Managerial Finance
Eighth Edition

J. Fred Weston
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About the Authors

J. Fred Weston earned his A.B. in Political Science, his MBA in Business Economics, and his Ph.D. in Finance, all from the University of Chicago. Dr. Weston began his teaching career at the University of Chicago and in 1949 joined the staff of the University of California, Los Angeles, where he has been professor of managerial economics and finance in the Graduate School of Management since 1955 and has served as Chairman of Finance and Chairman of Business Economics. In 1979, Professor Weston was selected one of the five outstanding teachers on the UCLA campus. He is currently the Cordner Professor of Money and Financial Markets.

Dr. Weston was Associate Editor of *The Journal of Finance* from 1948 to 1955, and a member of the journal's editorial board. He has served as President of the American Finance Association, President of the Western Economic Association, and President of the Financial Management Association. He was also a member of the American Economic Association Census Advisory Committee.

Dr. Weston has published extensively in the financial literature. In addition to *Managerial Finance,* he is the author of several other books, including *The Role of Mergers in the Growth of Large Firms, Public Policy toward Mergers* (with Sam Peltzman), and *Financial Theory and Corporate Policy* (with Thomas E. Copeland).

Dr. Weston has served extensively as a consultant to business firms on financial and economic policies.

Thomas E. Copeland received his B.A. in Economics from Johns Hopkins University, his MBA in Finance from the Wharton School, and his Ph.D. from the University of Pennsylvania. Since that time he has been a member of the faculty at UCLA's Graduate School of Management where he has served as Chairman of the Finance Curriculum Area. He has twice received an award for best teacher in the MBA program, is active in executive education, and has directed UCLA's program for the Young President's Organization.

Also with J. Fred Weston, Dr. Copeland has authored *Financial Theory and Corporate Policy,* the most widely used advanced level corporation finance text. His academic publications include articles about stock splits, theory of market trading activity, receivables policy, leasing, bid–ask spreads, nonprofit organizations, and portfolio performance measurement. His current research focuses on the value of listing on the NYSE, empirical evidence on block and new issue liquidity premia, spinoffs, and issues in experimental economics. Dr. Copeland is a member of the editorial board of *The Midland Corporate Financial Journal* and the *Financial Review.*

Dr. Copeland is a member of the board of directors of Kalama Chemical, Seattle, Washington, and is experienced in the valuation of privately held corporations.

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Preface

In the eighth edition of *Managerial Finance*, we have tried to rethink the material in a fundamental way to reflect the important developments that continue to take place in the field of finance. In reworking the materials, we have sought to achieve a smoother, more cohesive and integrated treatment of managerial finance. Topic coverage is more complete, and the modern finance literature has been fully utilized to provide guidance to practicing financial managers. Our aim is to present the state of the art of received theory as a guide to making practical financial decisions.

The central unifying theme in the eighth edition is the *valuation orientation*. Valuation is the basis for decisions in all major areas of finance: time value of money, capital budgeting, capital structure, cost of capital, dividend policy, financing decisions, mergers, and financial reorganizations.

Impacts of New Developments

Managerial Finance continues to reflect important new developments in the financial environment. The changing value of the U.S. dollar, for example, dramatizes the increased importance of international finance. The relative value of the dollar has created serious problems for some industries and new challenges and opportunities for others. In making the necessary adjustments to economic changes in both domestic and international markets, finance plays a significant role along with the other disciplines important in managing organizations.

New financial instruments and new financial institutions also continuously change the environment in which business firms must operate. Academic researchers have made significant advances, especially in the areas of capital budgeting, asset pricing, cost of capital, and applications of option pricing theory. At the same time, business firms are making increased use of financial theory, and feedback from the world of financial practitioners is affecting financial theory. These developments have guided the revisions made in the eighth edition of *Managerial Finance*.

Changes in the Eighth Edition

Although there are many changes in the eighth edition, this edition continues the basic philosophy of previous editions: to provide users with coverage of all important areas of financial management while providing flexibility in the use of materials. We have continued to reflect important new advances in the applications of valuation analysis, asset pricing models, option pricing models, and the state-preference framework.

Specific changes in the eighth edition of *Managerial Finance* include the following:

1. End-of-chapter problems have been updated and revised where appropriate. We have also added new problems to round out the coverage of concepts and to provide appropriate emphasis on areas of central importance. Interest rate levels used in the problems seek to strike a middle range between the extreme highs of the early summer of 1982 and the lows reached in early 1983 and mid-1985.
2. Time value of money and capital budgeting have been introduced early (Chapters 5 and 6) so they can be used as tools of analysis in all subsequent decision areas.

3. A new chapter (Chapter 7) has been added to describe how the market determines discount rates.
4. The materials on financial forecasting (Chapter 10) have been revised to introduce some statistical concepts used in subsequent topics, particularly decision making under uncertainty and its applications.
5. Decision models for credit management and policy (Chapter 14) reflect the new capital budgeting approach taken in recent literature.
6. The treatment of decision making under uncertainty and its applications (Chapters 16 and 17) has been streamlined and clarified.
7. Option pricing (Chapter 18) begins with the simplified binomial option pricing model, which is then generalized to the Black-Scholes model.
8. The literature on market efficiency has been summarized (Chapter 19) because the concepts are basic to correct thinking about financial decision making.
9. The theory and measurement of the cost of capital discussions (Chapter 21) have been reorganized and clarified.
10. Dividend policy (Chapter 22) has been rewritten to reflect the theoretical literature as well as practical applications of dividend policy, including consideration of clientele effects.
11. Valuation measurement (Chapter 23) has been reworked and clarified.
12. The analysis of refunding decisions (Appendix A to Chapter 26) has been reformulated and streamlined.
13. The discussion of warrants and convertibles (Chapter 28) has been rewritten to integrate the material with the recent literature, which reflects the application of option pricing models.
14. Pension fund management (Chapter 29) has been added to reflect the increasing responsibility of financial managers in this area and to illustrate the impact of ERISA on the corporate debt implications of pension liabilities.
15. Merger analysis (Chapter 30) has been refocused to a fundamental valuation approach and extended to incorporate broader issues of corporate restructuring and control.
16. The reorganization and bankruptcy materials (Chapter 31) have been rewritten to integrate more fully the impact of the Bankruptcy Reform Act of 1978.

We hope that as a result of these substantial revisions, the reader will have a gratifying intellectual experience with the new *Managerial Finance*. The increased rigor of the eighth edition will pay off in increased insights and ease of moving from concept to concept as well facilitating practical applications in decision making.

Flexibility in the Use of the Materials

Much of the book's specific content is the result of our classroom teaching experience over a number of years, including executive development programs. This experience, in addition to our consulting with business firms on financial problems and policies, has helped us to identify the most significant responsibilities of financial managers, the most fundamental problems facing firms, and the most feasible approaches to practical decision making. Some topics are conceptually difficult, but so are the issues faced by financial managers. Business managers must be prepared to handle complex problems, and finding solutions to these problems necessarily involves the use of advanced tools and techniques.

We have not avoided the many unresolved areas of business financial theory and practice. Although we could have simplified the text in many places by side-stepping the difficult issues, we preferred to provide a basic framework based on the "received doctrine" and then go on to present materials (sometimes in chapter appendixes) on a number of important but controversial issues. We hope that our presentation, along with the additional references provided at the end of each chapter, will stimulate the reader to further inquiry.

We acknowledge that the level and difficulty of the material are uneven. Certain sections are simply descriptions of the institutional features of the financial environment and, as such, can be comprehended easily and rapidly. Other parts—notably the materials on capital budgeting, uncertainty, option pricing, and the cost of capital—are difficult. We hope that by alternating easy and tough material, we will provide a refreshing change of pace for the reader.

Managerial Finance has traditionally been a highly flexible text, and this flexibility has been increased in the eighth edition. This book can be used in a one-quarter or one-semester introductory course. However, when so used, it will not be possible to cover all of the chapters. Some instructors concentrate on the basic theory chapters for a one-quarter or one-semester course, which would include Chapters 1, 5–7, 16–18, and 20–23, representing 11 of the 32 chapters. For a one-semester course of 15 to 18 weeks, one or more additional major parts of the book can be added. Other instructors simply take the chapters in sequence, covering Chapters 1–19 or Chapters 1–23 as time permits. Still others cover the entire book in a sequence of two quarters or two semesters. We have also found that business executives can work through the book on their own with the assistance of the book's *Study Guide* described below.

Several reviewers suggested that it might be desirable to reduce the total length of the book. Although the idea was appealing, we did not follow the suggestion for several reasons. We want the book to cover the entire field of business finance and to deal with all of the financial management functions. Eliminating institutional material and concentrating only on theory and technique would give the student an unrealistic, sterile view of finance. Some of the more advanced theories and techniques could have been eliminated because they are difficult, but they are essential for sound decision making. These considerations, plus the flexibility in the use of materials, which makes it unnecessary to cover the entire book in one course, caused us to refrain from eliminating these sections. Furthermore, the book has a tradition of functioning as a text or reference work for use in subsequent courses and for the practicing financial executive as well.

Ancillary Materials

Several items are available to supplement *Managerial Finance*. For the professor, there is a comprehensive *Instructor's Manual*, which contains alternative subject sequences and teaching methods, course outlines, answers to all text questions, solutions to all text problems, and an extensive array of test questions and problems. Also available to the instructor is a comprehensive set of *Transparency Masters*, which feature solutions to selected end-of-chapter problems. As a supplement to problems in the text, an additional set of *Supplemental Problems* and solutions is available to adopters. These were developed with the assistance of Roger Bey, Keith Johnson, and Ramon Johnson, among others.

For the student, the *Study Guide* highlights key points in the text and presents a comprehensive set of problems similar to those at the end of each chapter. Each problem is solved in detail, so a student who has difficulty working the end-of-chapter problems can be aided by use of the *Study Guide*.

A casebook and a book of readings can also be used to supplement *Managerial Finance*. *Cases in Managerial Finance*, sixth edition, by Roy L. Crum and Eugene F. Brigham and *Issues in Managerial Finance*, second edition, by Eugene F. Brigham and Ramon E. Johnson, are available.

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The field of finance will continue to experience significant changes. It is stimulating to participate in these exciting developments, and we hope that *Managerial Finance* will contribute to continued advances in the theory and practice of finance. We welcome comments and suggestions of any kind from our readers.

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