WHY FINANCE MATTERS:
Chapter 1

TWO FINANCIAL DECISIONS
INVESTMENT OR CAPITAL BUDGETING

WHAT TO INVEST IN

FINANCING

HOW TO PAY FOR IT

SUCCESS IS JUDGED IN TERMS OF VALUE
The flow of cash

Company Operations \[\rightarrow\] Financial Manager \[\rightarrow\] Capital Markets

\[\rightarrow\] (2) (3) \[\rightarrow\] (1) (4) \[\rightarrow\] (5)

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... or
  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?
A case to consider:
  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

STOCKHOLDERS  MANAGERS
BONDHOLDERS  CUSTOMERS
SUPPLIERS  GOVERNMENT

A NEXUS OF CONTRACTS