Chapter Outline

1.1 What is Corporate Finance?
1.2 Corporate Securities as Contingent Claims on Total Firm Value
1.3 The Corporate Firm
1.4 Goals of the Corporate Firm
1.5 Financial Markets
1.6 Outline of the Text

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What is Corporate Finance?

Corporate Finance addresses the following three questions:

1. What long-term investments should the firm engage in?
2. How can the firm raise the money for the required investments?
3. How much short-term cash flow does a company need to pay its bills?

The Balance-Sheet Model of the Firm

The Financial Manager

To create value, the financial manager should:

1. Try to make smart investment decisions.
2. Try to make smart financing decisions.

The Firm and the Financial Markets

Ultimately, the firm must be a cash generating activity.
1.3 The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
- However, businesses can take other forms.

1.4 Goals of the Corporate Firm

- The traditional answer is that the managers of the corporation are obliged to make efforts to maximize shareholder wealth.

A Comparison of Partnership and Corporations

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Partnership</th>
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</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>Shares can easily be exchanged.</td>
</tr>
<tr>
<td>Voting Rights</td>
<td>Usually each share gets one vote</td>
</tr>
<tr>
<td>Taxation</td>
<td>Double</td>
</tr>
<tr>
<td>Reinvestment and dividend payout</td>
<td>Broad latitude</td>
</tr>
<tr>
<td>Liability</td>
<td>Limited liability</td>
</tr>
<tr>
<td>Continuity</td>
<td>Perpetual life</td>
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</tbody>
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Managerial Goals

- Managerial goals may be different from shareholder goals:
  - Expensive perquisites
  - Survival
  - Independence
- Increased growth and size are not necessarily the same thing as increased shareholder wealth.
Do Shareholders Control Managerial Behavior?

- Shareholders vote for the board of directors, who in turn hire the management team.
- Contracts can be carefully constructed to be incentive compatible.
- There is a market for managerial talent—this may provide market discipline to the managers—they can be replaced.
- If the managers fail to maximize share price, they may be replaced in a hostile takeover.