**Corporate finance**

A division or department that oversees the financial activities of a company. Corporate finance is primarily concerned with maximizing shareholder value through long-term and short-term financial planning and the implementation of various strategies. Everything from capital investment decisions to investment banking falls under the domain of 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?

**Task of financial manager**

1. **Investment** decisions.
2. **Financing** decisions.
3. **Asset management** decisions

**Investment Decisions**

* What is the optimal firm size?
* What specific assets should be acquired?
* What assets (if any) should be reduced or eliminated?

**Financing Decisions**

* What is the best type of financing?
* What is the best financing mix?
* What is the best dividend policy (e.g., dividend-payout ratio)?
* How will the funds be physically acquired?

**Asset Management Decisions**

* How do we manage existing assets *efficiently*?
* Financial Manager has varying degrees of operating responsibility over assets.
* Greater emphasis on current asset management than fixed asset management.

**Agency Theory**

A supposition that explains the relationship between principals and agents in business. Agency theory is concerned with resolving problems that can exist in agency relationships; that is, between principals (shareholders) and agents of the principals (management).

**Agency** **problems**

1.) The problems that arise when the desires or goals of the principal and agent are in conflict, and the principal is unable to verify (because it difficult and/or expensive to do so) what the agent is actually doing;

2.) The problems that arise when the principal and agent have different attitudes towards risk. Because of different risk tolerances, the principal and agent may each be inclined to take different actions.

Thus, **Principals must provide *incentives* so that management acts in the principals’ best interests and then *monitor* results.** (Incentives include stock options, perquisites, and bonuses.)

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| **Profit Maximization** | **Wealth (earning per share) maximization** |
| Maximizing a firm’s earnings after taxes | Maximizing earnings after taxes divided by shares outstanding. |
| **Problems** |  |
| * Could increase current profits while harming firm (e.g., defer maintenance, issue common stock to buy T-bills, etc.). * Ignores changes in the risk level of the firm. | * Does not specify timing or duration of expected returns. * Ignores changes in the risk level of the firm. * Calls for a zero payout dividend policy. |
|  | **strength** |
|  | * Value creation occurs when we maximize the share price for current shareholders. * Takes account of: current and future profits and EPS; the timing, duration, and risk of profits and EPS; dividend policy; and all other relevant factors. * Share price serves as a barometer for business performance.   **Thus goal of firm is wealth maximization** |