

**UNIVERSITY OF TORONTO  
DEPARTMENT OF ECONOMICS**

**ECO359 – FINANCIAL ECONOMICS II  
CORPORATE FINANCE**

**Course Outline – Summer 2023**

**Instructor:** Dr. Ata Mazaheri  
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**Course Delivery**

Please refer to the announcement of Quercus.

**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, 2018, *Corporate Finance*, 8<sup>th</sup> 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*, 2<sup>nd</sup> 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:**

	Weight	Time (Tentative)	Location
Midterm	<b>30%</b>	July 26 (2PM)	TBA
Term Paper	<b>20%</b>	August 14 (end of the day)	
Final Exam	<b>50%</b>	TBA	TBA
Total	<b>100%</b>		

#### **Notes:**

- **Midterm:** Material covered till the end of **Lecture-6**.
- **Final Exam:** Inclusive of all the material learned in the lecture.

If you are unable to write the midterm test at its scheduled time because of illness or other compelling circumstances, you need to present documentation supporting your reasons for missing the midterm, no later than a week after the assessment. There will be no makeup test. If you miss a term test with a legitimate reason, the final exam will be re-adjusted for the total of 80%.

## **Aids Allowed in Tests and Final Exam**

- The assessments are closed. A formula sheet will be attached. You are allowed a non-programmable calculator.

## **Term Paper**

For the purpose of this report pretend that you are hired by a major financial institution and that you are providing a report on one of the listed corporations. You can choose any company that is listed on S&P or on TSX 60, the only conditions are:

1. The first letter of the ticker of the company should be the first letter of your first name or your last name.
2. You cannot choose a financial firm.

To complete the project, you need to first collect data on the firm you have chosen. For the purpose of this:

- a) Consider the company annual report which is readily available from Yahoo Finance or the company's web site. The annual report typically includes the CEO's letter which will give you some insight on the company's future prospect.
- b) You can also search for the ticker of the company in Yahoo Finance for information on the Corporate Governance. There is also a section on "Analyst Opinion" as well as "Major Holders".

Then you need to provide your analysis and for the purpose of this exercise:

- a) Use information you collected from the annual report to construct a pro forma balance sheet for the future performance of the company. The pro forma balance sheet should cover a minimum of five years. Based on this pro forma balance sheet calculate the important ratios for the company such as projected P/E ratio, Tobin's ratio, Quick ratio, etc.
- b) Provide a picture of the corporate governance that includes percentage of institutional ownership, percentage of insider ownership, etc. Provide an analysis of the quality of the of corporate governance.
- c) Based on your own analysis rate this corporation.
- d) Compare and contrast your rating with "Analyst Opinion" that you found on Yahoo Finance.
- e) Summarize your findings in an executive report. The executive report should provide a summary of your own analysis as well as the comparison of your opinion with the published views of other analysts. It should also include your recommendation on whether your company is a good investment in the short run (1-2 years) and long run (5+ years).

## **Statement on Equity, Diversity, and Inclusion (EDI)**

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The University of Toronto is committed to equity, human rights and respect for diversity. All members of the learning environment in this course should strive to create an atmosphere of mutual respect where all members of our community can express themselves, engage with each other, and respect one another's differences. U of T does not condone discrimination or harassment against any persons or communities.

## **Statement on AI**

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The knowing use of generative artificial intelligence tools, including ChatGPT and other AI writing and coding assistants, for the completion of, or to support the completion of, an examination, term test, assignment, or any other form of academic assessment, may be considered an academic offense in this course.

## **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:**

<b>Date</b>	<b>Topic</b>	<b>Session Material</b>	<b>Recommended Questions</b>
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
	<b>Mid-Term Test</b> (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
Lec-11	IPO Theories of IPO Mergers & Acquisitions, Takeovers (Cont'd)		

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