembaga Urusan dan Tabung Haji (now known as Lembaga Tabung Haji). Islamic banking refers to a system of banking that complies with Islamic law also known as Shariah law. The underlying principles that govern Islamic banking are mutual risk and profit sharing between parties, the assurance of fairness for all and that transactions are based on an underlying business activity or asset.

These principles are supported by Islamic banking's core values whereby activities that cultivate entrepreneurship, trade and commerce and bring societal development or benefit is encouraged. Activities that involve interest (riba), gambling (maisir) and speculative trading (gharar) are prohibited.

Through the use of various Islamic finance concepts such as ijarah (leasing), mudharabah (profit sharing), musyarakah (partnership), financial institutions have a great deal of flexibility, creativity and choice in the creation of Islamic finance products. Furthermore, by emphasising the need for transactions to be supported by genuine trade or business related activities, Islamic banking sets a higher standard for investments and promotes greater accountability and risk mitigation.

The first Islamic bank in Malaysia (Bank Islam Malaysia Berhad, BIMB) was established in 1983. In 1993, commercial banks, merchant banks and finance companies were allowed to offer Islamic banking products and services under the Islamic Banking Scheme (IBS). These institutions however, are required to separate the funds and activities of Islamic banking transactions from that of the conventional banking business to ensure that there would not be any co-mingling of funds.

The list of banks in Malaysia offering Islamic products (updated in 2015) have grown to 16 banks. Apart from banks, other non-banks intermediaries offering syariah based products are Malaysia Building Society Berhad (MBSB) and cooperatives registered under the Cooperative Commission of Malaysia (SKM).

In Malaysia, the National Shariah Advisory Council additionally set up at Bank Negara Malaysia (BNM) advises BNM on the Shariah aspects of the operations of these institutions, as well as on their products and services.

b. Takaful

Syarikat Takaful Malaysia Berhad is a first takaful company in Malaysian. The company was formed in 1984 at the recommendation of Task Force on the Study for the Establishment of an Islamic Insurance Company in Malaysia commissioned by the government.

Takaful is insurance protection based on Shariah principles. You contribute a sum of money to a common takaful fund in the form of participative contribution. You undertake a contract (aqad) to become one of the participants by agreeing to mutually help each other, should any of the participants suffer a specified loss.

Both insurance and takaful have similar basic principles. For example, in both insurance and takaful, you must suffer a financial loss when the insured event occurs. While takaful offers products similar to conventional insurance, it has some unique features:

- The surplus of the fund is shared between you and the takaful company based on a pre-agreed ratio. The amount in the surplus fund is calculated after deducting expenses such as claims, technical reserves, management expenses and re-takaful.

  You are entitled to this surplus if you had not made a claim during the period of the takaful.

- You are entitled to this surplus if you had not made a claim during the period of the takaful.

c. Islamic Capital Market

The Islamic Capital Market (ICM) functions as a parallel market to the conventional capital market in Malaysia. In the ICM, market transactions are carried out in ways that do not conflict with the conscience of Muslims and the religion of Islam.

Investing in Shariah-compliant securities is not limited to only Muslims as Shariah- compliant securities are part of the securities listed on Bursa Malaysia. In general, all ICM instruments and institutions must comply with Shariah principles, namely:

1	2	3	4	5
Prohibition of riba (interest)	Application of al bai' (trade and commerce)	Avoidance of gharar (ambiguity) in contractual agreement	Prohibition of maisir (gambling)	Disengagement from production of prohibited commodities, such as liquor, pork, tobacco, etc.

Among the products currently available for which Shariah principles are applied include:

Sukuk

Sukuk is a financing instrument for the purpose of raising funds by companies or governments (issuers) and the underlying transaction is structured based on various Shariah principles/contracts. Sukuk investors are entitled to the income/profit arising from the underlying transaction.

Shariah-Compliant Securities

Shariah-compliant securities are securities listed on Bursa Malaysia which have been classified as Shariah permissible for investment, based on the company's compliance with Shariah principles in terms of its primary business and investment activities.

Islamic Unit Trust Funds

Islamic unit trust funds are a collective investment scheme that offers investors the opportunity to invest in a diversified portfolio of Shariah-compliant securities, fixed income securities and money market instruments.

Islamic Real Estate Investment Trusts

Islamic real estate investment trusts or I-REITs are collective investment vehicles (typically in the form of trust funds) that pool money from investors and use the pooled capital to buy, manage and sell real estate. I-REITs provide an investment opportunity for those who wish to invest in real estate through Shariah-compliant capital market instruments.

EXERCISE QUESTIONS

Based on the statement in the table below, show the right answer by circle or bold the True (T) or False (F).

1	Accounting firm is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange.	T /F
2	Non-bank financial intermediaries (NBFIs) are thus a heterogeneous group of financial institutions other than commercial banks.	T /F
3	Common Stock can also be treated as a debt instrument as they do not confer voting rights on its holders and have a dividend payment that is structured like interest (coupon) paid for bonds issues.	T /F
4	Maximizing the wealth of the shareholders takes into account the time the return is gained and the risk.	T /F
5	The share holders will react well on the good financial decision by selling out their share, thus lead on to the increment of the market stock price.	T /F
6	Dividend policies generally have the significant impact on the firm ordinary share price.	T /F
7	Decision related to the working capital investment is not routine whereby it will affect the company's survival and endurance.	T /F
8	A central bank is an independent national authority that conducts monetary policy, regulates banks, and provides financial services including economic research.	T /F
9	Finance institution is an institution which channels the saving of individuals, government and business into a form of loan and investment.	T /F
10	Financial markets are also known as securities markets.	T /F
11	Short term securities are sold in the capital market.	T /F
12	The secondary market is defined as a market where new securities are bought and sold for the first time.	T /F
13	Bai-al-Salam is a contract whereby payment is made in cash at point of contract but delivery of asset purchased is deferred to a pre-determined date.	T /F
14	Takaful is a manfaah (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to a client at an agreed rental-fee and predetermined lease period as agreed in aqd (contract).	T /F

EXERCISE QUESTIONS

Based on the statement in the table below, show the right answer by circle or bold the True (T) or False (F).

15	In finance, the main goal in a firm is to maximize the price of the company's asset market price.	T / F
16	One of the information limitations of maximizing profit is it does not take into account the time the return is gained in any project.	T / F
17	The non-bank intermediaries have the ability to generate multiple expansion of credit. Commercial banks do not have such ability. They simply mobilize savings for investment.	T / F
18	Sukuk are collective investment vehicles (typically in the form of trust funds) that pool money from investors and use the pooled capital to buy, manage and sell real estate.	T / F
19	Equity Market is an auction market in which participants buy and sell commodity and futures contracts for delivery on a specified future date.	T / F
20	Both insurance and takaful have similar basic principles. For example, in both insurance and takaful, you must suffer a financial loss when the insured event occurs.	T / F
21	Commercial paper is a short term instruments promissory notes issued by company at discount to face value and redeemed at face value.	T / F
22	In finance, generally there are 2 company goals which is profit maximization and maximization of shareholder wealth.	T / F
23	In finance, profit maximization means maximizing the total market value (or market price) of the existing shareholders common stock.	T / F
24	Objective to maximize shareholder wealth stresses on the amount of profit gained and not when is it gained. Hence its does not consider the timing of the returns. It does not matter how late the profits are received as long as the amount are huge.	T / F
25	Objective to maximize the profit ignore the risk and uncertainty involved in any investment.	T / F

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