Chapter 1 Introduction to Corporate Finance

OVERVIEW

- This chapter provides an overview of the field of finance.

- In the lectures, the role of corporations, financial managers and financial markets in the financial decision making process were briefly explained.

- The success of any firm in financial management is measured by increase in the value of the firm. The financial decisions made by firms are generally geared towards this objective.

- Generally, there are two types of financial decisions that are made in a corporation: investment decisions and financing decisions.

- In order to make these decisions a financial manager not only uses input from the corporation, but also from financial markets.

- Related topics, such as different types of corporations, the role of the financial manager, and the importance of well-functioning financial markets in the financial decision making process, were discussed.

LEARNING OBJECTIVES

After studying this chapter, you must have the understanding of the:
- definition of a corporation and how finance fits into the corporate structure;
- role of the financial manager in a corporation;
- functions of financial markets;
- principal-agent problems, agency costs and information asymmetries.

POINTS EMPHASISED IN THE LECTURE

Corporate investment and financing decisions
- Both types of decisions were presented under the umbrella the corporation. These two concepts are driving the book.

- The emphasis on **corporation** is very important. ***You must not deviate into business structures that are not necessarily the core focus of the book***.

- The financial manager is pictured as an intermediary between capital markets and the firm's operations, responsible both for **financing decisions (decisions that involve raising money)** and **investment decisions (decisions that involve spending money)**.

- The financial manager must understand (i) how risky, long-lived assets are valued in order to make decisions that benefit the shareholders/owners, and (ii) the functions of financial markets.

- Financial markets provide a source of financing for corporations. Financial markets provide liquidity for investors by providing a place to trade securities.

- The **opportunity cost of capital** is another very important concept. *You may have encountered this phrase already from an economics course, but may not fully comprehend the component of risk that is attached to opportunity cost.* Opportunity cost of capital is the starting point of the emphasis on risk return trade-offs.

The financial goal of the corporation

- **Value maximisation** was presented as a traditional concept. But in the lecture, this goal was expanded to include other components, such as ethics and stakeholders.

- We did not attempt to define the goal of the corporation as etched in stone. Issues concerning **ethics**, stakeholders and other issues which impact value creation, were likewise pointed out.

- The **separation of ownership and management** is an important characteristic of the corporation. It has advantages and disadvantages. In the ideal case, this enables the managers to make decisions without worrying about owners' preferences. But, this also gives rise to **principal-agent problems** and **agency costs**.

- **Information asymmetries** are major barriers to resolving principal-agent problems facing corporations. Related to this is the topic of corporate governance (system of rules, practices and processes by which a company is directed and controlled). **Corporate governance** is a mechanism designed to balance the interests of a company's many stakeholders (e.g., shareholders, management, customers, suppliers, investors/financiers, government and the community).