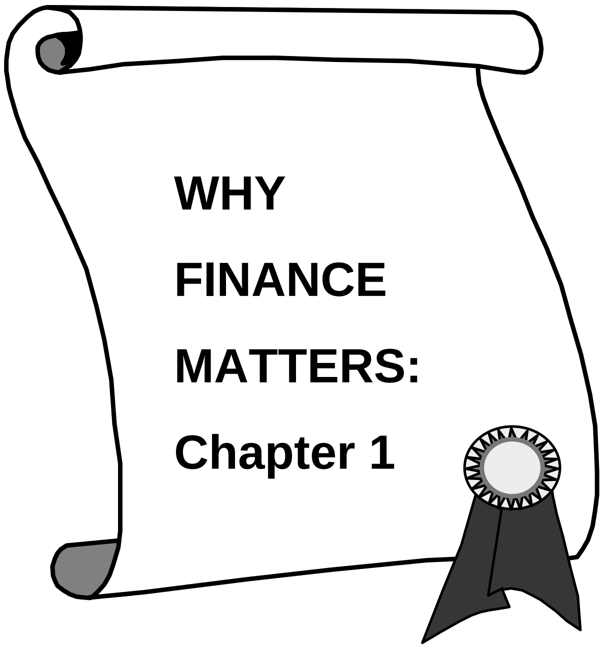


TWO FINANCIAL DECISIONS

INVESTMENT OR CAPITAL BUDGETING

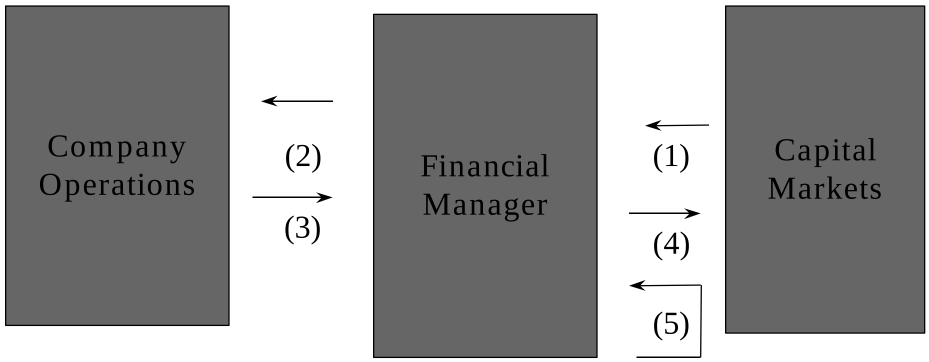
FINANCING

WHAT TO INVEST IN

HOW TO PAY FOR IT

SUCCESS IS JUDGED IN TERMS OF VALUE

The flow of cash

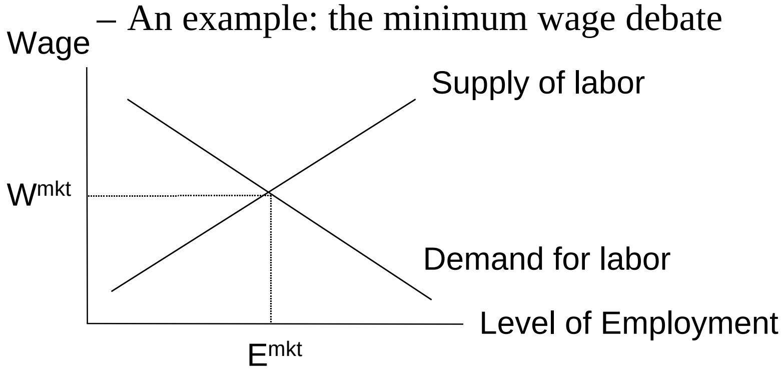


FINANCIAL DECISION MAKING

- Theory vs. Cases
  - An example from the pool hall
- Assumptions
  - The building blocks of theories- language
  - Judged by logical consistency- not realism
- Theories
  - Hypotheses, implications ... judged by accuracy of predictions

FINANCIAL DECISION MAKING

- The science vs. the art of finance
- Positive vs. normative economics
  - An example: the minimum wage debate



THE GOAL OF THE FIRM

- MAXIMIZE PROFITS?

Problem: Ignores timing and uncertainty

MAXIMIZE SHAREHOLDERS' WEALTH

The concept of wealth

- **Who is wealthier?**

  Fife: Has $100,000 in bank and expects no future income... <u>or</u>

  Rose: Has nothing in the bank, but expects $150,000 in 3 years
- **Is the goal of zero profits for 5 years ever consistent with wealth maximization?**
- **Need to consider risk and the time value of money**

Consider a different question:

- Does the objective of wealth maximization ever conflict with the objective that firms act in a socially responsible manner?

or...

Should firms go past the point of wealth maximization in being socially responsible?

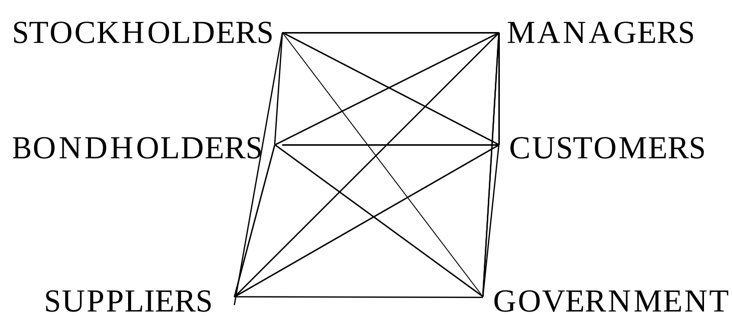
<u>A case to consider</u>:

Should a chemical company voluntarily clean up a local river ?

What do managers actually do?

- Managers are rational “utility maximizers”
- Leads to “agency problem”
  – Managers are agents of shareholders’
- Agency problem more severe with advent of corporations
  - 1. Owner-managed firm
  - 2. Single owner-not manager
  - 3. Many owners-single manager
- How are managers kept in line?

THE CONTRACT VIEW OF THE FIRM



A NEXUS OF CONTRACTS