

Finance I (Corporate Finance), fall 2008

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Exercise sessions tbd, office hours to be negotiated in class once the schedule is set.

Course information:

- first part of the finance sequence (second part to be taught by Prof Zemcik).
- based on Jean Tirole's Theory of Corporate Finance
- augmented by appropriate readings from top-level journals
- A Ortmann likely to teach chapters 1 – 5, 12, and 16
- J Cho likely to teach chapters 6 – 11

Grading:

- final, no midterm
- Final carries two thirds of the weight of the final score.
- Final heavily based on the weekly assignments (not graded but highly recommended).
- Term paper, minimum requirement a crit lit review of about half a dozen articles and/or working papers on a topic of interest to the student. More ambitious termpapers are fine but
- Term paper carries one third of the weight of the final score.

Attendance policy and other requirements:

- Highly recommended (and, in fact, required by CERGE-EI rules)
- I expect you to have read (both textbook and articles) assignments ahead.

Course outline:

The basic game plan is to cover roughly one chapter of the textbook per week, and in addition to cover roughly one article per lecture. The specifics will be announced about a week ahead ...

Readings:

- Tirole, The Theory of Corporate Finance, Princeton University Press 2006.

This is an advanced theory textbook that distinguishes itself from the rest through the provision of a single, elementary model that is used to organize the main insights of the literature in a coherent manner.

From the website, slightly edited (see textbook p. 6):

The Theory of Corporate Finance

Jean Tirole

Honorable Mention, 2006 AAP Award for Best Professional/Scholarly Book in Finance & Economics

The past twenty years have seen great theoretical and empirical advances in the field of corporate finance. Whereas once the subject addressed mainly the financing of corporations--equity, debt, and valuation--today it also embraces crucial issues of governance, liquidity, risk management, relationships between banks and corporations, and the macroeconomic impact of corporations. However, this progress has left in its wake a jumbled array of concepts and models that students are often hard put to make sense of.

Here, one of the world's leading economists offers a lucid, unified, and comprehensive introduction to modern corporate finance theory. Jean Tirole builds his landmark book around a single model, using an incentive or contract theory approach. <snip>

Tirole conveys the organizing principles that structure the analysis of today's key management and public policy issues, such as the reform of corporate governance and auditing; the role of private equity, financial markets, and takeovers; the efficient determination of leverage, dividends, liquidity, and risk management; and the design of managerial incentive packages. He weaves empirical studies into the book's theoretical analysis. And he places the corporation in its broader environment, both microeconomic and macroeconomic, and examines the two-way interaction between the corporate environment and institutions. <snip>

The Theory of Corporate Finance will be the authoritative text for years to come.

Jean Tirole is Director of the Foundation Jean-Jacques Laffont-Toulouse School of Economics, and Scientific Director of the Institut d'Economie Industrielle at the University of Social Sciences in Toulouse, one of Europe's leading centers for the study of economics. He also holds a visiting position at the Massachusetts Institute of Technology. <snip>

Tirole is the author or coauthor of eight books, including <snip>, *The Theory of Industrial Organization*, *Game Theory* (with Drew Fudenberg), and *A Theory of Incentives in Procurement and Regulation* (with Jean-Jacques Laffont).

Reviews:

"A magnificent new book. . . . This is far more than the mere textbook it purports to be; it has a plausible claim to be the first truly comprehensive overview of corporate finance by an economist."--*The Economist*

"Impeccably systematized. . . . Tirole's book will have a prominent place in my library, and I am sure that I shall have plenty of occasions to refer to its authority in the future. It fully deserves a 'buy' rating."--Rudi Bogni, *Times Higher Education Supplement*

"Jean Tirole has provided the profession with its first comprehensive, advanced treatment of corporate finance theory. . . . [T]he overall result is far from idiosyncratic and it will have a major impact upon teaching and research in corporate finance."--David Webb, *Economic Journal*

Endorsements:

"Using a single elementary model, Tirole brings out with refreshing ease an unsuspected unity and simplicity in a field that might otherwise be perceived as dishearteningly fragmented and complex. This masterful book will be a formidable teaching tool at the graduate level and an essential reference for research in corporate finance." -- Marco Pagano, Professor of Economics, University of Naples Federico II

"The field of corporate finance has developed rapidly and extensively in the last twenty years, but those who want to teach it face a barrier: the absence of a widely accepted textbook. Jean Tirole's book fills that gap. Applying his celebrated analytical and expositional skills, Tirole synthesizes and unifies the field in a clear and accessible manner, emphasizing particularly the connections between corporate finance and contract theory and the role of incentives and control in firms' financial decisions. <snip>." -- Oliver Hart, Andrew E. Furer Professor of Economics, Harvard University

- Ross, Westerfield, and Jordan, Fundamentals of Corporate Finance, Irwin McGraw Hill.

This is an upper undergraduate text that provides some of the nuts and bolts concepts that we shall take for granted although we might insert some problems from this or similar books in the exercise sessions. (Our library has 25 copies of the 8th edition). There are also some copies of the 2006 edition of Brealey, Myers, & Allen, Principles of Corporate Finance (as well as copies of earlier editions) which is a text that's about the same level of difficulty and coverage.

□ Other books in the CERGE-EI library at your discretion,

Reading assignments for this week and next:

Wednesday this week: all of chapter 1 in Tirole and all of chapter 1 in Ross et al.

(to be covered Wednesday this and in parts next week Monday)

Also Monday next week (required reading, on electronic reserve):

**The theory and practice of corporate finance:
evidence from the field[☆]**

John R. Graham^a, Campbell R. Harvey^{a,b,*}

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Abstract

We survey 392 CFOs about the cost of capital, capital budgeting, and capital structure. Large firms rely heavily on present value techniques and the capital asset pricing model, while small firms are relatively likely to use the payback criterion. A surprising number of firms use firm risk rather than project risk in evaluating new investments. Firms are concerned about financial flexibility and credit ratings when issuing debt, and earnings per share dilution and recent stock price appreciation when issuing equity. We find some support for the pecking-order and trade-off capital structure hypotheses but little evidence that executives are concerned about asset substitution, asymmetric information, transactions costs, free cash flows, or personal taxes. © 2001 Published by Elsevier Science S.A.

JEL classification: G31; G32; G12

Keywords: Capital structure; Cost of capital; Cost of equity; Capital budgeting; Discount rates; Project valuation; Survey

Wednesday next week (the first two readings are required, the third is optional):

The determinants of corporate board size and composition: An empirical analysis[☆]

Audra L. Boone^a, Laura Casares Field^b,
Jonathan M. Karpoff^{c,*}, Charu G. Raheja^d

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Abstract

Using a unique panel dataset that tracks corporate board development from a firm's IPO through 10 years later, we find that: (i) board size and independence increase as firms grow and diversify over time; (ii) board size—but not board independence—reflects a tradeoff between the firm-specific benefits and costs of monitoring; and (iii) board independence is negatively related to the manager's influence and positively related to constraints on that influence. These results indicate that economic considerations—in particular, the specific nature of the firm's competitive environment and managerial team—help explain cross-sectional variation in corporate board size and composition.

Nonetheless, much of the variation in board structures remains unexplained, suggesting that idiosyncratic factors affect many individual boards' characteristics.

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JEL classifications: G34; L22

Keywords: Corporate boards; IPO; Board size; Board independence

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Corporate Board Composition, Protocols, and Voting Behavior: Experimental Evidence

ANN B. GILLETTE, THOMAS H. NOE, and MICHAEL J. REBELLO*

ABSTRACT

We examine voting by a board designed to mitigate conflicts of interest between privately informed insiders and owners. Our model demonstrates that, as argued by researchers and the business press, boards with a majority of trustworthy but uninformed “watchdogs” can implement institutionally preferred policies. Our laboratory experiments strongly support this conclusion. Our model also highlights the necessity of penalties on insiders when there is dissension among board members. However, penalties for dissent appeared to have little impact on the experimental outcomes.

Board structures around the world: An experimental investigation

ANN B. GILLETTE, THOMAS H. NOE, and MICHAEL J. REBELLO*

ABSTRACT

We model and experimentally examine the board structure–performance relationship. We examine single-tiered boards, two-tiered boards, insider-controlled boards, and outsider-controlled boards. We find that even insider-controlled boards frequently adopt institutionally preferred rather than self-interested policies. Two-tiered boards adopt institutionally preferred policies more frequently, but tend to destroy value by being too conservative, frequently rejecting good projects. Outsider-controlled single-tiered boards, both when they have multiple insiders and only a single insider, adopt institutionally preferred policies most frequently. In those board designs where the efficient Nash equilibrium produces strictly higher payoffs to all agents than the coalition-proof equilibria, agents tend to select the efficient Nash equilibria.

A little pop quiz !

Your name here:

Explain the following terms:

Capital budgeting =

Capital/financial structure =

Debt =

Equity =

Leverage =

Modigliani-Miller irrelevance results

Working capital management =

The time value of money =

Cash flow, DCF valuation =

Initial public offering, seasoned/secondary public offering =

NPV =

Systematic risk, beta coefficient, SML =

CAPM =

Options =