

## Areas of Finance

### Money & Capital Markets

Functions and regulation of markets and institutions

Interest rate determination

ECN 3210 The Financial System and the Economy  
E/F 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 Business Finance  
FIN 3950 Intermediate Financial Management  
FIN 4110 Managerial Finance  
FIN 4860 International Financial Management

## 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 stock)?             |
| 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

Investors buy securities for future cash flows (e.g., dividends, interest)

Investors' willingness to pay depends on their expectations about firm's *future* cash flows, which depend in part on firm's performance up to that point



### 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., general level of interest rates)

### 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

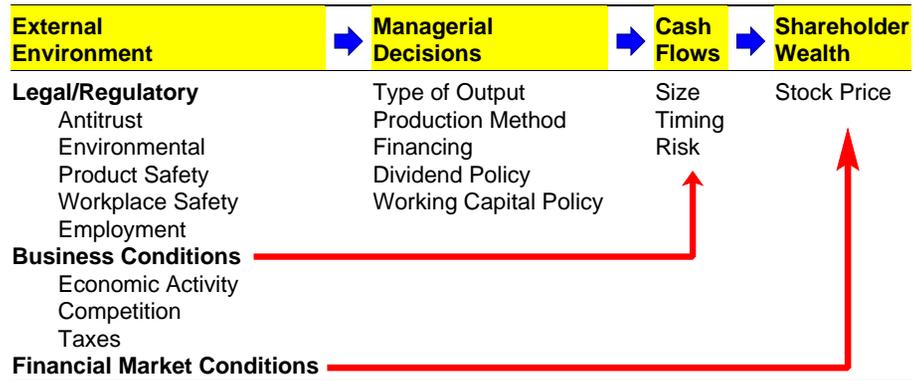
"Invisible Hand": maximizing wealth maximizes social welfare

Efficiency: optimal output mix, in optimal quantity, produced in least-cost way

### Other "Stakeholders"?

Management, employees, suppliers, creditors, customers, community

## 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.

## Other Issues

### Agency Relationships (Ethical Issues)

Conflicts of Interest Possible

Conflict: Shareholders (Owners) v. Managers

Problems: excessive compensation/perquisites, shirking, MBOs

Remedies: monitoring, firing, takeover, incentive compensation

Conflict: Shareholders (and Managers) v. Creditors

Problems: liquidating dividends, project switching

Remedies: monitoring, restrictive covenants

### Advantages of Corporate Form of Organization

Limited Liability for shareholders

Transferability of shares

Longevity of firm

⇒ Investment Risk Reduced

⇒⇒ Capital Formation Enhanced