STUDY SESSION

7

Corporate Finance

This study session first presents capital budgeting analysis, focusing on the application of concepts in the corporate finance decision-making process. These capital budgeting principles are critical for an analyst inside a company preparing capital budgeting recommendations as well as for an external analyst estimating the value of the company.

The remainder of the study session covers capital structure and dividend policy. The presentation of capital structure starts with the classic Modigliani–Miller irrelevance proposition. This proposition states that a company's value is not affected by capital structure choices. The reading then considers how the optimal capital structure is affected by taxes, agency costs, and the possibility of financial distress. The reading on dividend policy discusses the company's choice between reinvesting or distributing earnings and the choice between paying cash dividends and repurchasing shares. Analysts are interested in capital structure and dividend policies because of their effect on the risk and return characteristics of corporate equities and bonds.

READING ASSIGNMENTS

Reading 21	Capital Budgeting by John D. Stowe, PhD, CFA, and Jacques R. Gagné, FSA, CFA, CIPM
Reading 22	Capital Structure by Raj Aggarwal, PhD, CFA, Pamela Peterson Drake, PhD, CFA, Adam Kobor, CFA, and Gregory Noronha, PhD, CFA
Reading 23	Dividends and Share Repurchases: Analysis by Gregory Noronha, PhD, CFA, and George H. Troughton, PhD, CFA

LEARNING OUTCOMES

READING 21. CAPITAL BUDGETING

The candidate should be able to:

a calculate the yearly cash flows of expansion and replacement capital projects and evaluate how the choice of depreciation method affects those cash flows;

b explain how inflation affects capital budgeting analysis;

c evaluate capital projects and determine the optimal capital project in situations of 1) mutually exclusive projects with unequal lives, using either the least common multiple of lives approach or the equivalent annual annuity approach, and 2) capital rationing;

d explain how sensitivity analysis, scenario analysis, and Monte Carlo simulation can be used to assess the stand-alone risk of a capital project;

e explain and calculate the discount rate, based on market risk methods, to use in valuing a capital project;

f describe types of real options and evaluate a capital project using real options;

g describe common capital budgeting pitfalls;

h calculate and interpret accounting income and economic income in the context of capital budgeting;

i distinguish among the economic profit, residual income, and claims valuation models for capital budgeting and evaluate a capital project using each.

READING 22. CAPITAL STRUCTURE

The candidate should be able to:

a explain the Modigliani–Miller propositions regarding capital structure, including the effects of leverage, taxes, financial distress, agency costs, and asymmetric information on a company's cost of equity, cost of capital, and optimal capital structure;

b describe target capital structure and explain why a company's actual capital structure may fluctuate around its target;

c describe the role of debt ratings in capital structure policy;

d explain factors an analyst should consider in evaluating the effect of capital structure policy on valuation;

e describe international differences in the use of financial leverage, factors that explain these differences, and implications of these differences for investment analysis.

READING 23. DIVIDENDS AND SHARE REPURCHASES: ANALYSIS

The candidate should be able to:

a compare theories of dividend policy and explain implications of each for share value given a description of a corporate dividend action;

b describe types of information (signals) that dividend initiations, increases, decreases, and omissions may convey;

c explain how clientele effects and agency issues may affect a company's payout policy;

d explain factors that affect dividend policy;

e calculate and interpret the effective tax rate on a given currency unit of corporate earnings under double taxation, dividend imputation, and split-rate tax systems;

f compare stable dividend, constant dividend payout ratio, and residual dividend payout policies, and calculate the dividend under each policy;

g explain the choice between paying cash dividends and repurchasing shares;

h describe broad trends in corporate dividend policies;

i calculate and interpret dividend coverage ratios based on 1) net income and 2) free cash flow;

j identify characteristics of companies that may not be able to sustain their cash dividend.