STUDY SESSION 11
CORPORATE FINANCE

This study session covers the principles that corporations use to make their investing and financing decisions. Capital budgeting is the process of making decisions about which long-term projects the corporation should accept for investment and which it should reject. Both the expected return of a project and the financing cost should be taken into account. The cost of capital, or the rate of return required for a project, must be developed using economically sound methods. Corporate managers are also concerned with shorter-term liquidity and solvency and use financial statements to evaluate performance as well as to develop and communicate future plans.

The final reading in this study session is on corporate governance practices, which can expose the firm to a heightened risk of ethical lapses. Although these practices may not be inherently unethical, they create the potential for conflicts of interest to develop between shareholders and managers, and the extent of that conflict affects the company's valuation.

READING ASSIGNMENTS

LEARNING OUTCOMES

Reading 44: Capital Budgeting

The candidate should be able to:

a. explain the capital budgeting process, including the typical steps of the process, and distinguish among the various categories of capital projects;

b. discuss the basic principles of capital budgeting, including the choice of the proper cash flows;

c. explain how the following project interactions affect the evaluation of a capital project: 1) independent versus mutually exclusive projects, 2) project sequencing, and 3) unlimited funds versus capital rationing;

d. calculate and interpret the results using each of the following methods to evaluate a single capital project: net present value (NPV), internal rate of return (IRR), payback period, discounted payback period, and profitability index (PI);

e. explain the NPV profile, compare and contrast the NPV and IRR methods when evaluating independent and mutually exclusive projects, and describe the problems associated with each of the evaluation methods;

f. describe and account for the relative popularity of the various capital budgeting methods and explain the relation between NPV and company value and stock price.

Reading 45: Cost of Capital

The candidate should be able to:

a. calculate and interpret the weighted average cost of capital (WACC) of a company;

b. describe how taxes affect the cost of capital from different capital sources;

c. describe alternative methods of calculating the weights used in the WACC, including the use of the company's target capital structure;

d. explain how the marginal cost of capital and the investment opportunity schedule are used to determine the optimal capital budget;

e. explain the marginal cost of capital's role in determining the net present value of a project;

f. calculate and interpret the cost of fixed rate debt capital using the yield-to-maturity approach and the debt-rating approach;

g. calculate and interpret the cost of noncallable, nonconvertible preferred stock;

h. calculate and interpret the cost of equity capital using the capital asset pricing model approach, the dividend discount model approach, and the bond-yield-plus risk-premium approach;

i. calculate and interpret the beta and cost of capital for a project;

j. explain the country equity risk premium in the estimation of the cost of equity for a company located in a developing market;

k. describe the marginal cost of capital schedule, explain why it may be upward-sloping with respect to additional capital, and calculate and interpret its break-points;

l. explain and demonstrate the correct treatment of flotation costs.

Reading 46: Working Capital Management

The candidate should be able to:

a. describe primary and secondary sources of liquidity and factors that influence a company's liquidity position;

b. compare a company's liquidity measures with those of peer companies;

c. evaluate overall working capital effectiveness of a company, using the operating and cash conversion cycles, and compare its effectiveness with other peer companies;

d. identify and evaluate the necessary tools to use in managing a company's net daily cash position;

e. compute and interpret comparable yields on various securities, compare portfolio returns against a standard benchmark, and evaluate a company's short-term investment policy guidelines;

f. assess the performance of a company's accounts receivable, inventory management, and accounts payable functions against historical figures and comparable peer company values;

g. evaluate the choices of short-term funding available to a company and recommend a financing method.

Reading 47: Financial Statement Analysis

The candidate should be able to demonstrate the use of pro forma income and balance sheet statements.

Reading 48: The Corporate Governance of Listed Companies: A Manual for Investors

The candidate should be able to:

a. define and describe corporate governance;

b. discuss and critique characteristics and practices related to board and committee independence, experience, compensation, external consultants, and frequency of elections, and determine whether they are supportive of shareowner protection;

c. describe board independence and explain the importance of independent board members in corporate governance;

d. identify factors that indicate a board and its members possess the experience required to govern the company for the benefit of its shareowners;

e. explain the provisions that should be included in a strong corporate code of ethics and the implications of a weak code of ethics with regard to related-party transactions and personal use of company assets;

f. state the key areas of responsibility for which board committees are typically created and explain the criteria for assessing whether each committee is able to adequately represent shareowner interests;

g. evaluate, from a shareowner's perspective, company policies related to voting rules, shareowner sponsored proposals, common stock classes, and takeover defenses.