

**Commerce 4FG3
FINANCIAL THEORY
Fall 2012 Course Outline**

**Finance and Business Economics
DeGroote School of Business
McMaster University**

INSTRUCTOR AND CONTACT INFORMATION

Dr. D. Mountain

Instructor

Tuesday 11:30 – 2:20

Class location: KTH/B105

Office: DSB-310

Office Hours:

Tuesday 2:45 – 3:45 pm or by
appointment

Tel (905) 525-9140 x23988

COURSE OVERVIEW

This course explores the theoretical and conceptual foundations of finance. Among the theories, upon which modern finance is founded are (1) utility theory, (2) state-preference theory, (3) mean-variance portfolio theory, (4) the capital asset pricing model, (5) the arbitrage pricing theory, and (6) the Modigliani-Miller and information theories of capital structure. A common theme is “How do individuals and society allocate scarce resources through a price system based on the valuation of risky assets?” Utility theory provides the foundations of rational decision making when deciding on risky alternatives. “How do people make choices?” State-preference theory, mean-variance portfolio theory, and arbitrage pricing provide descriptions of the objects of choice. Combining these objects of choice with the theory of choice determines how risky alternatives are valued. In turn, appropriately determined asset prices provide signals to the economy for necessary resource allocation. Finally, the Modigliani-Miller and information theories of capital structure asks the question “Does the method of financing have any effect on the value of assets, including the firm? Theories of agency cost and signalling contribute to answering this question. Furthermore, this has important implications for the firm’s debt-to-equity mix and dividend policy.

The course also includes quantitative methods for testing some basic propositions in finance such as the introduction of regression based quantitative methods for testing some basic propositions in finance, such as the capital asset pricing model and the arbitrage pricing theory.

PREREQUISITE

Commerce 3FA3 and registration in any Commerce or Engineering and Management program; or Economics 2I03 and Economics 3G03.

COURSE ELEMENTS

Credit Value: 3	Team skills: Yes	IT skills: Yes	Global: No
WebCT: No	Verbal skills: Yes	Numeracy: Yes	Political: No
Participation: No	Written skills: Yes	Innovation: Yes	Social: No

REQUIRED TEXT

- Financial Theory and Corporate Policy by T.E. Copeland, J.F. Weston, and K. Shastri, 4th ed., 2005, Pearson Addison Wesley.

SUPPLEMENTARY TEXT (ON RESERVE)

- Economics Organization and Management by P. Milgrom and J. Roberts, 1992, Prentice-Hall.

EVALUATION

a) Term Work: The term work consists of three tests (1-hour in length) and one assignment.

Assignment	Due on November 12	12 points
Test #1	October 9	22 points
Test #2	October 30	22 points
Test #3	November 20	22 points
Term Work (TW)		78 points

b) Final Examination (FE): 22 points

c) Final Grade: The final examination is worth 22 points. If you do better on the final relative to your term work, the final will be worth 32 points.

Your final mark (FM) is

$$FM = \max \left[TW + FE, \frac{FE}{22} * 32 + \frac{TW}{78} * 68 \right]$$

Conversion

At the end of the course your overall percentage grade will be converted to your letter grade in accordance with the following conversion scheme.

LETTER GRADE	PERCENT	LETTER GRADE	PERCENT
A+	90 - 100	C+	67 - 69
A	85 - 89	C	63 - 66
A-	80 - 84	C-	60 - 62
B+	77 - 79	D+	57 - 59
B	73 - 76	D	53 - 56
B-	70 - 72	D-	50 - 52
		F	00 - 49

ACADEMIC DISHONESTY

It is the student's responsibility to understand what constitutes academic dishonesty. Please refer to the University Senate Academic Integrity Policy at the following URL:

<http://www.mcmaster.ca/policy/Students-AcademicStudies/AcademicIntegrity.pdf>

This policy describes the responsibilities, procedures, and guidelines for students and faculty should a case of academic dishonesty arise. Academic dishonesty is defined as to knowingly act or fail to act in a way that results or could result in unearned academic credit or advantage. Please refer to the policy for a list of examples. The policy also provides faculty with procedures to follow in cases of academic dishonesty as well as general guidelines for penalties. For further information related to the policy, please refer to the Office of Academic Integrity at:

<http://www.mcmaster.ca/academicintegrity>

REQUESTING RELIEF FOR MISSED ACADEMIC TERM WORK

1. Students may request relief from a regularly scheduled midterm, test, assignment or other course component in the following two ways:
 - a) **for absences from classes lasting up to five (5) days; or**
 - b) **for absences from classes lasting more than five (5) days.**
 - a) **For absences from classes lasting up to five (5) days**
Students must use the MSAF (McMaster Student Absence Form). This is an on-line, self-reporting tool, for which submission of medical or other types of supporting documentation is normally not required. Students may use this tool to submit a maximum of one (1) request for relief of missed academic work per term. Students must follow up with their course instructors regarding the nature of the relief within two days of submitting the form. Failure to do so may negate the opportunity for relief. It is the prerogative of the instructor of the course to determine the appropriate relief for missed term work in his/her course.
 - b) **For absences from classes lasting more than five (5) days**
Students cannot use the MSAF. They **MUST** report to the APO to discuss their situation and will be required to provide appropriate supporting documentation.
2. Students who wish to submit more than one request for relief of missed academic work per term cannot use the MSAF. They must report to the APO and discuss their situation with an academic advisor. They will be required to provide supporting documentation and meet with the Director.

3. The MSAF cannot be used during any final examination period.
4. Students who require accommodations to meet a religious obligation or to celebrate an important religious holiday must make their requests in writing within three weeks of the start of term to the APO.
5. Students seeking relief due to: work-related (for part-time students only) commitments; representing the university at an academic or varsity athletic event; and/or conflicts between two (or more) overlapping scheduled midterm exams, have the option of applying for special exam arrangements. Such requests must be made to the APO at least ten (10) working days before the scheduled exam along with acceptable documentation. There will be only one common sitting for the special exam. Instructors cannot themselves allow students to unofficially write make-up exams/tests. Adjudication of the request must be handled by the APO.

STUDENT ACCESSIBILITY SERVICES

Student Accessibility Services (SAS) offers various support services for students with disabilities. Students are required to inform SAS of accommodation needs for examinations on or before the last date for withdrawal from a course without failure (please refer to official university sessional dates). Students must forward a copy of such SAS accommodation to the instructor immediately upon receipt. If a student with a disability chooses NOT to take advantage of an SAS accommodation and chooses to sit for a regular exam, a petition for relief may not be filed after the examination is complete. The SAS website is:

<http://sas.mcmaster.ca>

POTENTIAL MODIFICATIONS TO THE COURSE

The instructor and university reserve the right to modify elements of the course during the term. The university may change the dates and deadlines for any or all courses in extreme circumstances. If either type of modification becomes necessary, reasonable notice and communication with the students will be given with explanation and the opportunity to comment on changes. It is the responsibility of the student to check their McMaster email and course websites weekly during the term and to note any changes.

ADDITIONAL INFORMATION

Calculator Usage:

Students will be permitted the use of the McMaster Standard Calculator (Casio FX-991) on the mid-terms and on the final examination. No other calculators will be permitted.

COURSE SCHEDULE

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This course outline is tentative and could be subject to change as the course progresses.

Unless otherwise indicated all references are made to the Copeland, Weston and Shastri text. In addition, course material may deviate in places from the material covered in the textbooks. Therefore, class notes are very important for this course.

1. Consumption and Investment (Chapters 1 and 2)
2. Utility Theory: Given Uncertainty (Chapter 3)
3. State-Preference Theory (Chapter 4)
4. Mean-Variance Framework (Chapter 5)
5. Capital Asset Pricing Model (Chapter 6)
6. Arbitrage Pricing Model (Chapter 6)
7. Capital Budgeting Under Uncertainty (Chapters 2 and 9)
8. The Value of Information and Moral Hazards (Chapter 6 of Milgrom and Roberts)
9. Capital Structure and the Cost of Capital (Chapters 12, 14 and 15, Chapters 14 and 15 of Milgrom and Roberts)