

Finance 3220 Midterm 1 Study Guide

- **Chapter 1**
 - o **Partnership:** a business owned and run by more than one owner
 - 1. All partners are liable for the firm's debt.
 - 2. The partnership ends in the event of the death or withdrawal of any single partner
 - 3. Partners can avoid liquidation if the partnership agreement provides for alternatives (buyout of a decreased or withdrawn partner)
 - o **Limited Partnership:** a partnership with two kinds of owners, general partners and limited partners
 - Limited partners have **limited liability:** liability only pertains to their investment and their private property cannot be seized to pay off the firm's outstanding debts
 - o **Limited Liability Company:** a limited partnership without a general partner
 - o **Corporation:** A legally defined, artificial being, separate from its owners
 - **Stock:** the ownership or equity of a corporation dividend into shares
 - o **S Corporations:**
 - Elect subchapter S tax treatment and are exempted by the US Internal Revenue Service's tax code from double taxation
 - o **C Corporations:**
 - Have no restrictions on who owns their shares or the number of shareholders; they cannot qualify for subchapter S treatment and are subject to direct taxation
 - o **Agency Problem:**
 - When managers, despite being hired as the agents of shareholders, put their own self-interest ahead of the interests of those shareholders
 - o **Primary Market:**
 - A corporation issues new shares of stock and sells them to investors
 - o **Secondary Market:**
 - Markets, such as NYSE or NASDAQ, where shares of a corporation are traded between investors without the involvement of the corporation

Chapter 3

- **The Valuation Principle:**
 - o The value of a commodity or an asset to the firm or its investors is determined by its competitive market price. The benefits and costs of a decision should be evaluated using those market prices. When the value of the benefits exceeds the value of the costs, the decision will increase the market value of the firm.
- **Law of One Price:**
 - o In competitive markets, securities with the same cash flows must have the same price

- **Compound Interest:**
 - o The effect of earning "interest on interest"

Chapter 4

- **Stream of Cash Flows:**
 - o A series of cash flows lasting several periods
- **Perpetuity:**
 - o A stream of equal cash flows that occurs at regular intervals and lasts FOREVER
 - o Example:
 - *Consol*- A bond that promises its owner a fixed cash flow every year that is used by the British government
- **Annuity:**
 - o A stream of equal cash flows arriving at a regular interval and ending after specified time period

Chapter 5

- **EAR (Effective Annual Rate)**
 - o The total amount of interest that will be earned at the end of one year
- **APR (Annual Percentage Rate)**
 - o Indicates the amounts of interest earned in one year without the effect of compounding
 - It's indicating the amount of *simple interest* earned in one year
- **Amortizing Loan**
 - o A loan on which the borrower makes monthly payments that include interest on the loan plus some part of the loan balance
- **Nominal Interest Rate**
 - o Interest rates quoted by banks and other financial institutions that indicate the rate at which money will grow if invested for a certain period of time
- **Real Interest Rate**
 - o The rate of growth of purchasing power after adjusting for inflation

Chapter 6

- **Bond Certificate:**
 - o States the terms of a bond as well as the amounts and dates of all payments to be made
- **Face value, par value, principal amount**
 - o The notional amount of a bond used to compute its interest payments. The face value of the bond is generally due at the bond's maturity
- **Coupons:**
 - o The promised interest payments of a bond, paid periodically until the maturity date of the bond

- **Zero-coupon Bonds/Pure Discount Bonds:**
 - A bond that makes only one payment at maturity
 - Example: US Treasury Bills
- **Coupon Bonds:**
 - Bonds that pay regular coupon interest payments up to maturity, when the face value is also paid
- **Discount:**
 - A price at which coupon bonds trade that is less than their face value
- **Premium:**
 - A price at which coupon bonds trade that is greater than their face value
- **Par**
 - A price at which coupon bonds trade that is equal to their face value

Chapter 7

- **Common Stock:**
 - A share of ownership in the corporation, which confers rights to any common dividends as well as right to vote on election of directors, mergers, and other major events
- **Preferred Stock:**
 - Stock with preference over common shares in payment of dividends and in liquidation
- **Floor broker:**
 - A person at the NYSE with a trading license who represents order on the floor, balancing speed and price to get the best execution
- **Equity Cost of Capital:**
 - The expected rate of return available in the market on other investments that have equivalent risk to the risk associated with the firm's shares
 - Leads to stock price equation
- **Dividend Yield:**
 - The expected annual dividend of a stock divided by its current price; the percentage return an investor expects to earn from the dividend paid by the stock
 - $= \text{Div}_1 / P_0$
- **Capital Gain:**
 - The amount by which the selling price of an asset exceeds its initial purchase price
 - $= p_1 - p_0 / p_0$