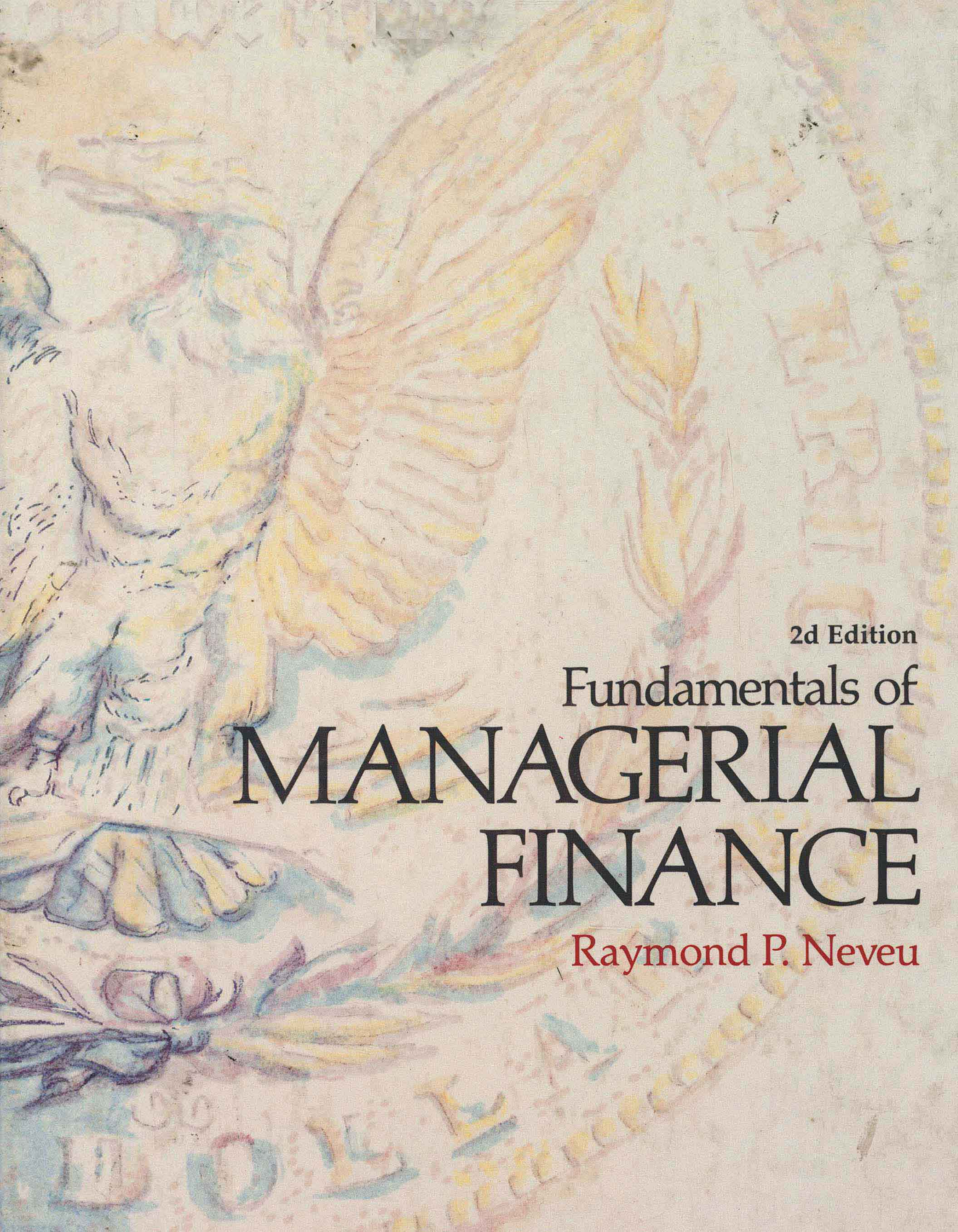

2d Edition

Fundamentals of MANAGERIAL FINANCE

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PREFACE

This book was designed and written for use in fundamental managerial finance courses. The first edition was used primarily in the first finance course taken by undergraduate business majors and in MBA programs that provide background courses for those students who have no prior exposure to managerial finance. In addition, portions of these materials have been used in executive development seminars. This second edition is intended for the same courses.

The Teachability Goal

My goal in writing this book was to produce a managerial finance text that students would find both readable and understandable and that instructors would find teachable. Classroom use, student evaluations, and adopter comments have confirmed the attainment of this goal. Thus, when the time came to revise the manuscript, careful attention was paid to maintaining these desirable qualities in preparing chapter revisions; in addition, new chapters were designed, written, class tested, and revised with these qualities in mind.

The Flexibility Goal

Flexibility became an additional goal for this second edition. This means giving the instructor a number of options in terms of deciding which chapters are to be assigned, the order of material coverage, the amount of financial theory to be introduced, and the mix of problems and/or cases to be assigned. A number of casebooks were used successfully in conjunction with the first edition. The book was also used without cases; the end-of-chapter materials were, and are, sufficient for this purpose. The flexible nature of this text is further described below. However, the lecture notes in the instructors' manual contain a chapter-by-chapter discussion of the options available in designing the course syllabus. By itself, this edition contains enough material for a one-semester or two-quarter course. The addition of a case book provides enough material for two semesters or three quarters.

The Unifying Concept

Maximizing shareholder wealth within a set of corporate risk-return characteristics is the unifying concept of this text. The opportunities and problems that confront financial managers and the decisions they must make are developed and explained within the framework of increasing shareholder returns and the accompanying risks that must be assumed. The concept of risk is itself examined repeatedly; traditional *total risk* as well as the modern portfolio concept of *systematic risk* are both explained. The implications of these alternative concepts of risk are identified and numerous applications of each are provided.

The Role of Examples

This text contains a large number of examples; they are intended to serve collectively as an important pedagogical tool both in and out of class. Some examples illustrate theoretical points, others explain computational procedures and techniques, and some examples describe current practices. The corporations that provided example data are identified wherever possible. In some cases, composite or typical practices are described, or the data are simplified for expository purposes. In these situations, corporate identity has been deleted.

Student Preparation

The materials in the text are fairly well self-contained. Students need to know some algebra. A course in accounting would help by providing some knowledge of financial statements. Some statistics is used, especially in Chapters 12, 16, and 17. However, all the needed statistical basics are explained in these chapters.

Changes in the Second Edition

The text has been expanded to 25 chapters organized into eight parts. The materials are intended to provide instructors with a large amount of flexibility in deciding the order and extent of material coverage. Additional end-of-chapter problems have been added to almost every chapter. The Glossary has been expanded. In addition, answers to selected end-of-chapter problems are included at the end of the book.

PART 1: INTRODUCTION. Chapter 1 contains added material on how risk affects the goal of corporate shareholder wealth maximization. The macroeconomic data used to explain the firm's operating environment in Chapter 2 have been updated; in addition, the section on depreciation and taxes has been rewritten and now includes some ACRS materials.

PART 2: FINANCIAL ANALYSIS AND PLANNING. The financial statements in Chapter 3 have been updated, and the funds statement is introduced earlier in the chapter. Additional explanations have been added to the budgeting techniques of Chapter 4. Some parts of Chapter 5 have been rewritten to improve clarity; the latter part of this chapter contains new materials that introduce the student to investment-financing decisions. Chapter 5 provides needed procedures for evaluating the expansion-financing problems contained in Chapter 15.

PART 3: WORKING CAPITAL MANAGEMENT. The examples in Chapter 6 have been updated and a discussion of the cash-to-cash cycle has been added. Chapter 7, Management of Current Assets, contains new sections dealing with money market mutual funds, money market strategies, and the implications for the management of corporate marketable securities. The section that deals with evaluating alternative credit terms has been rewritten. Chapter 8, Management of Current Liabilities, has been shortened with the deletion of some materials dealing with cash budgeting and revolving credit agreements. New materials deal with money market loans and the use of prime rates in pricing commercial and industrial loans. This Part can be covered immediately after Part 2; alternatively, Part 3 can be assigned after any of the subsequent sections have been covered.

PART 4: CAPITAL BUDGETING. Chapter 9, Mathematics of Finance, and Chapters 10 and 11, dealing with capital budgeting under conditions of certainty, have undergone some minor changes suggested by reviewers. Chapter 12, Capital Budgeting under Conditions of Risk, has been largely rewritten and now contains a Hiller type approach to risky capital budgeting. This group of chapters can be assigned any time after covering Part 1. Part 4 should be covered before assigning Part 5.

PART 5: VALUATION, COST OF CAPITAL, AND CAPITAL STRUCTURE. Chapter 13, Valuation, has undergone some changes intended to improve the students' understanding of the rationale behind the intrinsic value of financial assets. A number of new explanations have been added to Chapter 14, Cost of Capital. These additions provide links between the specific cost of capital measurements and the intrinsic value models of Chapter 13. Chapter 15, Capital Structure Planning Techniques, uses the additional materials added to Chapter 5 and presents a more extensive explanation of investment-financing decisions.

PART 6: CAPITAL ASSET PRICING AND MANAGERIAL FINANCE. The two chapters that constitute this part are new and contain an introduction to capital asset pricing theory and its applications to managerial finance. Chapter 16 develops the theory through security market lines; the needed statistics are explained as used. Chapter 17 begins with a summary of the Chapter 16 theory and then presents applications to capital budgeting, cost of capital, and capital structure planning. The chapter concludes by explaining the complications that are introduced in the presence of risky debt and bankruptcy costs. Taken together, these two chapters contain the most extensive development and explanation of capital asset pricing theory and applications found in any basic managerial finance textbook. The subsequent chapters in this text do not depend on Part 6 being covered. Thus, Part 6 can be assigned after covering the desired sections of Parts 7 and 8. Part 6 should be preceded by a coverage of the major ideas found in Parts 4 and 5.

PART 7: LONG-TERM FINANCING. The five chapters in this section have had their data and examples updated. New developments in bond and preferred stock provisions are contained in Chapter 19. The leasing section of Chapter 21 has been updated to reflect developments in financial or capital leases.

PART 8: SPECIAL TOPICS IN MANAGERIAL FINANCE. Some new materials have been added to International Financial Management, Chapter 23. Some recent developments in merger activity have been added to the Chapter 24 discussion of mergers and acquisitions. Chapter 25, Failure and Bankruptcy, has been updated to reflect current legislative developments in this area.

The Study Guide and Supplement

The student supplement for this text has been greatly expanded. A large number of problems have been added. More important, however, the basic structure of the chapters has been modified, and each of the 25 chapters, corresponding to the textbook chapters, contains the following materials:

1. An introduction that identifies the major points of the chapter
2. A complete sentence outline of the chapter
3. Review questions
4. Primary and supplementary problems
5. Answers to review questions
6. Solutions to primary problems (Solutions to all supplementary problems are given at the end of the study guide.)

The Instructor's Manual

A number of important changes have occurred in this manual. There is a chapter corresponding to each textbook chapter. The format for these chapters is as follows:

1. Introductory notes on the chapter materials
2. A chapter outline
3. Teaching notes
4. Answers to end-of-chapter questions in the textbook
5. Solutions to end-of-chapter problems in the textbook

In addition, the instructor's manual contains an extensive test bank of objective questions. A set of transparency masters has also been added.

Acknowledgments

A large number of people contributed to the success of the first edition and to the improvements contained in this revision. Thanks must first be extended to the adopters who ultimately made this revised edition possible. Second, I would like to extend my appreciation to the many individuals who provided comments, reviews, and suggestions, on both the first edition and on the draft second edition. Realizing that some important contributors may be inadvertently omitted, I should like to thank the following individuals for their contributions:

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R. P. N.

TABLE OF CONTENTS

PART 1

Introduction

Part 1 contains an introduction to managerial finance. Chapter 1 defines managerial finance and explains the objectives of corporate financial management within the context of risk and return. This chapter also outlines the historical development of finance as a separate area of managerial specialization and summarizes the organization of the text.

Chapter 2 discusses the operating environment of corporate financial management and explains how the corporation is challenged by this environment in seeking to meet its goals. Special attention is focused on the importance of financial markets to financial managers.