

MODERN CORPORATE FINANCE

A
MULTIDISCIPLINARY
APPROACH
TO
VALUE
CREATION



ALAN C. SHAPIRO • SHELDON D. BALBIRER

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**A Multidisciplinary Approach
to Value Creation**

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*Prentice Hall
Upper Saddle River, New Jersey 07458*

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Illustrator (Interior): Omegatype Typography, Inc.
Cover Illustration/Photo: Burstein Goldman/The Stock Rep., Inc.
Composition: Omegatype Typography, Inc.

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Upper Saddle River, New Jersey 07458

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Library of Congress Cataloging-in-Publication Data

Shapiro, Alan C.

Modern corporate finance : a multidisciplinary approach to
value creation / Alan C. Shapiro, Sheldon D. Balbirer.
p. cm.

Includes bibliographical references and index.

ISBN 0-13-080098-8

1. Corporations—Finance. I. Balbirer, Sheldon D. II. Title.
HG4011.S445 2000
658.15—dc21 99-34674

CIP
Rev.

Prentice-Hall International (UK) Limited, London
Prentice-Hall of Australia Pty. Limited, Sydney
Prentice-Hall Canada, Inc., Toronto
Prentice-Hall Hispanoamericana, S.A., Mexico
Prentice-Hall of India Private Limited, New Delhi
Prentice-Hall of Japan, Inc., Tokyo
Prentice-Hall (Singapore) Pte. Ltd.
Editora Prentice-Hall do Brasil, Ltda., Rio de Janeiro

Printed in the United States of America

10 9 8 7 6 5 4 3 2

To Diane and Roslyn, our wives,
for their love and support.

Preface

Money has a universal fascination, but few people seem to understand it very well. It is the subject of countless myths, false theories, and illogical beliefs. One of the few organized attempts to study the relationship between money—past, present, and future—and financial markets and financial decision making is provided by the discipline of financial economics. In the course of their work, financial economists have dispelled many of the myths and ad hoc reasoning surrounding traditional financial advice and substituted an insightful and subtle logic firmly grounded in economic analysis.

Our basic objective in writing *Modern Corporate Finance: A Multidisciplinary Approach to Value Creation* is to make accessible to students and practitioners alike the practical implications for managers of the exciting new theoretical and empirical breakthroughs in financial economics. The book is written to help the reader understand how and why finance matters, regardless of whether the reader intends to pursue a career in finance. We have tried to motivate the non-finance major by illustrating the application of financial analysis and reasoning to problems faced by executives in marketing, operations, and personnel. It is intended for managers and other professionals enrolled in executive MBA and evening MBA programs as well as other executive education programs but is equally suitable for use by first-year MBA students taking their introductory corporate finance course.

Although the book relies on material covered in economics, accounting, and statistics courses, it is self-contained so that prior knowledge of those areas is useful but not essential. The only real prerequisites are algebra and an interest in understanding how the world works.

DISTINCTIVE FEATURES

Modern Corporate Finance identifies the discipline that the external financial market imposes on the financial affairs of the firm. It also attempts to decipher the messages the market sends about the proper objectives of corporate financial decision making and the appropriate tactics and strategies for achieving them. Throughout, the text emphasizes value creation and the role of corporate finance in facilitating this process.

To achieve these aims this book tells finance as a single coherent story, rather than as a collection of short stories. It also includes features that distinguish it from its competitors.

Practical Approach

There is nothing quite so practical as a theory that works. We have tried to reinforce this belief by taking a commonsense approach to finance. This involves showing students *why* the various theories discussed make sense and *how* to use these theories to solve problems. The book relates the subject matter to material students are already familiar with or have learned in previous chapters, making it less intimidating and more interesting. Basic intuition is emphasized throughout.

Numerous Applications of Finance Principles

In keeping with its down-to-earth approach, the textbook contains numerous real-world examples and vignettes that help illustrate the application of financial theories and demonstrate the use of financial analysis and reasoning to solve financial problems. These examples promote understanding of basic theory and add interest to finance.

Appeal to Non-finance Majors

Because so many of the issues dealt with by nonfinancial executives have financial implications, from determining advertising budgets and credit policies to investing in management training programs, it is clear that financial theory has broad application to general management as well. Persuading readers who are not interested in pursuing a career in finance of this is a different matter. We have attempted to motivate these doubting Thomases by using numerous illustrations, scattered throughout the text, of the application of financial analysis to nonfinancial problems. Moreover, we have attempted to concentrate on those aspects of corporate finance that are most important to financial and nonfinancial executives. In this way, we have tried to highlight why the reader should care about the topics covered.

Emphasis on Value Creation

The text emphasizes two related issues: how companies create value and how corporate finance can facilitate the process of value creation. Because this is a book on corporate finance, the focus is on how the financial manager can add value to the firm. The viewpoint taken in this text is that the comparative advantage of the financial manager lies in understanding the intricacies of the modern financial marketplace and using this knowledge to full advantage to manage the firm's financial affairs.

The text's guiding principle is that financial management is subordinate to the "real" business of the firm, which is to produce and sell goods and services. This does not, of course, preclude the financial manager from finding and exploiting

profitable opportunities that may occasionally arise in financial markets. It does, however, require that the financial executive be able to recognize when these circumstances exist or are likely to exist. This necessitates a firm grounding in modern finance theory.

Having said all of this, we should recognize that the processes of creating value—particularly shareholder value—and running the “real” business are interrelated. Specifically, firms that are effective at running the real business (by creating value for customers and a productive work environment for employees) should also be in a position to create shareholder value. Thus, the strategic goal of creating competitive advantage and the financial goal of creating shareholder value are two sides of the same coin. This interdisciplinary approach to value creation permeates the text and is unique to this work.

Incorporation of the Human Factor in Finance

Although this text takes its basic driving principle to be the maximization of shareholder wealth, it recognizes that the separation between ownership and control can help explain the frequent discrepancy between observed corporate financial policy and neoclassical economic predictions. This is the topic known as agency theory, and it is utilized to analyze manager–owner and stockholder–bondholder conflicts in professionally managed firms. The material is also useful in helping to understand the wave of corporate restructuring that is now occurring.

By integrating agency theory and its companion, information asymmetry, and their applications throughout, we have tried to illustrate the human factor in financial decision making. The basic perspective taken is that seemingly irrational (from the standpoint of the shareholder) managerial actions can best be understood as the rational response of managers to uncertainty and specific evaluation criteria and mechanisms.

Coverage of International Topics

On a more personal note, we believe that managers must view business from a global perspective; *international* is not just another section of the domestic economy, like office machines or autos, that can be ignored at no cost. Instead, an international orientation has become a business necessity, not a luxury. Those American television manufacturers determined to remain purely domestic operations learned this lesson the hard way; their greatest competitive threat came from companies located 8,000 miles away, across the Pacific, not from other American producers. To facilitate the development of a global perspective, we have tried to integrate domestic and international financial management throughout the book. To the extent we have succeeded, this is one of the distinctive features of the text.

Focused Coverage

The subject matter of this book is focused on those subjects in corporate finance that are critical to an understanding of finance. Focused textbook coverage is a plus for programs that have reduced the amount of time devoted to finance and

wish to have a relatively short book that concentrates on the key topics of corporate finance. At the same time, we have taken advantage of the new technology available via the Internet to develop a web site that contains additional topic coverage. The availability of a menu of additional topics on our web site allows instructors to customize a text based on their individual course needs. Students benefit because they can keep the text while having available a broader array of chapters in cyberspace. The combination of the two gives students a comprehensive reference after completing the course.

Numerous Questions and Problems

Another distinctive feature of *Modern Corporate Finance* is the large number of end-of-chapter questions and problems and their close relationship to the material in the chapters. Good conceptual questions are as important as computational problems in promoting understanding, and the ones presented in this text are consistently challenging, interesting, and extremely useful. They provide practical insights into the types of decisions faced by financial executives and offer practice in applying financial concepts and theories.

Additional Features

The textbook also includes a number of other distinguishing features that relate to the subject matter covered; it

- Includes the most comprehensive discussion and illustration of financial statement analysis available; shows students how to conduct a detailed financial analysis and points out the numerous pitfalls involved in such an analysis; provides a unique discussion of the qualitative aspects of corporate control; as well as showing how segmented financial statements can be used to evaluate the performance of individual units of a diversified firm (Chapter 2).
- Emphasizes the distinction between accounting and economic performance (Chapter 2).
- Links financial planning and working capital management to the strategic planning process (Chapter 3)
- Shows the linkages between corporate growth strategies and shareholder value creation, and indicates when such growth can actually dissipate value (Chapter 5).
- Demonstrates how to value a firm using the concept of free cash flow and presents several alternatives to estimate the terminal value using the real-life example of Warner Communications at the time of its acquisition by Time, Inc. (Appendix 5A).
- Indicates the circumstances under which corporate diversification can create value, and when it cannot (Chapter 6).
- Stresses the value of international, as opposed to domestic, diversification (Chapter 6).
- Contains a relatively early introduction to option pricing and contingent claims, which allows these concepts to be used for valuing growth options and

explaining stockholder–bondholder conflicts in later discussions of capital structure and financial strategy (Chapter 7).

- Features a detailed discussion of estimating project cash flows, including incremental versus total cash flows, the effects of inflation on cash flows, the valuation of foreign projects, and the valuation of growth options. It gives students hands-on experience in estimating project cash flows and helps them gain an appreciation for the real-world difficulties in valuing projects (Chapter 9).
- Provides a discussion of how the total risk of an investment project can be assessed (Appendix 9A) and how that risk can affect expected cash flows (Chapter 14).
- Features a discussion of how investment decisions can help create competitive advantage and thereby enhance shareholder value (Chapter 9).
- Contains a unique chapter on how companies create value—including value-based analysis and corporate restructuring—as well as the links between return on investment, required return on capital invested, and the pricing of stocks. It also deals with issues of executive compensation from a financial standpoint (Chapter 11).
- Features a detailed presentation of financing patterns of companies around the world and discusses the evolution of these financing patterns, particularly the rise of securitization. This helps to put financing options and patterns into perspective (Chapter 12).
- Addresses the qualitative factors that determine financial strategy, concentrating on the costs of financial distress and the value of financial flexibility, thereby putting the design of financial packages in perspective (Chapter 14).

ORGANIZATION

Although the ideas underlying financial economics are interrelated, by necessity they must be elaborated individually. Eventually, they must also be integrated because they are all part of a grand framework. To accomplish this objective, the book is arranged so that each chapter builds on the previous material.

To bring the full power of modern finance theory to bear on the subject matter of corporate financial management, we require a unified theory of how and why individuals behave in the presence of choice situations involving limited resources, current versus future consumption, and uncertainty. This is supplied by the general equilibrium framework of financial economics, which attempts to study how all the financial factors mentioned earlier interact simultaneously. We introduce this material in Chapter 1 by discussing a series of deceptively simple principles and then applying those principles to specific problems faced by the modern financial manager. By providing an overview of the basic concepts and principles applicable to the practice of corporate finance in the first chapter, readers have a clear road map of where we are headed and why. This discussion also helps set these ideas in perspective.

Chapters 2 and 3 discuss financial planning and the evaluation and control of operations. Topics include basic financial statements and how management,

investors, lenders, and other interested parties can analyze these statements to check on a firm's financial well-being. These chapters also show how financial managers can forecast future financial statements and use these projections to develop an overall financial plan for the firm.

In Chapters 4 to 7, we provide students with a firm grounding in the essentials of modern corporate finance: the time value of money, the pricing of stocks and bonds, portfolio theory and the capital asset pricing model, market efficiency, the nature and pricing of options, and the crucial distinction between accounting profits and cash flow. This material supplies the foundation that enables students to see financial problems from a different frame of reference. Above all else, our aim is to get students to begin thinking in the distinctive way that characterizes the mindset of a financial economist.

Chapters 8 to 11 apply these basic financial principles to the capital-budgeting decision. In these chapters, we are concerned with the most important problem facing management—finding or creating investment projects worth more than they cost. Topics covered include the basics of capital budgeting, the estimation of project cash flows and the project cost of capital, risk analysis in capital budgeting, and corporate strategy and its relationship to the capital-budgeting decision. Throughout these chapters, we emphasize how management creates value for its shareholders.

Chapters 12 to 15 are concerned with developing a long-term financing strategy. They discuss the long-term financing options firms have, how firms go about raising long-term capital, the theory and practice surrounding capital structure, and dividend policy. Throughout these chapters, the emphasis is on how financing can add value.

The web site for this textbook contains coverage of special topics in financial management, including mergers and acquisitions, international finance, leasing, convertibles and warrants, management of working capital (cash management, accounts receivable, and inventory), bankruptcy and reorganization, and financial hedging techniques. These important subjects are treated as applications of concepts and principles developed in the body of the text.

FOR THE STUDENT

The Prentice Hall Finance Center CD

Contained in the inside back cover of this text is the *Prentice Hall Finance Center CD*. This robust learning tool contains the following features, all designed to increase student awareness of what finance professionals do, ensure comprehension and mastery of the financial mathematics contained in the text, and supply a direct link to PHLIP (Prentice Hall Learning on the Internet Partnership).

- **Careers Center.** Introduces the student to a vast array of professional opportunities in finance through video interviews with professionals and insights into what they do on the job in an average day. Here the student will meet an

options trader, a mutual fund manager, investment analysts, a CFO, and others. Also accessible are features for personal development, resume writing, interviewing techniques, and career planning information.

- **FINCOACH—The Financial Math Practice Center.** Contains more than 5 million problems and self-tests in virtually all math areas covered in this text and financial management. Save problems, review them, print them. This is a step-by-step guide to solve any corporate finance mathematics problem and allow the student to rapidly gain mastery in all mathematical challenges.
- **Student Lecture Notes.** Downloadable for printing out, this handy lecture aid for the student contains PowerPoint presentations with space for lecture note taking for each chapter in the text.

FOR THE INSTRUCTOR

- **Instructor's Resource Manual.** Prepared by the authors of the text, this manual contains concise chapter teaching strategies, detailed chapter outlines, additional problems and worked out solutions, and suggested cases from popular external sources. An Instructor's Guide to using PHLIP (Prentice Hall Learning on the Internet Partnership) and a Guide to Using the Prentice Hall Finance Center are also contained in this manual.
- **Solution's Manual.** Prepared by the authors of the text, this manual contains complete answers to end-of-chapter questions and worked out solutions to all problems in the text. This manual will be available for purchase by the student if the instructor so desires.
- **Test Item File.** This file contains over 800 true/false, multiple-choice, and short-answer questions.
- **PH Custom Tests.** Available for both Windows and Macintosh, PH Custom is the computerized version of the test item file. It permits the instructor to edit, add or delete questions from the test item file, and generate their own custom exams.
- **FINCOACH Test Manager and FINCOACH Instructor's Manual.** Test Manager software has been developed to allow instructors to generate tests based on FINCOACH—The Financial Management Math Practice Program contained within the Prentice Hall Finance Center CD available to all students using *Corporate Finance*. In addition, an Instructor's Manual for using FINCOACH Test Manager and FINCOACH in the course has been developed and is included with every copy of Test Manager.
- **PowerPoint Presentation.** To encourage more active learning, the slides include sample problems for students to solve in class. The presentations are available from the Prentice Hall PHLIP web site (<http://www.prenhall.com/shapiro> or <http://www.prenhall.com/financecenter>).
- Additional materials are available for instructors by clicking "faculty site" in the above referenced URLs for *Corporate Finance*. ID and Password designations are available from the local Prentice Hall representative. These faculty sites include:
 - Instructor's Manual downloadable per chapter.

- Downloadable Excel spreadsheet templates and solutions to all end-of-chapter problems, including solutions to Integrated Problems.

ACKNOWLEDGMENTS

We greatly appreciate the comments and suggestions of the following reviewers: Victor Abraham, Los Angeles Technical College; Anat Admati, Stanford University; Vickie L. Bajtelsmit, Colorado State University; John F. Boschen, College of William and Mary; Richard A. DeFusco, University of Nebraska at Lincoln; Joseph E. Finnerty, University of Illinois at Urbana-Champaign; Delvin D. Hawley, University of Mississippi; Marlin Jensen, Auburn University; Robert Kleiman, Oakland University; Thomas M. Krueger, University of Wisconsin–La Crosse; Surendra Mansinghka, San Francisco State University; William McDaniel, Florida Atlantic University; Joseph Messina, San Francisco State University; L. W. (Bill) Murray, University of San Francisco; Joe Ogden, University of Buffalo; Patricia A. Ryan, Drake University; Scott Smart, Indiana University; Robert Stretcher, Hampton University; Michael Toyne, Northeastern State University; David Volkman, University of Nebraska at Omaha; and Joe Walker, University of Alabama at Birmingham.

We'd like to thank all of the people at Prentice Hall who helped with the project, including Jodi Hirsh, Lori Braumberger, and Gladys Soto. A special thanks goes to our editor, Paul Donnelly, who kept us on task and helped pull the pieces of this project together.

During the development of *Corporate Finance* both Prentice Hall and ourselves benefited immensely from feedback we accumulated from many of our colleagues who teach in the area of corporate finance. This feedback came in the form of responses to a survey conducted in the fall of 1998 and personal conversations. We are most appreciative to all of these individuals for sharing their thoughts and their valuable time with regard to our text. They are Saul Adelman, Miami University; Kofi Amoateng, North Carolina Central University; Leslie Anderson, Portland State University; Thomas Anderson, Kennesaw State University; Tony Apap, University of West Florida; David Arnold, College of the Southwest; Leroy Ashorn, Sam Houston State University; Anthony Avallone, Point Loma Nazarene University; Yu-Jung Avis, College of St. Rose; Curtis Bacon, Southern Oregon University; Sung Bae, Bowling Green State University; Bruce Bagamary, Central Washington University; Dean Baim, Pepperdine University; Ray Baker, Rockford College; Mary Ballantyne, Passaic County Community College; Joel Barber, Florida International University; Marisa Baron, Isothermal Community College; Scottie Barty, Northern Kentucky University; Ron Bealer, Norwalk Community Technical College; Thomas Bear, Stetson University; Kenneth Beller, Washington State University–Tri Cities; Scott Below, East Carolina University; Yvette Bendeck, University of Houston–Clearlake; Gary Benesh, Florida State University; Art Berman, Chemeketa Community College; Robert Berry, University of Houston; Carol Billingham, Central Michigan University; John Bilson, Illinois

Institute of Technology; Michael Binder, Buena Vista University; Homer Bonitsis, New Jersey Institute of Technology; John Boos, Ohio Wesleyan University; Brian Boscaljon, Calvin College; Steve Bouchard, Goldey Beacom College; James Boyd, Kent State University; Michael Boyd, Stetson University; William Brent, Howard University; Billie Brotman, Kennesaw State University; William Brown, Claremont Mckenna College; Richard Brunell, Concordia University; Wayne Buchanan, Alice Lloyd College; Paul Bursik, Saint Norbert College; Alva Butcher, University of Puget Sound; Kirt Butler, Michigan State University; Robert Butler, Olivet College; Joseph Byers, Community College of Allegheny County; Ezra Byler, Millikin University; Tony Byrd, University of Central Florida; Julie Cagle, Xavier University; Alan Carper, Bob Jones University; David Carter, Abilene Christian University; Steven Carvell, Cornell University; Stephen Cassidy, Howard University; Jennifer Caudill, Auburn University; Karen Chambliss, Florida Institute of Technology; P Chandy, University of North Texas; Robert Chatfield, University of Nevada Las Vegas; Leo Cheatham, Northeast Louisiana University; Carl Chen, University of Dayton; Chao Chen, California State University–Northridge; Haiyang Chen, Youngstown State University; Yin-Wong Cheung, University of California Santa Cruz; Andreas Christofi, Monmouth University; Bert Connell, Loma Linda University; C. Mitchell Conover, University of North Carolina–Wilmington; Clyde Cooley, Weber State University; Thomas Corrigan, Sacred Heart University; John Cresson, Northeastern State University; Robert Cullen, Mercyhurst College; Tom Curry, Morningside College; Robbie Dail, Beaufort County Community College; Wallace Davidson, Southern Illinois University–Carbondale; Steve Davis, Northwestern College; Dennis Debrecht, Carroll College; Karen Denning, West Virginia University; Anand Desai, Kansas State University; Les Dlabay, Lake Forest College; David Dubofsky, Virginia Commonwealth University; Martine Duchatelet, Barry University; Mary Ducey, Texas Southern University; John Dunkelberg, Wake Forest University; Michael Dunn, California State University–Northridge; Dan Ebels, University of Michigan–Ann Arbor; David Echevarria, St. Joseph's University; Richard Edelman, American University; Al Eferstein, Lindsey Wilson College; Imad Elhaj, Colorado School of Mines; Barry Ellis, Southeastern Oklahoma State University; Ronel Elul, Brown University; Lisa Fairchild, Loyola College; Hsing Fang, California State University–Los Angeles; Greg Fink, Richard Stockton State College; Peggy Fletcher, Northeastern University; Jennifer Foo, Stetson University; Swint Friday, University of South Alabama; Mark Geiger, William Woods University; Richard Gendreau, Bemidji State University; Tommy Georgiades, DeVry Institute of Technology; Bruno Gerard, University of Southern California; John Gerlach, Sacred Heart University; Erika Gilbert, Illinois State University; Preston Gilson, Fort Hays State University; Chris Gingrich, Eastern Mennonite University; Ruth Gitzendanner, Tri State University; David Gordon, Governors State University; Douglas Gordon, Arapahoe Community College; Ray Gorman, Miami University–Oxford; Diane Gregory, Bentley College; Deborah Griest, Lake Tahoe Community College; John Griffith, University of Minnesota–Duluth; Richard Gritta, University of Portland; Russell Grosjean, Erie Community College; Mahmoud Haddad, University of Tennessee–Martin; Richard Halberg, Houghton

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McManis, Nicholls State University; Kathy McNichol, La Salle University; Guillermo Melendez, Metropolitan University; David Merrifield, Christian Heritage College; Joseph Messina, San Francisco State University; Stuart Michelson, University of Central Florida; David Minars, Brooklyn College of CUNY; John Mitchell, Central Michigan University; Cheryl Mitteness, St. Cloud State University; Naval Modani, University of Central Florida; Timothy Moffitt, Kalamazoo College; Lynn Moller, Kansas Wesleyan University; Robert Monfort, Saint Josephs College; Scott Moore, John Carroll University; Dianne Morrison, University of Wisconsin–La Crosse; Saeed Mortazari, Humboldt State University; Jon Moulton, Oregon State University; David Mullis, University of South Carolina; Laurie Murphy, Flathead Valley Community College; L. William Murray, University of San Francisco; James Nelson, University of Arizona; Randy Nelson, Colby College; William Nelson, Indiana University Northwest; Jeffry Netter, University of Georgia; Chee Ng, Rowan University; Joan Nix, Queens College of CUNY; John Nofsinger, Marquette University; Gary Noreiko, University of Southern Colorado; Jamie O'Brien, South Dakota State University; Oris Odom, University of Texas at Tyler; Jim Owens, West Texas A&M University; R. Daniel, Pace University of West Florida; Therese Pactwa, Florida International University; Roger Palmer, University of St. Thomas; Chang Park, Clinch Valley College; Andrew Parkes, East Central University; Sam Penkar, University of Houston–Downtown; Jonathan Peters, Wagner College; Corey Pfaffe, Maranatha Baptist Bible College; Michael Phillips, Austin Peay State University; Jim Philpot, Ouachita Baptist University; Eugene Poindexter, State University of West Georgia; J. C. Poindexter, North Carolina State University; Thomas Potter, University of North Dakota; Annette Poulsen, University of Georgia; Cynthia Powell, Southern Nazarene University; Rose Prasad, Central Michigan University; John Primus, California State University–Hayward; Richard Proctor, Siena College; Dennis Proffitt, Grand Canyon University; Frances Quinn, Merrimack College; Ganas Rakes, Ohio University–Athens; Kumoli Ramakrishnan, University of South Dakota; Sanjay Ramchander, Minnesota State University Mankato; Ganga Ramdas, Lincoln University; Robert Rainish, University of New Haven; Linda Ravelle, Moravian College; David Rayome, Northern Michigan University; John Reik, University of Minnesota; Cecilia Ricci, Seton Hall University; Hong Rim, Shippensburg University; Kenneth Roberts, Southwestern University; Georges Rocourt, Barry University; Foster Roden, University of North Texas; Bernard Rose, Rocky Mountain College; Mike Rosen, Pepperdine University; Stan Rosenberg, La Roche College; Herbert Roth, Shippensburg University; Arlyn Rubash, Bradley University; Bruce Rubin, Old Dominion University; Chip Ruscher, James Madison University; Patricia Ryan, Drake University; Robert Saemann, Alverno College; Paul Sarmas, Cal State Polytech University; Vincent Scerbinski, Southampton College; Patricia Schaeff, Miami University–Oxford; Burton Schaffer, California State University–Sacramento; Michael Schellenger, University Wisconsin Oshkosh; Stephen Schepman, Central Washington University; Bill Schmidt, Shorter College; Jeffrey Schultz, Christian Brothers University; Robert Schweitzer, University of Delaware; James Seifert, Marquette University; Jimmy Senteza, Washington State University; Rodney Serizawa, San Francisco State University; Edward Shafer, University of

Maryland; Dianna Shallenburger, Central Methodist College; Peter Sharp, California State University–Sacramento; Allen Shin, Frostburg State University; Kilman Shin, Ferris State University; Julian Shlager, Plymouth State College; Joseph Shott, Westmoreland County Community College; Connie Shum, Pittsburgh State University; Debra Skaradzinski, Hollins University; Fred Siegel, University of Louisville; Julie Smith, Oral Roberts University; Patricia Smith, North Carolina Wesleyan College; Ronald Smith, St. Thomas Aquinas College; Stephanie Smith, Texas A&M International University; Ira Sohn, Montclair State University; Patricia Sommerville, St. Mary's University; Kean Song, Prairie View A&M University; Austin Spencer, Western Carolina University; Katherine Spiess, University of Notre Dame; Hubert Spraberry, Howard Payne University; Jan Squires, Southwest Missouri State University; Suresh Srivastava, University of Alaska–Anchorage; Marty St. John, Westmoreland County Community College; Richard Stackman, University of Washington–Tacoma; Edward Stendardi, St. John Fisher College; Glenn Stevens, Franklin Marshall College; Jerry Stevens, University of Richmond; Eric Stiles, Fordham University; Gabe Stoeppler, Limestone College; Steve Stover, California Maritime Academy; John Stowe, University of Missouri–Columbia; Charles Strang, Western New Mexico University; Robert Stretcher, Hampton University; Jan Strockis, Santa Clara University; Barbara Suleski, Cardinal Stritch College; Mark Sullivan, Wor Wic Community College; Michael Sullivan, University of Nevada Las Vegas; Janice Swain, Regis College; George Swales, Southwest Missouri State University; Wonhi Synn, Elon College; Harry Tamule, Providence College; Amir Tavakkol, Kansas State University; Janet Thatcher, University of Wisconsin–Whitewater; Madeline Thimmes, Utah State University; Bruce Toews, Walla Walla College; José Trinidad, Southwest Texas State University; George Trivoli, Jacksonville State University; C. Joe Ueng, University of St. Thomas; E. Upton, Virginia Commonwealth University; David Vang, University of St. Thomas; Dennis Varin, Southern Oregon University; Sue Visscher, University of Toledo; Ashok Vora, Baruch College of CUNY; Jean Walker, West Texas A&M University; Edward Waller, University of Houston–Clearlake; Stan Warren, Niagara University; Randi Waxman, Columbia Union College; Samuel Weaver, Lehigh University; Marsha Weber, Moorhead State University; Loren Weishaar, Texas Lutheran College; Charles Wellens, Fitchburg State College; Gary Wells, Idaho State University; Peng Wen, Fresno Pacific College; Mark Wencel, Piedmont Community College; John White, Georgia Southern University; Michael White, Bob Jones University; Howard Whitney, Franklin University; Marilyn Wiley, Florida Atlantic University; Gary Wishniewsky, California State University–Hayward; Edward Wolfe, Western Kentucky University; Bob Wood, Tennessee Technical University; David Wright, University of Wisconsin; Mark Wrolstad, Winona State University; Jerry Yang, University of Arizona; Richard Yanow, Massachusetts College of Liberal Arts; Philip Young, Southwest Missouri State University; Ken Yung, Old Dominion University; Richard Zock, California State University–Hayward; and Thomas Zwirlein, University of Colorado.

Finally, we'd like to acknowledge the patience and encouragement of our wives, Diane and Roslyn, and our children, Tom and Kathryn, and Rena and Amy.

They had to bear the brunt of countless hours spent over the computer looking for the right words and examples to bring *Modern Corporate Finance* to life.

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A SPECIAL ACKNOWLEDGMENT

From my perspective, this book owes its greatest debt to Alan's earlier work *Modern Corporate Finance* (MCF), published in 1989 by Macmillan. I fell in love with it the first time I saw it. The work's emphasis on value creation, the integration of domestic and international finance, its interdisciplinary flavor, and student-friendly writing style (among other things) set the book apart from other graduate texts. Had MCF gone to a second edition, I never would have gotten into the textbook writing "business."

However, life takes some curious bounces, and I found myself developing material for a concise finance text to fit executive education and/or evening MBA programs, in which there may be a limited amount of time to spend on corporate finance. Paul Donnelly quickly recognized that the themes permeating my proposed work were identical to Alan's earlier work and brought us together for this collaborative effort. In the process of getting together to write this book, Alan and I found that we both grew up in the same neighborhood—Coney Island in Brooklyn. We also share the same alma mater—I did my undergraduate engineering work at Carnegie Tech, whereas Alan did his doctoral work in finance at Carnegie-Mellon. More important, we both see corporate finance as a dynamic field of study and hope we can share some of that excitement with you.

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