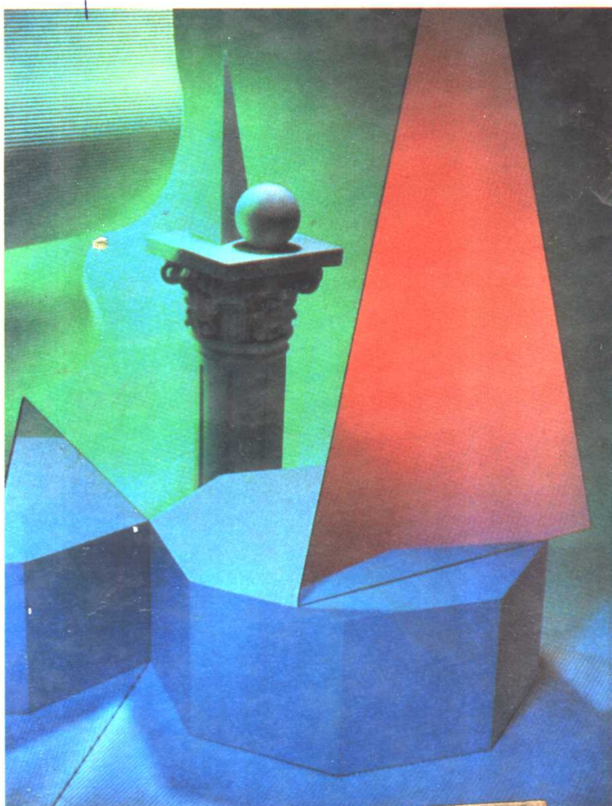
Essentials of Managerial Finance

Ninth Edition



J. Fred Weston
Eugene F. Brigham

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Ninth Edition

J. Fred Weston
University of California, Los Angeles
Eugene F. Brigham
University of Florida

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Acquisitions Editor: Ann Heath
Developmental Editor: Judy Sarwark
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PREFACE

The central focus of *Essentials of Managerial Finance* is on the role of financial management in maximizing the value of the firm. We begin with a discussion of such basic concepts as security markets, taxes, interest rates, and risk/return valuation models, and then we go on to explain how managerial finance can be used to help maximize the value of a firm. Placing the basic concepts first has three important advantages:

1. Explaining early in the book how financial markets operate, and how security prices are determined within these markets, helps students see how various corporate decisions affect the value of the firm. Also, early coverage of risk analysis and valuation models permits us to use and reinforce these key concepts throughout the book.
2. Structuring the book around value maximization enhances continuity—students can see better how the various topics interrelate with one another, and how different decisions interact to affect stock prices, and hence the value of the firm.
3. Most students—even those who do not plan to major in finance—are interested in stock and bond valuation, rates of return, and the like. Since one's ability to learn a subject is a function of his or her interest and motivation, and since *Essentials* begins with the inherently interesting subjects of security markets, security values, and rates of return, this organization is good from a pedagogic standpoint.

Relationship with Our Other Books

As the body of knowledge expanded, it first became difficult, then impossible, to provide "everything one needs to know about managerial finance" in one text, especially in one undergraduate text. This recognition led us to limit the scope of this book, and also to write other texts, with other coauthors, to deal with the materials that must necessarily be deleted from *Essentials.* Thus, Fred Weston has coauthored a theory text with Tom Copeland *(Finan-*

cial Theory and Corporate Policy), and Weston and Copeland have also coauthored the eighth edition of *Managerial Finance,* a very comprehensive text designed primarily for the MBA market. Gene Brigham has coauthored with Lou Gapenski both an intermediate undergraduate text (*Intermediate Financial Management,* third edition) and a comprehensive book aimed primarily at MBAs (*Financial Management: Theory and Practice,* fifth edition). Brigham has also written two other introductory undergraduate texts, *Fundamentals of Financial Management,* fifth edition, and *Introduction to Financial Management,* second edition, coauthored with B. J. Campsey. *Essentials* and *Fundamentals* are written at the same level, but their organizational structures differ significantly, while *Introduction* is significantly less complex, and it is designed for a somewhat lower-level market.

The relationship between *Essentials* and our more advanced books, especially Brigham and Gapenski's MBA book, *Financial Management,* and their upper-level undergraduate text, *Intermediate Financial Management,* deserves special comment. Because the advanced books are often used by students who have used *Essentials* in the introductory undergraduate course, there are two potential dangers: (1) There may be excessive overlap in certain areas, and (2) students may not be sufficiently exposed to alternative points of view on controversial subjects. Regarding overlap, both we and the reviewers have looked for excesses, and we have attempted to remove them. We should also note that our students in the advanced courses invariably tell us that they find it helpful to have the same difficult introductory materials repeated—they need the review. Students also say they like the fact that the style and notation used in the higher-level books are consistent with those in the introductory texts, as this makes learning easier. Regarding alternative points of view, we have made every effort to take a moderate, middle-of-the-road approach, and where serious controversy exists, we have tried to present the alternative points of view. Reviewers were asked to consider this point, and their comments have helped us avoid unwarranted biases.

Intended Market and Use

As noted before, *Essentials* is intended for use as an introductory text. The main parts can be covered in a one-term course, and, supplemented with cases and some outside readings, the book can also be used in a two-term course. If the book is used in a one-term course, the instructor will probably want to cover only selected chapters, leaving the others for students to examine on their own or to use as references in conjunction with work in later courses. In our classes, we normally cover Chapters 1 through 19, and finance majors then cover the remaining topics in the next course. Also, we have made every effort to write the chapters in a modular form, which makes it easy for instructors to cover the material in a different sequence than the one in the book.

Major Changes in the Ninth Edition

The theory and practice of finance are dynamic, and, as important new developments occur, they must be incorporated into a textbook such as this one. Also, we and a team of reviewers are constantly on the lookout for ways to improve the book in terms of clarity and understanding. As a result, we have made several important changes in this edition, including the following:

1. All sections have been updated to reflect the latest tax laws, interest rates, and other financial developments.
2. A new section on business ethics has been added to Chapter 1, and special attention is given to ethical issues throughout the remainder of the book.
3. A new section on career opportunities in finance has been added to Chapter 1.
4. A discussion of the nominal risk-free rate of interest, k_{RF}, called the "risk-free rate" throughout the text, has been added to Chapter 3. A discussion of our foreign trade balance is also included in Chapter 3.
5. Risk analysis has been moved from Chapter 6 to Chapter 4; it now follows the chapter on interest rates and capital markets, and it precedes the chapter on valuation models. This arrangement results in a smoother, more logical transition from the discussion of interest rates, to risk premiums, to risk-adjusted rates of return, and then on to time value of money and valuation models.
6. Additional "real world" examples have been added to the chapter sections entitled "A Managerial Perspective" to illustrate the importance of financial management.
7. The "statement of changes in financial position" has been replaced with a "statement of cash flows" to reflect the recent change in required financial accounting reports (Chapter 7).
8. The information provided on choosing a bank in Chapter 14 has been expanded to include a section on merchant banking.
9. Two new sections which discuss the modified internal rate of return (MIRR) and multiple IRRs have been added to Chapter 15. The modified IRR is more useful than the traditional IRR in capital budgeting, hence it is essential in any presentation of capital budgeting techniques.
10. Part of the discussion of capital structure theory, including the MM model and asymmetric information effects, has been moved from the body of Chapter 18 to a chapter appendix. This change was suggested by several reviewers who regarded the material as being too theoretical for inclusion in many introductory courses. Now instructors have more flexibility in choosing to cover or to skip the material.
11. The Chapter 21 discussion of zero coupon bonds has been completely rewritten to reflect the current tax treatment of these bonds.

12. A discussion of putable bonds has been added to Chapter 21, and the coverage of bond indentures has been updated to include material on the impact of LBOs and similar events on the bond ratings of firms such as RJR Nabisco.

13. Several changes have been made to Chapter 23, including the addition of a section on corporate alliances. Also, new examples were added to illustrate information presented in the chapter—these examples concerned acquisitions made by Federated Department Stores and the leveraged buyout of RJR Nabisco by KKR. Finally, a discussion of international mergers has been added to the chapter.

14. The sections on international finance and on small business finance have been expanded and placed directly in the relevant chapters; this reflects the increasing importance of these subjects.

15. Concept review questions have been added to the major sections within each chapter. These questions ask the students about key concepts in the section they have just read, and if they cannot answer the questions, then students should reread the section. Our own students call these questions "attention joggers," and they find them most useful.

16. The old chapter summaries have been replaced with new ones in which the main ideas covered in each chapter appear in a list of key concepts. This new format makes it much easier for students to review the chapter.

17. We have also added to each set of end-of-chapter problems (except in Chapter 1) an integrative problem that covers, in a comprehensive manner, all of the major concepts discussed in the chapter. These problems can be used as a basis for a lecture, or they can be used by students as comprehensive study problems. To facilitate their use as lecture problems, we have written the *Instructor's Manual* solutions in a lecture note format, and we developed a set of transparency masters that can be used to make acetate transparencies for overhead projectors. Also, since students often get left behind when instructors use overheads, we have developed a new ancillary, *Blueprints: A Problem Notebook,* which is designed to facilitate note taking and studying. *Blueprints* comes free with each copy of the text, and in it each integrative problem is restated, space is provided for taking notes, and graph and table set-ups and other features designed to help students take clear notes or think through the problems are provided. Using *Blueprints* as a guide, students will be able to take good notes and still have time to follow the lecture.

18. The number of end-of-chapter problems has been increased, and the range of difficulty expanded. Also, a separate section, "Computer-Related Problems," has been added to most chapters, and a diskette that contains *Lotus 1-2-3* models for these problems is available to instructors from The Dryden Press. The computerized problems are designed to show students the power of computers in financial analysis, but no knowledge of computers or programming is needed to use them.

Ancillary Materials

1. **Blueprints: A Problem Notebook.** This supplement, which was described earlier, is supplied free of charge with each new textbook. It contains a statement of the integrative problem for each chapter, space for taking notes or for answering the questions, and graph and table set-ups to facilitate working the problems.
2. **Instructor's Manual.** A comprehensive manual is available to instructors who adopt the book. The manual contains (1) answers to all text questions and problems, (2) sample exam questions, (3) suggested course outlines, (4) a detailed set of lecture notes (including suggestions for use of the acetate transparencies described in the next section), and (5) detailed solutions to the integrative lecture problems, with transparency masters to illustrate them.
3. **Transparencies.** A comprehensive set of acetate transparencies (nearly 200, with 6 to 8 per chapter, including 30 full-color acetates) is available to instructors who adopt the text. In addition, an extensive set of transparency masters (6 to 8 per chapter) has been developed for use with the integrative lecture problems.
4. **Test Bank.** A revised and enlarged test bank with more than 1,000 class-tested questions and problems, in objective format, is available both in book form, on IBM computer diskettes ($5\frac{1}{4}''$ and $3\frac{1}{2}''$), and in Macintosh format. The diskettes come in either the regular computerized test bank format or in WordPerfect. The new questions are more challenging than those in many test banks, and they are well suited for exams. Also, the questions have been arranged, within each chapter, by type (true-false, multiple choice problems, and multiple choice conceptual questions), by topic, and by degree of difficulty.
5. **Supplemental Problems.** A set of additional problems, organized according to topic and level of difficulty, is also available to instructors.
6. **Problem Diskette.** A diskette (either $5\frac{1}{4}''$ or $3\frac{1}{2}''$) containing *Lotus 1-2-3* models for the computer-related end-of-chapter problems is also available. To obtain the diskette, complete the insert card found at the front of the *Instructor's Manual.*

A number of additional items are available for purchase by students:

1. **Study Guide.** This supplement outlines the key sections of each chapter, provides students with self-test questions, and also provides them with a set of problems and solutions similar to those in the text and in the *Test Bank.*
2. **Casebook.** A new casebook, *Cases in Financial Management* (Dryden Press, 1990) by Eugene F. Brigham and Louis C. Gapenski, provides a set of 41 cases which illustrate applications of the methodologies and concepts developed in the text. A brief version of this text, *Cases in Finan-*

cial Management: Module A, contains 12 cases and is a perfect supplement for those professors seeking a limited number of cases.

3. **Readings Books.** A readings book, *Issues in Managerial Finance,* third edition (Dryden Press, 1987), edited by Ramon E. Johnson, provides an excellent mix of theoretical and practical articles which can be used to supplement the text. Another supplemental reader is *Advances in Business Financial Management: A Collection of Readings* (Dryden Press, 1989), edited by Philip L. Cooley, which provides a broader selection of articles from which to choose.
4. **Finance with Lotus 1-2-3: Text, Cases, and Models.** This text by Eugene F. Brigham, Dana A. Aberwald, and Susan E. Ball (Dryden Press, 1988), enables students to learn, on their own, how to use *Lotus 1-2-3,* and it explains how many commonly encountered problems in managerial finance can be analyzed with electronic spreadsheets.
5. **PROFIT+.** This software supplement by James Pettijohn contains 18 user-friendly programs that include the time value of money, forecasting, and capital budgeting. The program includes a user's manual, and it is available for the IBM PC.

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Errors in the Text

At this point, most authors make a statement like this: "We appreciate the help of the people listed above, but any remaining errors are our responsibility." Further, there are generally more than enough remaining errors. As a part of our quest for clarity, we resolved to avoid this problem in *Essentials,* and as a result of the error detection procedures we used, we are convinced that the book is virtually free of mistakes.

Some of our colleagues suggested that if we are so confident about the book's accuracy, we should offer a reward to people who find errors. With this in mind, but primarily because we want to detect any remaining errors and correct them in subsequent printings, we hereby offer a reward of $10.00 per error (misspelled word, arithmetic mistake, and the like) to the first person who reports it to us. (Any error that has follow-through effects is counted as two errors only.) Two accounting students have set up a foolproof audit system to make sure we pay—accounting students tend to be skeptics! Please report any errors to Eugene Brigham at the address below.

Conclusion

Finance is, in a real sense, the cornerstone of the enterprise system—good financial management is vitally important to the economic health of business firms, and, hence, to the nation and the world. Because of its importance, finance should be widely and thoroughly understood, but this is easier said than done. The field is relatively complex, and it is undergoing constant change in response to shifts in economic conditions. All of this makes finance stimulating and exciting, but also challenging and sometimes perplexing. We sincerely hope that *Essentials* will meet its own challenge by contributing to a better understanding of our financial system.

J. Fred Weston
Graduate School of Management
University of California at Los Angeles
Los Angeles, California 90024

Eugene F. Brigham
College of Business
University of Florida
Gainesville, Florida 32611

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