

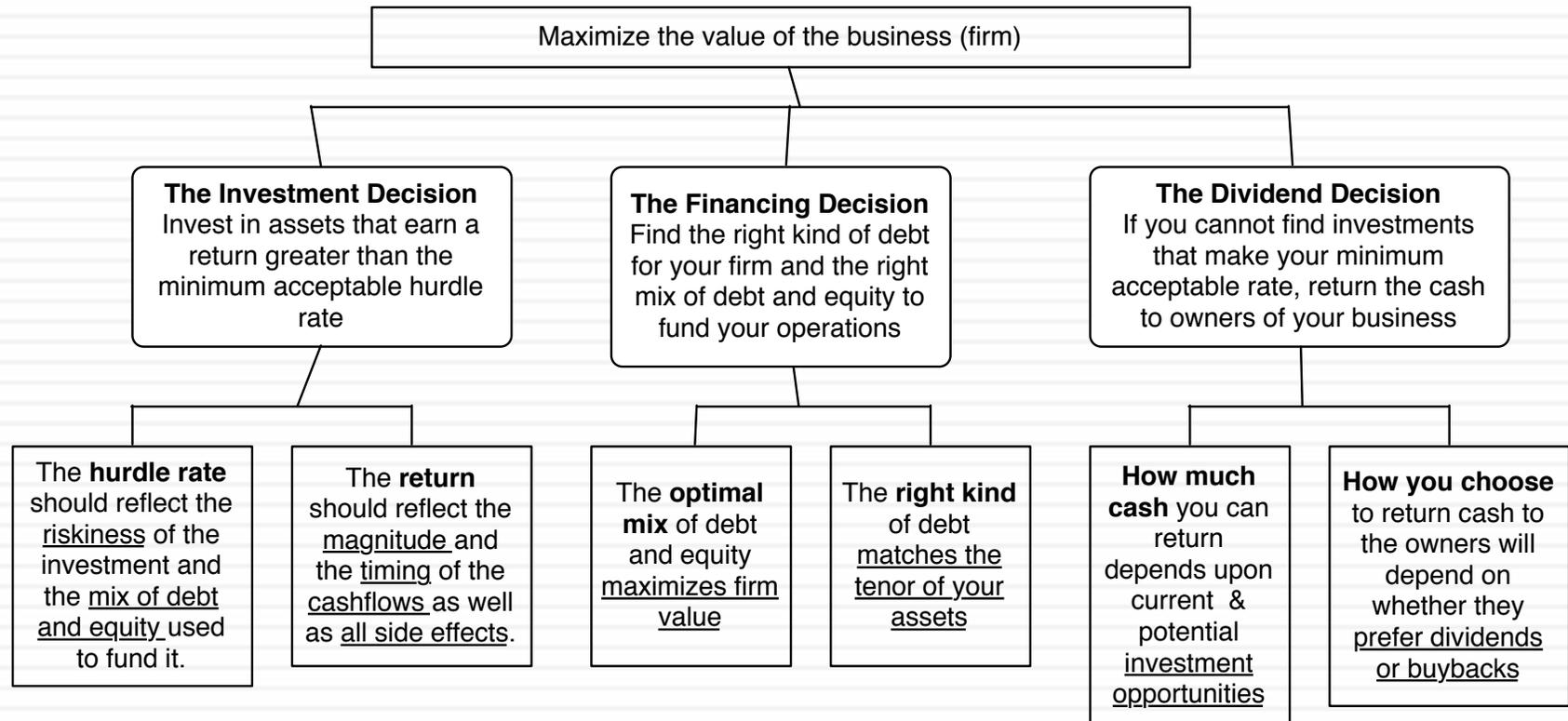


THE OBJECTIVE IN CORPORATE FINANCE

“If you don’ t know where you are going, it does’nt matter how you get there”

First Principles

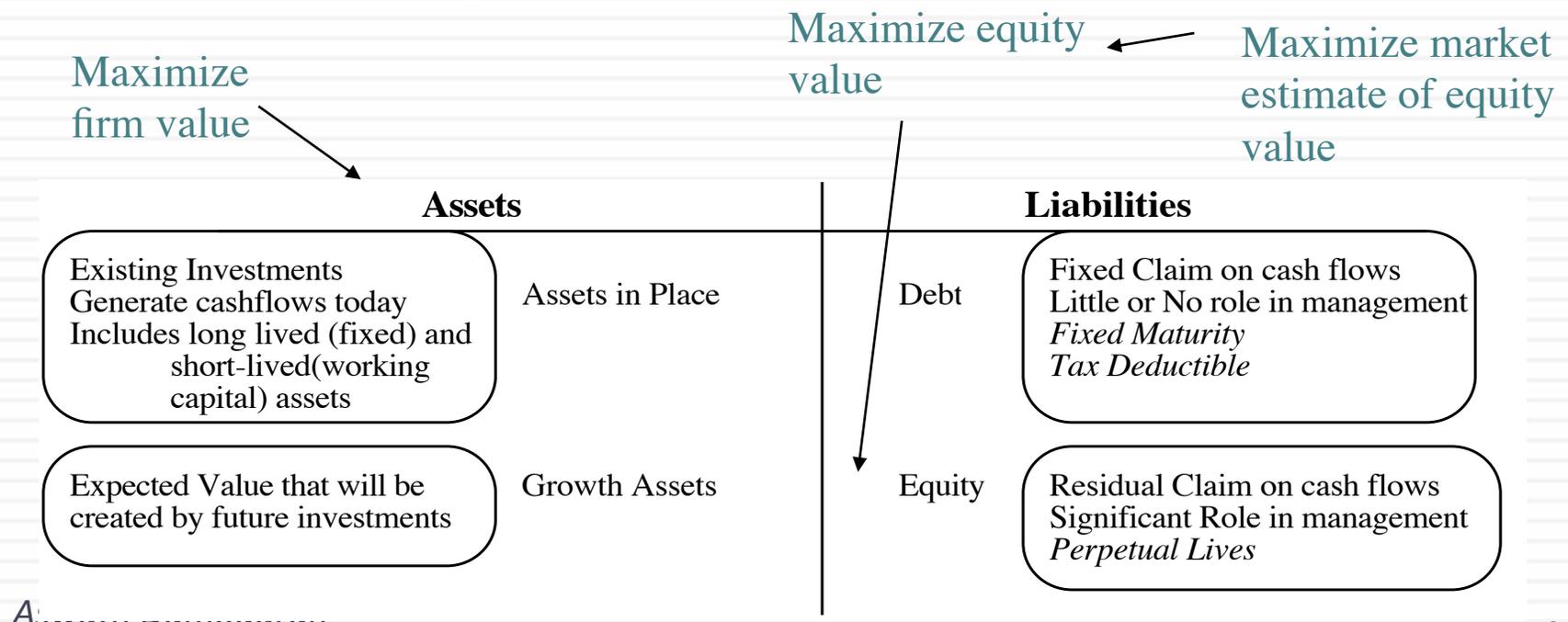
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The Objective in Decision Making

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- In traditional corporate finance, the objective in decision making is to maximize the value of the firm.
- A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.



Assets = Liabilities + Equity

Maximizing Stock Prices is too “narrow” an objective: A preliminary response

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- Maximizing stock price is not incompatible with meeting employee needs/objectives. In particular:
 - ▣ Employees are often stockholders in many firms
 - ▣ Firms that maximize stock price generally are profitable firms that can afford to treat employees well.
- Maximizing stock price does not mean that customers are not critical to success. In most businesses, keeping customers happy is the route to stock price maximization.
- Maximizing stock price does not imply that a company has to be a social outlaw.

Why traditional corporate financial theory focuses on maximizing stockholder wealth.

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- Stock price is easily observable and constantly updated (unlike other measures of performance, which may not be as easily observable, and certainly not updated as frequently).
- If investors are rational (are they?), stock prices reflect the wisdom of decisions, short term and long term, instantaneously.
- The objective of stock price performance provides some very elegant theory on:
 - Allocating resources across scarce uses (which investments to take and which ones to reject)
 - how to finance these investments
 - how much to pay in dividends

The Classical Objective Function

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