

CONTENTS

Foreword	xi
Acknowledgments	xv
About the CFA Institute Investment Series	xvii

CHAPTER 1

Corporate Governance 1

Learning Outcomes	1
1. Introduction	1
2. Corporate Governance: Objectives and Guiding Principles	2
3. Forms of Business and Conflicts of Interest	3
3.1. Sole Proprietorships	4
3.2. Partnerships	5
3.3. Corporations	5
4. Specific Sources of Conflict: Agency Relationships	6
4.1. Manager–Shareholder Conflicts	6
4.2. Director–Shareholder Conflicts	10
5. Corporate Governance Evaluation	10
5.1. The Board of Directors	11
5.2. Examples of Codes of Corporate Governance	24
6. Environmental, Social, and Governance Factors	37
7. Valuation Implications of Corporate Governance	39
8. Summary	40
Problems	42

CHAPTER 2

Capital Budgeting 47

Learning Outcomes	47
1. Introduction	48
2. The Capital Budgeting Process	49
3. Basic Principles of Capital Budgeting	50
4. Investment Decision Criteria	52
4.1. Net Present Value	52
4.2. Internal Rate of Return	53
4.3. Payback Period	55
4.4. Discounted Payback Period	57
4.5. Average Accounting Rate of Return	58
4.6. Profitability Index	58
4.7. NPV Profile	59

4.8.	Ranking Conflicts between NPV and IRR	61
4.9.	The Multiple IRR Problem and the No IRR Problem	65
4.10.	Popularity and Usage of the Capital Budgeting Methods	68
5.	Cash Flow Projections	70
5.1.	Table Format with Cash Flows Collected by Year	70
5.2.	Table Format with Cash Flows Collected by Type	72
5.3.	Equation Format for Organizing Cash Flows	72
6.	More on Cash Flow Projections	74
6.1.	Straight-Line and Accelerated Depreciation Methods	74
6.2.	Cash Flows for a Replacement Project	77
6.3.	Spreadsheet Modeling	79
6.4.	Effects of Inflation on Capital Budgeting Analysis	81
7.	Project Analysis and Evaluation	82
7.1.	Mutually Exclusive Projects with Unequal Lives	82
7.2.	Capital Rationing	84
7.3.	Risk Analysis of Capital Investments—Standalone Methods	86
7.4.	Risk Analysis of Capital Investments—Market Risk Methods	92
7.5.	Real Options	95
7.6.	Common Capital Budgeting Pitfalls	99
8.	Other Income Measures and Valuation Models	101
8.1.	The Basic Capital Budgeting Model	101
8.2.	Economic and Accounting Income	102
8.3.	Economic Profit, Residual Income, and Claims Valuation	106
9.	Summary	110
	Problems	113

CHAPTER 3

Cost of Capital **127**

	Learning Outcomes	127
1.	Introduction	128
2.	Cost of Capital	128
2.1.	Taxes and the Cost of Capital	129
2.2.	Weights of the Weighted Average	131
2.3.	Applying the Cost of Capital to Capital Budgeting and Security Valuation	133
3.	Costs of the Different Sources of Capital	135
3.1.	Cost of Debt	135
3.2.	Cost of Preferred Stock	138
3.3.	Cost of Common Equity	140
4.	Topics in Cost of Capital Estimation	146
4.1.	Estimating Beta and Determining a Project Beta	146
4.2.	Country Risk	153
4.3.	Marginal Cost of Capital Schedule	154
4.4.	Flotation Costs	157
4.5.	What Do CFOs Do?	160
5.	Summary	160
	Problems	163

CHAPTER 4	
Measures of Leverage	171
Learning Outcomes	171
1. Introduction	171
2. Leverage	172
3. Business Risk and Financial Risk	173
3.1. Business Risk and Its Components	174
3.2. Sales Risk	174
3.3. Operating Risk	176
3.4. Financial Risk	182
3.5. Total Leverage	184
3.6. Breakeven Points and Operating Breakeven Points	189
3.7. The Risks of Creditors and Owners	191
4. Summary	194
Problems	194
CHAPTER 5	
Capital Structure	199
Learning Outcomes	199
1. Introduction	199
2. The Capital Structure Decision	200
2.1. Proposition I without Taxes: Capital Structure Irrelevance	201
2.2. Proposition II without Taxes: Higher Financial Leverage Raises the Cost of Equity	203
2.3. Taxes, the Cost of Capital, and the Value of the Company	205
2.4. Costs of Financial Distress	210
2.5. Agency Costs	211
2.6. Costs of Asymmetric Information	212
2.7. The Optimal Capital Structure According to the Static Trade-Off Theory	213
3. Practical Issues in Capital Structure Policy	216
3.1. Debt Ratings	216
3.2. Evaluating Capital Structure Policy	217
3.3. Leverage in an International Setting	218
4. Summary	222
Problems	223
CHAPTER 6	
Dividends and Share Repurchases: Basics	229
Learning Outcomes	229
1. Introduction	229
2. Dividends: Forms	230
2.1. Regular Cash Dividends	231
2.2. Extra or Special (Irregular) Dividends	232
2.3. Liquidating Dividends	234

2.4. Stock Dividends	234
2.5. Stock Splits	236
3. Dividends: Payment Chronology	238
3.1. Declaration Date	238
3.2. Ex-Dividend Date	238
3.3. Holder-of-Record Date	239
3.4. Payment Date	239
3.5. Interval between Key Dates in the Dividend Payment Chronology	239
4. Share Repurchases	241
4.1. Share Repurchase Methods	243
4.2. Financial Statement Effects of Repurchases	245
4.3. Valuation Equivalence of Cash Dividends and Share Repurchases: The Baseline	249
5. Concluding Remarks	250
6. Summary	251
Problems	252

CHAPTER 7

Dividends and Share Repurchases: Analysis 257

Learning Outcomes	257
1. Introduction	258
2. Dividend Policy and Company Value: Theory	258
2.1. Dividend Policy Does Not Matter	258
2.2. Dividend Policy Matters: The Bird-in-the-Hand Argument	260
2.3. Dividend Policy Matters: The Tax Argument	260
2.4. Other Theoretical Issues	261
2.5. Dividend Theory: Summary	271
3. Factors Affecting Dividend Policy	271
3.1. Investment Opportunities	272
3.2. The Expected Volatility of Future Earnings	272
3.3. Financial Flexibility	273
3.4. Tax Considerations	273
3.5. Flotation Costs	276
3.6. Contractual and Legal Restrictions	277
3.7. Factors Affecting Dividend Policy: Summary	278
4. Payout Policies	279
4.1. Types of Dividend Policies	279
4.2. The Dividend versus Share Repurchase Decision	285
4.3. Global Trends in Payout Policy	291
5. Analysis of Dividend Safety	293
6. Summary	297
Problems	298

CHAPTER 8

Working Capital Management 303

Learning Outcomes	303
1. Introduction	304

2. Managing and Measuring Liquidity	305
2.1. Defining Liquidity Management	305
2.2. Measuring Liquidity	307
3. Managing the Cash Position	312
3.1. Forecasting Short-Term Cash Flows	313
3.2. Monitoring Cash Uses and Levels	315
4. Investing Short-Term Funds	316
4.1. Short-Term Investment Instruments	316
4.2. Strategies	320
4.3. Evaluating Short-Term Funds Management	322
5. Managing Accounts Receivable	323
5.1. Key Elements of the Trade Credit Granting Process	324
5.2. Managing Customers' Receipts	326
5.3. Evaluating Accounts Receivable Management	328
6. Managing Inventory	330
6.1. Approaches to Managing Levels of Inventory	331
6.2. Inventory Costs	332
6.3. Evaluating Inventory Management	332
7. Managing Accounts Payable	334
7.1. The Economics of Taking a Trade Discount	335
7.2. Managing Cash Disbursements	336
7.3. Evaluating Accounts Payable Management	337
8. Managing Short-Term Financing	337
8.1. Sources of Short-Term Financing	337
8.2. Short-Term Borrowing Approaches	339
8.3. Asset-Based Loans	340
8.4. Computing the Costs of Borrowing	341
9. Summary	343
Problems	344

CHAPTER 9

Financial Statement Analysis	347
Learning Outcomes	347
1. Introduction	347
2. Common-Size Analysis	348
2.1. Vertical Common-Size Analysis	350
2.2. Horizontal Common-Size Analysis	353
3. Financial Ratio Analysis	356
3.1. Activity Ratios	357
3.2. Liquidity Analysis	363
3.3. Solvency Analysis	365
3.4. Profitability Analysis	369
3.5. Other Ratios	383
3.6. Effective Use of Ratio Analysis	386
4. Pro Forma Analysis	392
4.1. Estimating the Sales-Driven Relations	395
4.2. Estimating the Fixed Burdens	396

4.3. Forecasting Revenues	397
4.4. Constructing Pro Forma Statements	397
5. Summary	401
Problems	402

CHAPTER 10

Mergers and Acquisitions

Learning Outcomes	407
1. Introduction	408
2. Mergers and Acquisitions: Definitions and Classifications	410
3. Motives for Merger	413
3.1. Synergy	413
3.2. Growth	413
3.3. Increasing Market Power	414
3.4. Acquiring Unique Capabilities and Resources	414
3.5. Diversification	414
3.6. Bootstrapping Earnings	415
3.7. Managers' Personal Incentives	416
3.8. Tax Considerations	416
3.9. Unlocking Hidden Value	416
3.10. Cross-Border Motivations	417
4. Transaction Characteristics	418
4.1. Form of Acquisition	419
4.2. Method of Payment	420
4.3. Mind-Set of Target Management	422
5. Takeovers	424
5.1. Pre-Offer Takeover Defense Mechanisms	424
5.2. Post-Offer Takeover Defense Mechanisms	426
6. Regulation	429
6.1. Antitrust	430
6.2. Securities Laws	433
7. Merger Analysis	434
7.1. Target Company Valuation	434
7.2. Bid Evaluation	446
8. Who Benefits from Mergers?	450
9. Corporate Restructuring	451
10. Summary	452
Problems	454

Glossary	463
References	475
About the Authors	481
About the CFA Program	487
Index	489