

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

⇒ Investment Risk Reduced

⇒⇒ 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 sell 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

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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

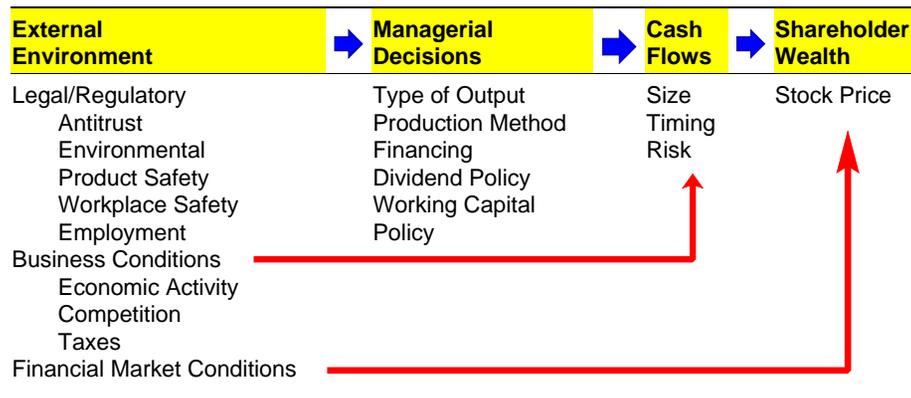
Losses of value due to sub-optimal decisions (mostly opportunity costs)
Costs of remediation (mostly out-of-pocket)

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

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Context for Decision-Making



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

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