

FOURTH EDITION



FOUNDATIONS OF
MANAGERIAL FINANCE

LAWRENCE J. GITMAN






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F O U R T H E D I T I O N

FOUNDATIONS OF MANAGERIAL FINANCE

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Foundations of Managerial Finance, Fourth Edition

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T O T H E I N S T R U C T O R

Under its former title of *Basic Managerial Finance*, this book has consistently met the needs of the introductory finance course in undergraduate business degree programs. It has also worked quite well in executive training programs and seminars, as well as in technical and continuing education. The fourth edition not only continues to satisfy market needs, but anticipates change.

Users asked that the title more accurately reflect how the streamlined, straightforward, and easily understandable approach blends the traditional accounting orientation with modern valuation techniques. Many recommended the new title, *Foundations of Managerial Finance (FMF)*, as the best alternative. Also, *Foundations* features an enhanced learning system that integrates pedagogy and color with concepts and practical applications. This system equips instructors to concentrate on the more difficult theories, concepts, and techniques needed to make keen financial decisions in an ever-changing and increasingly competitive global business environment. The improved pedagogy and generous use of examples also make the fourth edition an easily accessible resource for long-distance learning and self-study programs, as well as for large lecture-driven courses open to non-finance majors.

Since the previous edition, however, much has changed in both boardroom and classroom. Instructors and students alike have access to a seemingly infinite supply of data, and must somehow make sense of it all. The format of *Foundations* strives to help users do just that: To organize and use information in new and exciting ways. The book comes in two parts: a hardcover, four-color textbook; and a paperback, two-color book, subtitled *Applications*. This format allows students and professors to take only what they need, where they need it. For example, students can read the text outside the classroom, and bring the *Applications* book to each class, where instructors work through problems and cases. And instructors can tote the *Applications* with solutions and lecture notes into class. Each component now fits easily into briefcase or book bag, along with course notes, study guides, and business calculators. From computer lab to library or from office to lecture hall, the fourth edition of *Foundations of Managerial Finance* can go wherever users need to be.

Major Changes in the Fourth Edition

Reengineered Teaching/Learning System

LG

The *FMF* Teaching/Learning System ties the two books together by building on proven learning goals (LGs). The LGs, marked by a special icon in the margin, are listed at the start of each chapter, tied to first-level heads, reviewed point by point at the chapter's end, reviewed and marked as well in the *Applications* book and *Study Guide*, and referenced in the Instructor's Manual, Lecture Notes, and Test Bank. Now more than ever, students will know what to learn, where to find it in the chapter, and whether they've mastered it. Moreover, instructors can build lectures and assignments around the LGs. Following this preface is an eight-page Visual Guide to the *FMF* text package that walks users through all of the components of the *FMF* Teaching/Learning System.

The *FMF* Toolbox is a key visual aid in the Teaching/Learning System. The Toolbox is a cluster of icons used throughout *Foundations* in a number of ways. Inside the Toolbox, students find the learning tools and resources—learning goals, software tutorials, problem-solving disk routines, and spreadsheet templates—available to them as they attempt to master each learning goal. Documentation for the software tools appear in Appendix C, “Instructions for Using the *FMF* Disk,” in *Applications*, and in Appendix B, “Using Computers and Spreadsheets in Managerial Finance” in *Foundations*.

The *FMF* Example Method is also a key part of the Teaching/Learning System because it infuses practical presentations into the learning process. Where applicable in this new edition, the solution of each realistic example demonstrates the use of time lines, tables, and business/financial calculators. Students can easily spot the calculator keystrokes of inputs, functions, and outputs in discussions and examples of time-value techniques in Chapter 11 and subsequent applications of those techniques. Financial tables are available in both Appendix A of the text and as a handy laminated card inserted into the *Applications* book.

Chapter Cases in the *Applications* book enable students to strengthen their practical understanding of financial techniques. Without the added expense of a separate case book, students can apply what they have learned in realistic settings. For example, in Chapter 12, students try their hand at assessing the effect of a proposed risky investment on a firm's bond and stock values.

Improved Organization

The text's flexible organizational structure was carefully designed to ensure a smooth transition from accounting to managerial finance topics. It is structured around the corporate balance sheet, with linkages to share price. Various financial decisions are examined as they relate to the balance sheet and in terms of their influence on return, risk, and share price. Although the text is sequential, instructors can assign almost any chapter as a self-contained

unit, thereby customizing the text to various course lengths and various teaching strategies. Because each instructor has particular topic preferences, the book's coverage is intentionally both extensive and flexible.

Specific improvements include the following: The chapter on financial statements, depreciation, and cash flow now begins Part II on financial analysis and planning so that students can review key accounting and basic cash flow concepts just prior to learning important analytical and planning techniques. To serve as a motivational device, the material on career opportunities in the field of managerial finance appears in Chapter 1 rather than in an end-of-text appendix. Part V, Chapters 14 and 15, now focuses solely on long-term investment decisions, and Part VI, Chapters 16 to 20, which focuses on long-term financing decisions, now begins with the chapter on capital structure and dividend policy. The restructuring of Parts V and VI distinguishes more clearly between the firm's investment and financing decisions to help students better understand these two key activities of the financial manager.

Part VII has been added to this edition to cover two important special topics in managerial finance—mergers, LBOs, divestitures, and failure in Chapter 21 and international managerial finance in a completely new chapter, Chapter 22. Note that *in addition to* being covered in the separate chapter, the international material continues to be integrated throughout the text using brief discussions of chapter topics. For example, the discussion of the consolidation of international financial statements in Chapter 3 is integrated into the chapter learning goals and end-of-chapter summaries in the text and problem material in the *Applications* book. Inclusion of the two special topic chapters allows interested instructors and students to expand coverage beyond the more fundamental topics covered in the first twenty chapters.

The first three parts are devoted to the firm's environment and short-term operations, and the next three parts are concerned with long-term financial topics. Finally, the new seventh part, "Special Managerial Finance Topics," includes the two chapters discussed above.

Stronger Ties Between Theory and Practice

Practitioner Previews open each chapter with intriguing insights into the financial management of actual companies. These chapter launchers introduce students to industry leaders who explain in their own words the relevance of forthcoming material from a practical point of view. For example, in Chapter 11, Leo Vannoni, assistant treasurer of Reebok International Ltd., discusses how his firm uses time value of money concepts.

For their contributions to the Practitioner Previews special thanks go to the following:

Carter Barrett

*System Vice-President
Wachovia Bank of Georgia*

Glynis Bryan

*Assistant Treasurer
Ryder System Inc.*

Mark R. Collman

*Senior Financial Manager
Syncordia Corporation*

Virginia Dennett

*Director and Team Leader
Bank of Boston*

William Dordelman

*Assistant Treasurer
Comcast, Inc.*

Sherrlyn J. Dunn

*Vice-President, Finance
Hunter Industries*

Karen Edlund*Assistant Treasurer**M/A-COM***William Flaherty***Director of Mergers and**Acquisitions**Blockbuster Entertainment***William C. Goings***Senior Business Analyst**Amoco Production Co.***Charles F. Kane***Director, Finance and**Administration**Stratus Computer, Inc.***Christopher Knight***Controller**Wilson N. Jones Memorial Hospital***Scott McNelis***Manager, Corporate Financial**Analysis**Hershey Foods Corporation***Martin Malk***Chief Financial Officer**Hotel Del Coronado***George V. Novello***Managing Director and Head of**Equity Mutual Funds**Greenwich Street Advisors***Christopher H. Savage***Assistant Controller and Director**The Gillette Company***Stewart A. Schoder***Director, International Treasury**Sara Lee Corporation***Gary Schwass***Chief Financial Officer**Duquesne Light***Irena Simmons***Manager of Treasury Services**Lotus Development***Woodrow A. Sutton***Treasurer**Encyclopaedia Britannica, Inc.***Samme Thompson***Senior Vice President**Kidder, Peabody & Co.***Steven R. Wasserman***Director of Investments and**Financial Analysis**EG&G Inc.***Leo Vannoni***Assistant Treasurer**Reebok International Ltd.*

All new Finance in Action boxed examples offer insights into important topics through real company experiences, both large and small. Chapter 11, for example, illustrates the concept of effective rates of return by taking a closer look at annual rates of return of mutual funds over a ten-year period. Each Finance in Action box is classified with regard to one of five themes: Careers, Ethics, In the News, International, and Small Business.

The *Applications* book includes new *Lotus 1-2-3* spreadsheet problems, keyed to the more complex problems in various chapters. The *FMF Disk*, shrinkwrapped with new copies of the *Applications* book at no additional cost, now includes *Lotus* preprogrammed templates so as to familiarize students with a popular commercial spreadsheet program, not to make them experts on *Lotus*. For quick reference a spreadsheet icon appears next to applicable problems with documentation in Appendix C. Appendix B in the text, "Using Computers and Spreadsheets in Managerial Finance," provides insight into the use of computers and spreadsheets in managerial finance today.



More Contemporary Coverage, Including Key Tax Provisions of the *Omnibus Budget Reconciliation Act of 1993*

To keep course content current, my colleagues have come to expect and rely on updated coverage of important current and emerging issues, instruments,

and techniques affecting the practice of financial management. Consistent exposure to current practical applications enables students to walk away from the book and onto the job with forward-looking, practical insight, rather than a merely static conceptual grasp of the challenges ahead. In addition to the many current Finance in Action items, contemporary topics include the following:

- Current thinking on agency costs relating to incentive and performance plans, the associated issue of executive compensation, and the financial manager's role in total quality management (TQM) (Chapter 1)
- The key tax provisions of the recently passed *Omnibus Budget Reconciliation Act of 1993* and the changing role of financial institutions (Chapter 2)
- Data on recent yields of popular marketable securities (Chapter 8)
- The problem faced by small businesses in managing their accounts receivable (Chapter 9)
- Efficient methods for using business/financial calculators to streamline various time value of money calculations (Chapter 11)
- Insights into the stock valuation activities of professional securities analysts (Chapter 12)
- The linkage between the optimal capital budget (financing and investment equilibrium) and the common presence of a management-imposed budget constraint (Chapter 13)
- Recognition of removal and cleanup costs in the analysis of replacing old assets (Chapter 14)
- Practical insight into determination of the optimal capital structure and dividend reinvestment plans (Chapter 16)
- Recent trends in the investment banking industry (Chapter 17)
- The use of preferred stock and the latest treatment of common stock voting rights (Chapter 19)
- The effects of contingent securities on earnings and the cause of market premiums on convertibles (Chapter 20)
- NAFTA and the European Open Market (Chapter 22)

Key Content Improvements in the Fourth Edition

Because users often like to know where new material appears, here are the significant but less sweeping changes made in the fourth edition:

Chapter 1 on the role of finance and the financial manager now includes summary tables on career opportunities in both financial services and managerial finance, describes the basic forms of business organization (formerly covered in Chapter 2), introduces the concept of stakeholder wealth preservation, provides timely insights into the agency issue, including descriptions of incentive and performance plans and discussion of the current thinking with regard to executive compensation, and discusses the financial manager's role in total quality management (TQM).

Chapter 2 on the firm's environment now begins with discussion of business taxation, including comparison of average and marginal tax rates, con-

tains updated coverage of the changing role of financial institutions, and describes securities offerings and trading—the role of the investment banker and interpretation of bond and stock quotes.

Chapter 3 on financial statements, depreciation, and cash flow now uses the modified accelerated cost recovery system (MACRS) depreciation reference rather than ACRS and includes a streamlined step-by-step presentation of procedures for preparing the statement of cash flows.

Chapter 4 on the analysis of financial statements includes an evaluation of common-size income statements, introduces the return on total assets (ROA) in place of the ROI, and streamlines discussion of the modified DuPont formula.

Chapter 5 on breakeven analysis and leverage now includes a brief discussion of the ability to control leverage.

Chapter 6 on financial planning has an updated look at the overall planning process, includes added practical insights, and explains more effectively the interpretation of the “plug” figure used in applying the judgmental approach to preparation of the pro forma balance sheet.

Chapter 7 on working capital fundamentals stresses even more the importance of short-term financial management.

Chapter 8 on cash and marketable securities now includes more practical insights on cash management and recent yield data on the popular marketable securities.

Chapter 9 on accounts receivable and inventory briefly discusses the rationale for extending credit, describes the small-business problem associated with managing accounts receivable, and contains a summary table describing each of the basic collection techniques.

Chapter 10 on sources of short-term financing describes the general formula for use in finding the effective interest rate on a loan and adds practical insights to the discussions of various short-term financing techniques and vehicles.

Chapter 11 on the time value of money now opens with a brief section on the role of time value in finance, with a conceptual comparison of future and present values using time lines, and an explanation of how to use financial tables and business/financial calculators as important computational tools. Keystrokes are shown for all calculator routines. As a result, discussion of specific financial tables is no longer necessary. The present value of a perpetuity is now included in the discussion of the present value of cash flow streams.

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N	% i	PMT	PV	FV

Chapter 12 on risk, return, and valuation has been tightened up and now includes an improved discussion of the role of sensitivity analysis in assessing an asset's risk, contains an added caveat under coverage of common stock valuation models, and concludes with a look at the valuation activities of professional securities analysts.

Chapter 13 on the cost of capital is now consistent in its ongoing example, and ties the process of making financing and investment decisions to the common presence of a management-imposed budget constraint.

Chapter 14 on capital budgeting and cash flow principles now includes a clarified comparison of expansion and replacement decisions, presents a new streamlined and accessible format for finding a project's initial investment, and refers to both removal and cleanup costs associated with replacing old assets.

Chapter 15 on capital budgeting techniques now includes the formulas for finding NPV and IRR, and contains a brief discussion of why capital rationing should not exist.

Chapter 16 on capital structure and dividend policy includes a brief discussion of the practical reality of finding a firm's optimal capital structure and enhanced coverage of dividend reinvestment plans.

Chapter 17 on investment banking's role in raising long-term funds includes discussions of each of the most common roles played by investment bankers in security offerings, contains a figure depicting the breakdown of gross commissions, and compares public offerings to private placements.

Chapter 18 on long-term debt and leasing includes improved discussions of bond call features and financial (or capital) leases.

Chapter 19 on preferred and common stock now includes a new discussion on the use of preferred stock, and includes enhanced discussions of both the voting and preemptive rights of common stockholders.

Chapter 20 on convertibles, warrants, and options provides a new accounting-oriented description of the effects on earnings of contingent securities as well as a brief explanation of why market premiums often exist on convertibles.

Chapter 21 on mergers, LBOs, divestitures, and failure has been refined and updated to include more recent examples and practical wisdom with respect to corporate restructuring and business failure.

Chapter 22 on international managerial finance is a completely new chapter that augments the international material integrated throughout the text with cohesive coverage of all important aspects of international managerial finance. Rather than merely repeat and summarize the integrated international discussions, this chapter offers a fresh perspective that is consistent in

content and order of presentation with the chapter discussions. Coverage includes an introduction to emerging trading blocs—both NAFTA and the European Open Market—along with current statistics and insights.

Other Pedagogical Features

Progress Review Questions appear at the end of each section of the chapter (positioned before the next first-level head) and are marked with a special design element. As students progress through the chapter, they can test their understanding of each key theory, concept, and technique before moving on to the next section within the chapter.

End-of-chapter summaries are now keyed to learning goals and the *FMF Disk* using icons from the Toolbox. A vibrant, contemporary design, with pedagogical use of four colors in most charts, tables, and graphs, draws reader attention to features of the learning system. Marginal material includes running lists of key terms and definitions and equations references. Key terms are boldfaced in the index for easy access to the glossary entry. All figures have brief captions that highlight their content.

A list of companies discussed in the text appears just before this preface on pages xix and xx, in case professors want to assign specific companies for further or ongoing analysis. The endpapers now display frequently used symbols, since many students initially find the notation challenging.

Supplements to the Learning System

Teaching Tools for Instructors

Instructor's Manual¹ *Compiled by Hadi Salavitabar, State University of New York at New Paltz, and Lawrence J. Gitman.* This comprehensive resource really pulls the teaching tools together so that professors can use the text easily and effectively in the classroom. Each chapter provides an overview of key topics, references to the *FMF Disk*, and detailed answers and solutions to Progress Review Questions from the text and problems and chapter cases found in the *Applications* book, all of which Hadi and I worked out carefully to ensure accuracy and consistency.

Testing Materials *Created by Hadi Salavitabar, SUNY-New Paltz.* Thoroughly revised to accommodate changes in the text and significantly expanded to increase user flexibility, this test bank contains nearly 2,500 items, including all new true/false questions, significantly improved multiple-choice items, and

¹The *Instructor's Manual* includes the answers to all of the Progress Review Questions from the text as well as the answers to all (both the odd- and even-numbered) problems in the *Applications* book.

rejuvenated problems and essay questions. For quick test selection and construction, each chapter features a handy chart for identifying type of question, skill tested by learning goal, and level of difficulty. Because the test bank is available in both printed and electronic formats—ASCII files, WordPerfect word processing IBM-compatible files, and DOS or Macintosh TestMaster files—instructors should contact their HarperCollins representative to determine which format best meets their testing needs.

Instructors can also download the TestMaster version of the test bank into *QuizMaster*, an on-line testing program for IBM and Mac that enables users to conduct timed or untimed exams at computer workstations. On completing tests, students can see their scores and view or print a diagnostic report of those topics or objectives requiring more attention. When installed on a local area network, *QuizMaster* allows instructors to save the scores on disk, print study diagnoses, and monitor progress of students individually or by class section and by all sections of the course.

Presentation Tools *Designed by Thomas J. Liesz, Western State College in Colorado.* Developed from my lecture notes, the *Lecture Outline Transparency System* includes approximately 20 pages per chapter, all formatted so that an instructor can copy them to acetates or integrate them into his or her own notes. To support the more quantitative and challenging course material, each chapter comprises a lecture outline and broad overview of chapter themes; points to introduce transparency acetates; key terms and equations with definitions, plenty of examples and demonstrations, and worked-out table and time-line solutions; a section of teaching tips; and discussion problems, again with worked-out table and time-line solutions where appropriate. Finally, the *Electronic Transparency System* combines a collection of lecture notes, problems, and figures in a powerful software presentation kit.

Video Lecture Launchers These lecture launchers consist of videos from Fox television combined with a *Video Guide* by Cecilia L. Wagner, Seton Hall University. Adopters should ask their local HarperCollins representative about the media supplements to the teaching system, including video segments from *Fox Business News*, selected on the basis of timeliness, relevance to core topics in finance, and high production quality. Topics covered by the videos include ethics, financial markets, financial statements, ratio analysis, leverage, financial planning, cash management, inventory management, short-term financing, the time value of money, risk, return, and valuation, cost of capital, capital budgeting, capital structure, long-term financing, and issues in international managerial finance.

Learning Tools for Students

Beyond the book itself students have access to several resources for success in this course.

FMF Disk Packaged with new copies of the *Applications* book at no additional cost, your disk contains three useful tools: the *FMF Tutor*, the *FMF Problem-Solver*, and the *FMF Lotus Templates*. Appendix B in the text, “Using Computers and Spreadsheets in Managerial Finance,” provides insight into

the use of computers and spreadsheets in managerial finance. Documentation and practical advice for using the *FMF Disk* appears in the back of the *Applications* book in Appendix C, “Instructions for using the *FMF Disk*,” and in Appendix D, “Key Equations and Disk Routines.”



The FMF Tutor written by John Hansen, George Flowers, and Robert Bush, all of *Houston Baptist University*, extends self-testing opportunities beyond those on the printed page. The *Tutor* helps students to identify and solve various types of managerial finance problems. The *Tutor* icon flags all *Tutor* applications in both the *Applications* book and *Study Guide*. Through user-friendly menus, they can access over fifty-five different problem types, constructed by random number generation for an inexhaustible supply of problems with little chance of repetition. Routines include financial ratios, time value of money, valuation, cost of capital, and capital budgeting.



The FMF Problem Solver Programmed by Frederick Rexroad of Yellow Springs, Ohio, this software contains seven short menu-driven programs to accelerate learning by providing an efficient way to perform financial computations. The *Problem-Solver* icon points out all related applications throughout the text, the *Applications* book and *Study Guide*. Referenced to specific text pages for quick review of technique, the routines include financial ratios, breakeven analysis, cash budgets, pro forma statements, time value of money, bond and stock valuation, cost of capital, capital budgeting cash flows, capital budgeting techniques, bond refunding, and lease versus purchase.



The FMF Lotus Templates Developed by Enrique Roberto Lunski, *State University of New York at New Paltz*, provide users with programmed Lotus templates, for inputting data and solving problems using perhaps the most popular and widely accepted practical software application. The template files correspond to selected end-of-chapter problems, and the template file names follow the chapter number and the problem number.

Study Guide (ISBN 0067399032X) Created by Thomas M. Krueger, *University of Wisconsin-LaCrosse*, and D. Anthony Plath, *University of North Carolina-Charlotte*. An integral component of the *FMF Learning System*, this new edition offers many tools for studying finance: an introductory section called “And Now a Word From Our Sponsor” on overcoming the fear of finance, getting the most from the guide, and preparing thoroughly for tests and a unique section titled “Want to Win Friends, Fame, and Fortune?” on effective methods for setting up and solving finance problems, with a step-by-step example. Each chapter includes the following features: chapter review enumerated by learning goals; topical chapter outline, also broken down by learning goals for quick review; applications section including definition, objective items, a sample problem with a detailed solution, and then a full set of problems, some of which allow for use of software on the *FMF Disk*. Answers to definition and multiple-choice items appear in an appendix; however, solutions to problems remain at the end of each chapter. New FMF text packages include, free of charge, Chapter 11 (Time Value of Money) of the *Study Guide* so students can preview this superior learning tool before making a purchase decision, and five pages from the *Study Guide* are shown here on pages xxx to xxxiv.

This exhibit is a sample page from the *Study Guide* to accompany the fourth edition of Gitman, *Foundations of Managerial Finance*. Please contact your bookstore for ordering information on this effective study tool.

Chapter 1

Finance and the Financial Manager

CHAPTER SUMMARY

LG 1 Like most textbooks, the first chapter of *Foundations of Managerial Finance* provides an overview of the discipline, coverage, and textbook structure. Careful reading will provide a base that will enhance comprehension of concepts presented in subsequent chapters. Understanding these concepts will also improve personal financial decisions.

Chapter 1 acquaints the reader with the financial activities and decisions of business. Finance is defined as the art and science of managing money. The "science" aspect corresponds to the process, institutions, markets, and instruments involved in financing business assets, maximizing revenues, and minimizing expenses. The "art" aspect corresponds to the efficient coordination of personnel, processes, and procedures.

Many popular career opportunities exist in finance. Financial services industries such as banking, personal financial planning, investments, and real estate allow individuals to design and deliver financial services and products. Budgeting, cash management, credit administration, and funds procurement are important duties of the financial manager or treasurer. Career opportunities are rapidly arising in international finance for those able to manage the political and exchange rate risks arising from conducting businesses in multiple currencies.

Financial management should be understood by all business executives. Financial management effectiveness and efficiency will dictate the success of every organization, private or public, large or small, profit-seeking or not-for-profit, manufacturing, service, retail, or financial. All managers need a basic understanding of managerial finance, because forecasts and results are measured in financial terms. The objective of maximizing the value of the organization applies to all organizations. Several career opportunities are described in the text.

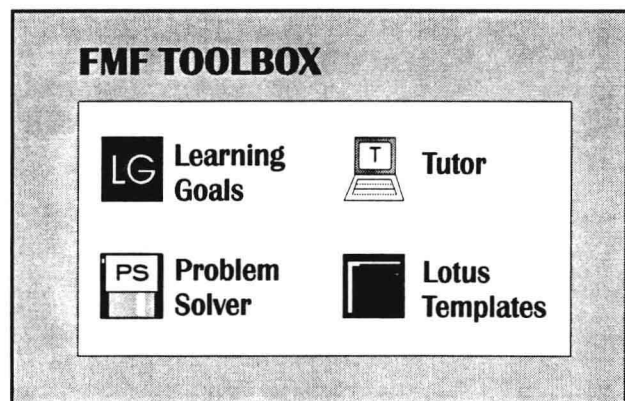
LG 2 The three basic forms of business organization are the sole proprietorship, the partnership, and the corporation. A sole proprietorship is a business owned by one person who operates it for his or her own profit. A partnership involves two or more owners doing

This exhibit is a sample page from the *Study Guide* to accompany the fourth edition of Gitman, *Foundations of Managerial Finance*. Please contact your bookstore for ordering information on this effective study tool.

relationship between compensation and share price, evidence indicates that maximizing share price is normally the primary goal.

LG 6 Ethical concerns may reduce the flexibility of financial managers seeking to maximize firm value. Yet, over time, ethical behavior is considered to be necessary for share price maximization. Employment of total quality management (TQM) techniques are consistent with the minimization of agency problems and ethical behavior of the business. Furthermore, productivity appears to increase quality in all financial manager activities.

Chapter 1 concludes with an overview of the text, which was developed around a set of learning objectives. The *toolbox* facilitating mastery of these objectives includes an Applications Workbook and a diskette with three sets of routines. The FMF Tutor includes additional questions for extended practice. Many routine financial calculations and procedures presented in the text can be solved with the FMF Problem-Solver. More complex problems can be solved using the FMF Lotus Template.



This exhibit is a sample page from the *Study Guide* to accompany the fourth edition of Gitman, *Foundations of Managerial Finance*. Please contact your bookstore for ordering information on this effective study tool.

EXAMPLE PROBLEMLG
1LG
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Amy Chen, who we met in Chapter 1, is considering an alternate computer. The alternative would require a lower cash outlay of \$50,000, but

the total benefits from the new computer (measured in today's dollars) would be a lesser \$55,000. Other data from the text problem includes:

Benefit of old computer:	\$ 35,000
Proceeds of sale of old computer:	<u>28,000</u>
Net benefit of \$80,000 computer:	\$ 13,000

Should Amy select the \$80,000 computer described in the text or the \$55,000 computer?

EXAMPLE SOLUTION

1. *State the Problem.*

Amy is attempting to maximize her firm's value by selecting the computer that will provide the highest rate of return without being too risky a venture. Finding information concerning the costs and benefits of the old and new computer is the "art" of finance, while applying marginal analysis is the "science" of finance. Excluding tax considerations, her analysis would be similar in a proprietorship, partnership, or corporation.

2. *Locate the relevant data.*

Amy needs to get information on the costs of each computer and the revenues expected to be generated with each.

3. *Select the proper tool/equation to evaluate the problem:*

Amy will subtract the financial costs of each computer from their financial benefits and then select the option that will provide the highest net benefit.