Financing alternatives

- Debt Financing:
  - arranging funding by borrowing money
- Equity Financing
  - arranging funding by selling ownership shares in the company, publicly or privately

Characteristic	*Debt Financing*	*Equity Financing*
Maturity	Specific: specifies a date by which debt must be paid	N/A
Claim on income	Non-discretionary, usually a recurring cost and usually fixed: debt obligations must be repaid, regardless of whether the company is profitable, payments must be regular, balloon (repaid all at once) or combination	Discretionary cost: at managements discretion and if company is profitable: shareholders receive dividends after creditors have been paid
Claim on assets	Priority: lenders have prior claims on assets	Residual: shareholders have claims only after the firm satisfies claims of lenders
Influence over management	Usually little: usually no influence unless debit vehicles come with conditions or if management fails to make payments on time	Varies: as owners of the company, shareholders can vote on some aspects of corporate operations, although in practice only large shareholders have such influence
Tax consequences	Deductible: debt payments reduce taxable income, lowering tax obligations	Not deductible: dividend payments are not tax deductible
Employee benefit potential	N/A	Stock options: issuing company shares creates the opportunity to use stock options as a motivation or retention tool

4. Foundations and biases in financial decision making

Expected utility theory

- Individuals should act when confronted with decision making under certainty in a certain way
- Theory is really set up to deal with risk, not uncertainty:
  - risk is when you know what the outcomes could be, and can assign probabilities
  - uncertainty is when you cant assign probabilities, or you cant come up with a list of possible outcomes

Prospect theory

- Developed by Kahneman and Tversky based on observing actual behavior
- Experimental evidence says that people often behave contrary to expected utility theory
- Expected utility theory is normative: what people should do
- Prospect theory is positive: what people do

Prospect theory

	Gains	**Losses**
High Probability (certain effect)	95% to win $10 000 vs. 100% to win $9 499 Risk averse Take unfavorable settlement	95% to lose $10 000 vs. 100% to lose $9501 Risk seeking Reject favorable settlement
Low probability (probability effect)	5% to win $10 000 vs. 100% to win $501	5% to lose $10 000 vs. 100% to lose $499

	Risk seeking Reject favorable settlement	Risk averse Take unfavorable settlement

Heuristics and biases in decision-making

- List of cognitive biases:
  - → Mental/psychological accounting
  - → Framing
  - → Gamblers fallacy
  - → Anchoring and adjustment
  - → Overconfidence
  - → Mood

Prospect Theory and mental accounting

- Problem with prospect theory is that it was set up to deal with one-shot gambles – but what if there have been prior gains or losses?
- Do we go back to zero (segregation) or move along curve (integration)

Impact of overconfidence on financial decision-making

- Inflated sense of abilities
- Investments are under diversified
- Too ready to enter markets
- Overinvest
- Allow cash flows to dictate investment
- Acquire other companies too quickly
- Take on too much debt

Step to eliminate bias

- Awareness of bias
- Motivation
- Direction and magnitude awareness
- Ability

Concepts Review in Tutorial

What is the role of a capital management?

- Markets for buying and selling equity (shares/stocks) and debt (bonds) instruments. Capital markets channel savings and investment between suppliers of capital such as retail investors and institutional investors, and users of capital like businesses, government and individuals.
- Capital markets are vital to the functioning of an economy, since capital is a critical component for generating economic output. Capital markets include primary markets, where new stock and bond issues are sold to investors, and secondary markets, which trade existing securities
- Capital markets typically involve issuing instruments such as stocks and bonds for the medium-term and long-term. In this respect, capital markets are distinct from money markets, which refer to markets for financial instruments with maturities not exceeding one year.

What are the financial decisions faced by managers? How are they related to each other?

- Dividend Decisions: returns, equity
- Financing Decisions: capital market – debt & equity finance
- Investment Decisions: assets

What is an example of a real business financial position faced by each?