

**UNIVERSITY OF TORONTO
DEPARTMENT OF ECONOMICS**

**ECO359 – FINANCIAL ECONOMICS II
CORPORATE FINANCE**

Course Outline – Summer 2014

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Course Description:

Financial Economics II focuses on the process of capital budgeting decision and extends it to how the cash for the investments should be raised – the firm’s capital structure. We start the capital structure question with the benchmark framework provided by the Modigliani-Miller theorems then extend it further by considering issues of taxation and bankruptcy costs. Subsequent lectures include the impact of agency costs and asymmetric information on the capital structure.

Objectives:

By the end of this course you are expected to learn:

- The capital budgeting decision
- Modigliani-Miller theorem
- The impact of Taxes, bankruptcy on capital structure
- Agency costs and capital structure
- Asymmetric Information and capital structure
- Dividend policy
- Initial public Offering (IPO)
- Mergers and Acquisitions (M&A)

Textbook:

Required Text: Ross, Westerfield, Jaffe, Roberts, 2011, *Corporate Finance*, 6rd edition, McGraw-Hill. [RWJR]

Other references will also be used but are not required:

Books:

J. Amaro de Matos, 2001, *Theoretical Foundations of Corporate Finance*, Princeton University Press.

Copeland, Thomas and Fred Weston, 2004, *Financial Theory and Corporate Policy*, 2nd Edition, Addison-Wesley. [CW]

Published Articles: (Referred to as [A#])

- [1] Bhattacharya, S. 1979, Imperfect information, dividend policy and the ‘Bird in the Hand’ fallacy, *Bell Journal of Economics and Management Science*, 10(1), pp. 259-70.
- [2] Jensen, M.C., 1986, Agency costs of cash flow, corporate finance, and takeovers, *American Economic Review*, 76 659-665.
- [3] Jensen, M.C. and W.H. Meckling, 1976, Theory of the firm: managerial behavior, agency costs and ownership structure, *Journal of Financial Economics*, 3(4), 305-60.
- [4] Miller, M. and K. Rock, 1985, Dividends policy under asymmetric information, *Journal of Finance*, 40, pp. 1031-1052.
- [5] Myers, S.C. and N. Majluf, 1984, Corporate financing and investment decisions when firms have information that investors do not have, *Journal of Financial Economics*, pp. 187-221.
- [6] Myers, S., 1979, Determinants of corporate borrowing, *Journal of Financial Economics* 5, 147-75.
- [7] Rock, K. 1986, Why new issues are underpriced?, *Journal of Financial Economics*, pp. 187-212.
- [8] Ross, S.A. 1977, The determination of financial structure: the incentive signaling approach, *Bell Journal of Economics and Management Science*, 8(1), pp. 23-40.

Evaluation:

Mid-term Examination	40%
Final Examination	<u>60%</u>
TOTAL	100%

The midterm test will test the class on all material covered up to the end of the previous class, unless stated otherwise in class. The final exam likewise, will emphasize material not previously tested, but will still include questions from earlier material in the course. If you are unable to write the midterm exam at its scheduled time because of illness or other compelling circumstances, you need to contact me within 24 hours of the missed

examination. You will also have to present documentation supporting your reasons for missing the examination. There **will be no makeup midterm examination**. If you miss the midterm exam with a legitimate reason, the final exam will be re-adjusted for the total of 100%.

Aids Allowed in Tests and Final Exam

- For the midterm, as well as the final exam formula sheets will be provided for you. These will be posted on the course web site at least several days ahead of the assessment.
- A non-Programmable calculator.

E-mail Policy

Email should NOT be seen as an alternative to meeting with the instructor (or the TA) during office hours. Nor should email be used as a mechanism to receive private tutorials (especially prior to tests) or to explain material that was covered in lectures you missed. Therefore, I will not respond to email inquiries unless it is an emergency. I will take up 'generic' questions that could be of interest to all students at the beginning of the next class.

Preparation

- Lecture notes are posted several days ahead of the lecture. It is important to read them before attending each lecture. It is necessary to try the recommended text problems after each lecture before attending the next lecture. The solutions to the end of chapter problems will be posted on the website.
- Problem sets identify the problems by the lecture. After each lecture solve the related problems.

Schedule:

Date	Topic	Session Material	Recommended Questions
Lec-1	Introduction, the Investment Decision	RWJR: Ch 1, 4	1: 1, 2, 3, 4, 5, 6 4: 2, 4, 5, 6, 7
Lec-2	Financial Statements, Cash Flow Analysis	RWJR: Ch 2 RWJR: Ch 8	8: 1, 3, 5, 7, 10, 14, 17, 20, 21
Lec-3	Risk and Capital Budgeting	RWJR: Ch 13 – Appendix 13A, RWJR: Ch 15	13: 1, 3, 4, 8, 9, 12, 13, 15 15: 3, 4, 10
Lec-4	Capital Structure and the Cost of Capital	RWJR: Ch. 16	16: 1, 3, 5, 6, 7, 8, 10, 12, 13, 14, 15, 16, 17, 19, 20, 21
Lec-5	Capital Structure: Limit to the Use of Capital	RWJR: Ch. 17	17: 1, 2, 3, 4, 6, 7, 8, 11, 13, 14, 15, A18
Lec-6	Financial Leverage and Capital Structure Policy	RWJR: Ch. 18	18: 1, 2, 3, 4, 6, 7, 9, 10, 11, 12, 13, 15
	Mid-Term Test (The end of Lec-6)		
Lec-7	Capital Structure and Agency Costs	A2, A3, A6	
Lec-8	Capital Structure & Asymmetric Information	A5, A8	
Lec-9	Dividend Policy	RWJR: Ch. 19 A1, A4	19: 4, 5, 6, 7, 8, 9, 10, 11, 13, 14, 16, 17, 19, 20, 22, 23
Lec-10	IPO Theories of IPO Mergers & Acquisitions, Takeovers	RWJR: Ch 20 A7 RWJR: Ch 30	20: 1, 3, 7, 8, 10, 13, 14, 17 30: 1, 8, 10, 11, 13

Note: Chapter references are to RWJR textbook. A# refers to the # on the set of assigned articles.