STUDY SESSION

10

Corporate Finance

Corporate Governance, Capital Budgeting, and Cost of Capital

This study session provides an introduction to corporate governance and corporate investing and financing decisions. The first reading provides a framework for understanding and analyzing corporate governance and stakeholder management. The reading also provides an introduction to environmental and social considerations in investing. The second reading covers capital budgeting. Capital budgeting is the process of making decisions about which long-term projects the corporation should accept for investment. The final reading introduces how to estimate a company's cost of capital.

READING ASSIGNMENTS

Reading 34	Corporate Governance and ESG: An Introduction by Assem Safieddine, PhD, Young Lee, CFA, Donna F. Anderson, CFA, and Deborah Kidd, CFA
Reading 35	Capital Budgeting by John D. Stowe, PhD, CFA, and Jacques R. Gagné, FSA, CFA, CIPM
Reading 36	Cost of Capital by Yves Courtois, CMT, CFA, Gene C. Lai, PhD, and Pamela Peterson Drake, PhD, CFA

LEARNING OUTCOMES

READING 34. CORPORATE GOVERNANCE AND ESG: AN INTRODUCTION

The candidate should be able to:

a describe corporate governance;

b describe a company's stakeholder groups and compare interests of stakeholder groups;

c describe principal–agent and other relationships in corporate governance and the conflicts that may arise in these relationships;

d describe stakeholder management;

e describe mechanisms to manage stakeholder relationships and mitigate associated risks;

f describe functions and responsibilities of a company's board of directors and its committees;

g describe market and non-market factors that can affect stakeholder relationships and corporate governance;

h identify potential risks of poor corporate governance and stakeholder management and identify benefits from effective corporate governance and stakeholder management;

i describe factors relevant to the analysis of corporate governance and stakeholder management;

j describe environmental and social considerations in investment analysis;

k describe how environmental, social, and governance factors may be used in investment analysis.

READING 35. CAPITAL BUDGETING

The candidate should be able to:

a describe the capital budgeting process and distinguish among the various categories of capital projects;

b describe the basic principles of capital budgeting;

c explain how the evaluation and selection of capital projects is affected by mutually exclusive projects, project sequencing, and capital rationing;

d calculate and interpret net present value (NPV), internal rate of return (IRR), payback period, discounted payback period, and profitability index (PI) of a single capital project;

e explain the NPV profile, compare 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 expected relations among an investment's NPV, company value, and share price.

READING 36. 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 the use of target capital structure in estimating WACC and how target capital structure weights may be determined;

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 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 describe uses of country risk premiums in estimating the cost of equity;

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.