Areas of Finance

Money & Capital Markets

Functions and regulation of markets and institutions
Interest rate determination

- ECON 3210 The Financial System and the Economy
- ECON/FIN 4260 Financial Markets and Institutions

Investments

Security valuation
Portfolio formation

- FIN 3810 Investments
- FIN 4810 Portfolio Theory and Management

Business/Corporate/Managerial Finance

raising/using new funds
managing existing assets
coordinating other managers

- FIN 3010 Principles of Corporate Finance
- FIN 3950 Corporate Finance
- FIN 4110 Cases in Finance
- FIN 4860 International Financial Management

Forms of Business Organization

Sole Proprietorship
One person owns business, bears full liability
Easy to form

Partnership
Two or more people own business, each bears full liability
Easy to form

Limited Partnership
General partner bears full liability
Limited partners have limited

Corporation
Expensive to form
Shareholders have limited liability
Transferability of shares
Longevity of firm
$\Rightarrow$ Investment Risk Reduced
$\Rightarrow\Rightarrow$ Capital Formation Enhanced

Major Corporate Financial Decisions

Issue(s)

Firms need (real) assets to operate and funds to acquire them
To raise funds, firms sell securities (financial assets) to investors

Importance

Implications for firm's survival, shareholders' wealth

Decisions

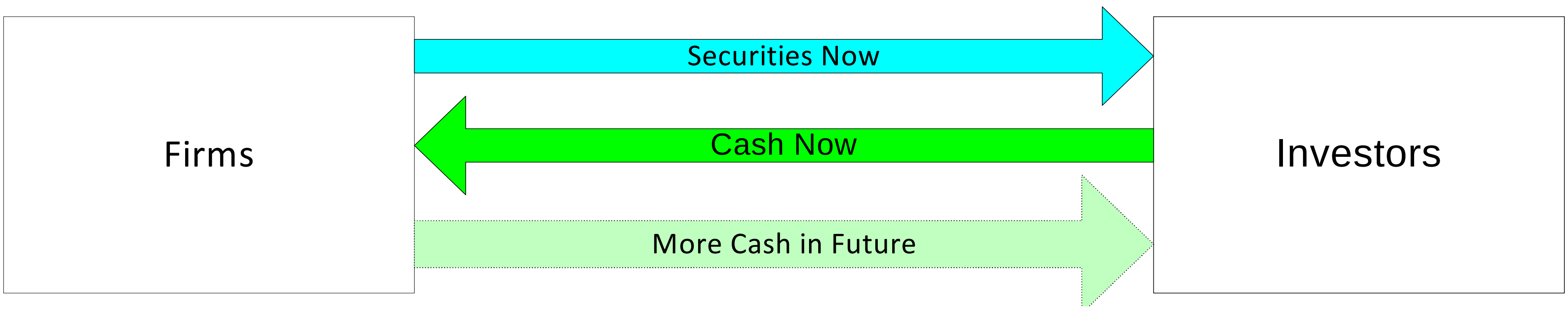
✓	Capital Budgeting	Which assets to acquire?
	Capital Structure	How to finance the assets (debt or equity)?
	Dividend Policy	How to reward stockholders (dividend or capital gain)?
	Working Capital Policy	How much to rely on current assets/liabilities?

Assets	Claims
Current Assets	Current Liabilities
Fixed Assets	Long-Term Debt
	Equity

Decisions ⇒ Cash Flows ⇒ Stock Price ⇒ Shareholder Wealth

Security Values and Firm Performance

Issue
Firms sells securities to investors in order to raise cash
Investors buy securities in order to receive future cash flows (e.g., dividends, interest)
Investors' willingness to pay depends on their expectations about firm's *future* cash flows



Determinants of Security Values
Size of future cash flows
Timing of future cash flows
Risk of future cash flows
Current financial market conditions (e.g., level of interest rates, other opportunities)

Financial Markets
Firms raise funds
Investors judge firm's *prospects*

Goals of the Firm

Maximize Shareholder Wealth
Shareholders own the firm, bear the risk
Share price reflects expectation of future performance

Why not Maximize Profits?
Not cash
Ignores opportunity costs (“normal” profit)
Ignores timing (today’s v. tomorrow’s profits)
Ignores risk (“quality of earnings”)
Capital structure
Dividend policy

What about Social Responsibility?
Competitive pressure
“Invisible Hand”: maximizing wealth maximizes social welfare
    Efficiency: optimal output mix, in optimal quantity, produced in least-cost way

Other “Stakeholders”?
Management, employees, suppliers, creditors, customers, community

Agency: Ethical Issues

Agency Relationships
Exists when one person–the Principal–hires another–the Agent–to make decisions on his (the Principal's) behalf
Ethically, the Agent should always act in the interests of the Principal
However, conflicts of interest are possible, because Agents are people, too

Agency Costs
Losses of value due to sub-optimal decisions (mostly opportunity costs)
Costs of remediation (mostly out-of-pocket)

Possible Conflicts
- Shareholders (Principals) v. Managers (Agents)
  - Problems: excessive compensation/perquisites, shirking, MBOs
  - Remedies: monitoring, firing, takeover, incentive compensation
- Conflict: Shareholders and Managers (Agents) v. Creditors (Principals)
  - Problems: liquidating dividends, project switching
  - Remedies: monitoring, restrictive covenants

Context for Decision-Making

External Environment	Managerial Decisions	Cash Flows	Shareholder Wealth
Legal/Regulatory	Type of Output	Size	Stock Price
Antitrust	Production Method	Timing	
Environmental	Financing	Risk	
Product Safety	Dividend Policy		
Workplace Safety	Working Capital		
Employment	Policy		
Business Conditions			
Economic Activity			
Competition			
Taxes			
Financial Market Conditions			

The external environment is given: managers must work within it. However, the environment also directly and independently affects cash flows and shareholder wealth.