Financial Theory, Breakdown of Separation Theorems, and Corporate Policies

Hung-Gay Fung,[a] Jot Yau,[b] Gaiyan Zhang,[c]

a. Dr. Y.S. Tsiang Professor ,College of Business Administration, University of Missouri-St. Louis, One University Blvd St. Louis, MO 63141, USA

b. Professor of Finance, Albers School of Business and Economics, Seattle University, Seattle, WA 98122, USA

c. Assistant Professor of Finance, College of Business Administration, University of Missouri-St. Louis, One University Blvd St. Louis, MO 63141, USA

Abstract: This study examines the implications of the separation theorems in finance to shed light on how these theorems can be refined to accommodate real life financial applications and decision makings. We also generalize the financial theory of the firm by incorporating real options in the production function to accommodate the complexity of real world issues. This modified financial theory of the firm does not presume a perfect market but accommodates changes in the environment to set up investment and financial policies. It also integrates different business functions such as marketing and human resources management into the decision-making framework for the long-term growth and value maximization of the firm.

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1. Introduction

Traditional financial theories on capital structure and option pricing were built on axiomatic assumptions of perfect financial markets and rational investors. The axiomatic approach is appealing because it builds on simple assumptions to derive the equilibrium results that can be generalized for different market settings. Typically, the assumptions are static in nature and the economy is assumed to be in