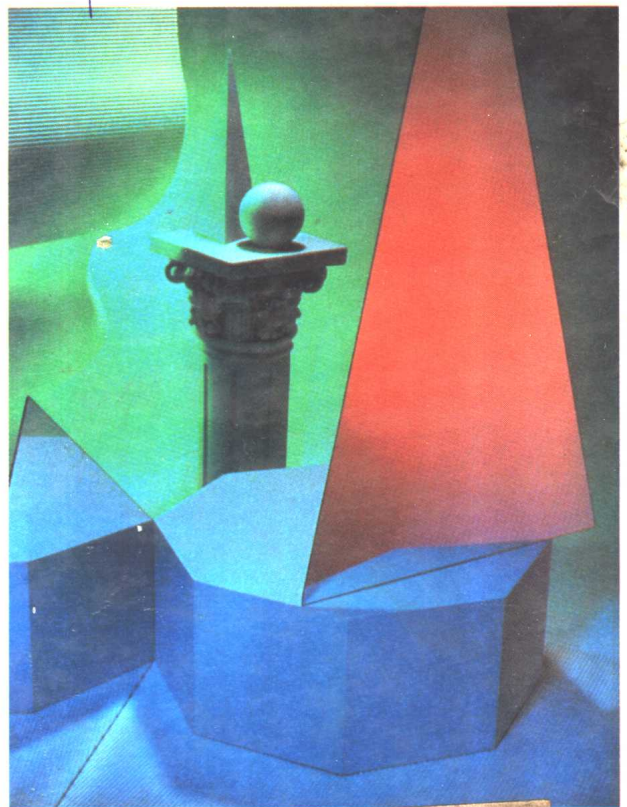


# Essentials of Managerial Finance

*Ninth Edition*

J. Fred Weston  
Eugene F. Brigham



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# Essentials of Managerial Finance

*Ninth Edition*

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**The Dryden Press**

*Chicago Fort Worth San Francisco Philadelphia  
Montreal Toronto London Sydney Tokyo*

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Text and Cover Designer: C. J. Petlick, Hunter Graphics  
Copy Editor: Maureen Duffy  
Compositor: The Clarinda Company  
Text Type: 10/12 ITC Garamond Book

**Library of Congress Cataloging-in-Publication Data**

Weston, J. Fred (John Fred), 1916–  
Essentials of managerial finance/J. Fred Weston, Eugene F.  
Brigham.—9th ed.  
p. cm.  
Includes bibliographical references and index.  
ISBN 0-03-030733-3  
1. Corporations—Finance. I. Brigham, Eugene F., 1930–  
II. Title.  
HG4026.W448 1990  
658.15—dc20

89-16780  
CIP

Printed in the United States of America  
901-039-987654321

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division of Holt, Rinehart and Winston, Inc.

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Inc., Orlando, FL 32887.

Address orders:  
The Dryden Press  
Orlando, FL 32887

Address editorial correspondence:  
The Dryden Press  
908 N. Elm Street  
Hinsdale, IL 60521

The Dryden Press  
Holt, Rinehart and Winston  
Saunders College Publishing

Cover Source: *Construct XXIII*. © Barbara Kasten/John Weber Gallery.

## 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 co-authored 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.

## Acknowledgments

This book reflects the efforts of a great many people over a number of years. First, we would like to thank the following, whose reviews and comments on prior editions and companion books have contributed to this edition: Mike Adler, Ed Altman, Bruce Anderson, Ron Anderson, Bob Angell, Vince Apilado, Bob Aubey, Gil Babcock, Peter Bacon, Kent Baker, Robert Balik, Tom Bankston, Les Barenbaum, Charles Barngrover, Bill Beedles, Moshe Ben Horim, Bill Beranek, Tom Berry, Bill Bertin, Scott Besley, Roger Bey, John Bildersee, Russ Boisjoly, Keith Boles, Geof Booth, Kenneth Boudreaux, Helen Bowers, Oswald Bowlin, Don Boyd, Pat Boyer, Joe Brandt, Elizabeth Brannigan, Greg Brauer, Mary Broske, Dave Brown, Kate Brown, Bill Brueggeman, Kirt Butler, Bill Campsey, Bob Carleson, Severin Carlson, David Cary, Steve Celec, Don Chance, Antony Chang, Susan Chaplinsky, Jay Choi, S. K. Choudhury, Lal Chugh, Maclyn Clouse, Margaret Considine, Phil Cooley, Joe Copeland, David Cordell, John Cotner, Charles Cox, David Crary, Roy Crum, Brent Dalrymple, Faramarz Damanpour, Bill Damon, Joel Dauten, Steve Dawson, Sankar De, Miles Delano, Fred Dellva, James Desreumaux, Bernard Dill, Greg Dimkoff, Les Dlabay, Mark Dorfman, Gene Drzycimski, Dean Dudley, David Durst, Ed Dyl, Dick Edelman, Charles Edwards, John Ellis, Dave Ewert, John Ezzell, Michael Ferri, Jim Filkins, John Finnerty, Susan Fischer, Steven Flint, Russ Fogler, Dan French, George Gallinger, Michael Garlington, Jim Garvin, Adam Gehr, Jim Gentry, Philip Glasgo, Rudyard Goode, Walt Goulet, Bernie Grablowsky, Ed Grossnickle, John Groth, Alan Grunewald, Manak Gupta, Sam Hadaway, Don Hakala, Gerald Hamsmith, William Hardin, John Harris, Paul Hastings, Bob Haugen, Steve Hawke, Del Hawley, Robert Hehre, George Hettenhouse,

Hans Heymann, Kendall Hill, Roger Hill, Tom Hindelang, Ralph Hocking, Ronald Hoffmeister, Robert Hollinger, Jim Horrigan, John Houston, John Howe, Keith Howe, Steve Isberg, Jim Jackson, Kose John, Craig Johnson, Keith Johnson, Ramon Johnson, Ray Jones, Manuel Jose, Gus Kalogeras, Mike Keenan, Bill Kennedy, Carol Kiefer, Joe Kiernan, Rick Kish, Don Knight, Dorothy Koehl, Jaroslaw Komarynsky, Duncan Kretovich, Harold Krogh, Charles Kroncke, Joan Lamm, Larry Lang, P. Lange, Howard Lanser, Martin Laurence, Ed Lawrence, Wayne Lee, Jim LePage, John Lewis, Chuck Linke, Bill Lloyd, Susan Long, Jim Longstreet, Judy Maese, Bob Magee, Ileen Malitz, Phil Malone, Terry Maness, Chris Manning, S. K. Mansinghka, Terry Martell, D. J. Masson, John Mathys, John McAlhany, Andy McCollough, Thomas McCue, Bill McDaniel, Robin McLaughlin, Jamshid Mehran, Larry Merville, Rick Meyer, Jim Millar, Ed Miller, John Mitchell, Carol Moerdyk, Bob Moore, Barry Morris, Gene Morris, Fred Morrissey, Chris Muscarella, David Nachman, Tim Nantell, Don Nast, Bill Nelson, Bob Nelson, Bob Niendorf, Timothy Nohr, Tom O'Brien, Dennis O'Connor, John O'Donnell, Jim Olsen, Robert Olsen, Jim Pappas, Stephen Parrish, Glenn Petry, Jim Pettijohn, Rich Pettit, Dick Pettway, Hugo Phillips, John Pinkerton, Gerald Pogue, R. Potter, Franklin Potts, R. Powell, Chris Prestopino, Jerry Prock, Howard Puckett, Herbert Quigley, George Racette, Bob Radcliffe, Bill Rentz, Ken Riener, Charles Rini, John Ritchie, Pietra Rivoli, Antonio Rodriguez, E. M. Roussakis, Dexter Rowell, Jim Sachlis, Abdul Sadik, Bill Sartoris, Thomas Scampini, Kevin Scanlon, Mary Jane Scheuer, Carl Schweser, John Settle, Alan Severn, Sol Shalit, Frederic Shipley, Dilip Shome, Ron Shrieves, Neil Sicherman, J. B. Silvers, Clay Singleton, Joe Sinkey, Stacy Sirmans, Jaye Smith, Patricia Smith, Steve Smith, Don Sorenson, David Spears, Ken Stanly, Ed Stendardi, Alan Stephens, Don Stevens, Jerry Stevens, Glen Strasburg, Philip Swensen, Ernie Swift, Paul Swink, Gary Tallman, Dulal Talukdar, Dennis Tanner, Russ Taussig, Richard Teweles, Ted Teweles, Andrew Thompson, William Tosar, George Trivoli, George Tsetsekos, Mel Tysseland, David Upton, Howard Van Auken, Pretorious Van den Dool, Pieter Vanderburg, Paul Vanderheiden, Jim Verbrugge, Patrick Vincent, Steve Vinson, Susan Visscher, John Wachowicz, Mike Walker, Sam Weaver, Kuo Chiang Wei, Bill Welch, Norm Williams, Tony Wingler, Ed Wolfe, Larry Wolken, Don Woods, Michael Yonan, Dennis Zocco, and Kent Zumwalt.

In addition, the following professors reviewed the manuscript and provided detailed comments and suggestions for improving the ninth edition:

Charles Barngrover	Timothy Nohr
Faramarz Damanpour	Bill Sartoris
George Gallinger	Mark Simmons
James Harriss	Alan Rufus Waters
Robert Miller	Larry Wolken
John Mitchell	

Dana Aberwald worked closely with us at every stage of the revision; her assistance was absolutely invaluable. Also, Chris Barry, Texas Christian Uni-

versity, wrote many of the small business sections; Dilip Shome, Virginia Polytechnic Institute, helped greatly with the capital structure chapter; Art Herrmann, University of Hartford, coauthored the bankruptcy appendix; and John Mitchell, Central Michigan University, reviewed the manuscript and also worked through the end-of-chapter problems, including the computer problems, to help ensure that they are as clear, accurate, and relevant as possible. Louis Gapenski worked with us on the integrative problems and on *Blueprints*, and offered advice on many other parts of the book. In addition, several of our students and colleagues at the University of Florida worked through and/or discussed with us all or major parts of the book and ancillaries to help eliminate errors and confusing sections, especially Andy McCollough, Craig Tapley, Brian Butler, Andy Janssen, and Randy Gressett. Carol Stanton and Brenda Sapp typed and helped proof the various manuscripts, and The Dryden Press staff, especially Barb Bahnsen, Maureen Duffy, Ann Heath, Karen Hill, Jane Perkins, Mike Roche, Cate Rzasa, Judy Sarwark, Bill Schoof, Jill Solimini, and Alan Wendt, helped greatly with all phases of the revision.

## 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 fool-proof 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.

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October 1989

# **CONTENTS IN BRIEF**

## **PART ONE**

### **INTRODUCTION TO MANAGERIAL FINANCE 1**

#### **CHAPTER 1**

### **AN OVERVIEW OF MANAGERIAL FINANCE 3**

#### **CHAPTER 2**

### **FINANCIAL STATEMENTS, TAXES, AND CASH FLOWS 35**

Appendix 2A Effects of Depreciation Methods on Taxes,  
Net Income, and Cash Flows 65

#### **CHAPTER 3**

### **FINANCIAL MARKETS, INSTITUTIONS, AND INTEREST RATES 71**

## **PART TWO**

### **ESSENTIAL CONCEPTS IN MANAGERIAL FINANCE 109**

#### **CHAPTER 4**

### **RISK AND RATES OF RETURN 111**

Appendix 4A Calculating Beta Coefficients 155

#### **CHAPTER 5**

### **TIME VALUE OF MONEY 161**

#### **CHAPTER 6**

### **BOND AND STOCK VALUATION 209**

## **PART THREE**

### **FINANCIAL ANALYSIS, PLANNING, AND CONTROL 267**

#### **CHAPTER 7**

### **FINANCIAL ANALYSIS 269**

#### **CHAPTER 8**

### **FINANCIAL FORECASTING 323**

Appendix 8A Microcomputers and Financial Forecasting 356

#### **CHAPTER 9**

### **FINANCIAL PLANNING AND CONTROL 361**

## **PART FOUR**

### **WORKING CAPITAL MANAGEMENT 397**

#### **CHAPTER 10**

### **WORKING CAPITAL POLICY 399**

#### **CHAPTER 11**

### **CASH AND MARKETABLE SECURITIES MANAGEMENT 427**

#### **CHAPTER 12**

### **CREDIT MANAGEMENT 461**

CHAPTER 13  
**INVENTORY MANAGEMENT** 489

CHAPTER 14  
**SHORT-TERM FINANCING** 515

PART FIVE  
**CAPITAL BUDGETING** 555

CHAPTER 15  
**CAPITAL BUDGETING TECHNIQUES** 557

CHAPTER 16  
**PROJECT CASH FLOWS AND RISK** 597

PART SIX  
**THE COST OF CAPITAL, LEVERAGE,  
AND DIVIDEND POLICY** 645

CHAPTER 17  
**THE COST OF CAPITAL** 647

CHAPTER 18  
**CAPITAL STRUCTURE AND LEVERAGE** 689  
Appendix 18A Capital Structure Theory 728

CHAPTER 19  
**DIVIDEND POLICY** 733

PART SEVEN  
**STRATEGIC LONG-TERM FINANCING DECISIONS** 771

CHAPTER 20  
**COMMON STOCK FINANCING AND  
THE INVESTMENT BANKING PROCESS** 773

CHAPTER 21  
**LONG-TERM DEBT** 807  
Appendix 21A Bankruptcy and Reorganization 840  
Appendix 21B Refunding Operations 848

CHAPTER 22  
**HYBRID FINANCING: PREFERRED STOCK, LEASING,  
AND OPTION SECURITIES** 855

CHAPTER 23  
**MERGERS, DIVESTITURES, HOLDING COMPANIES,  
AND LBOs** 899

APPENDIX A  
**MATHEMATICAL TABLES** A-1

APPENDIX B  
**ANSWERS TO SELECTED END-OF-CHAPTER PROBLEMS** B-1

APPENDIX C  
**SELECTED EQUATIONS AND DATA** C-1

# CONTENTS

## PART ONE

### INTRODUCTION TO MANAGERIAL FINANCE 1

#### CHAPTER 1

#### AN OVERVIEW OF MANAGERIAL FINANCE 3

A Managerial Perspective 3 The Changing Role of Managerial Finance 4  
Increasing Importance of Managerial Finance 6 The Financial Manager's  
Responsibilities 8 Career Opportunities in Finance 9 Alternative Forms of  
Business Organization 11 Finance in the Organizational Structure of the Firm 14  
The Goals of the Corporation 15 The Agency Problem 20 Managerial Actions  
to Maximize Shareholder Wealth 25 The Economic Environment 27  
Organization of the Book 28 *International* The International Environment 29  
*Small Business* Goals and Resources in the Small Firm 30 Summary 31

#### CHAPTER 2

#### FINANCIAL STATEMENTS, TAXES, AND CASH FLOWS 35

A Managerial Perspective 35 Financial Statements and Securities 36 The  
Federal Income Tax System 41 Depreciation 51 Cash Flow Analysis 55 *Small  
Business* Taxes and the Small Firm 56 Summary 57 **Appendix 2A Effects of  
Depreciation Methods on Taxes, Net Income, and Cash Flows** 65

#### CHAPTER 3

#### FINANCIAL MARKETS, INSTITUTIONS, AND INTEREST RATES 71

A Managerial Perspective 71 The Financial Markets 72 Financial Institutions 74  
The Stock Market 78 The Cost of Money 81 Interest Rate Levels 82 The  
Determinants of Market Interest Rates 86 The Term Structure of Interest Rates 92  
Other Factors That Influence Interest Rate Levels 97 Interest Rate Levels and  
Stock Prices 99 Interest Rates and Business Decisions 100 *International*  
Eurocurrency Market 101 Summary 102

**PART TWO**  
**ESSENTIAL CONCEPTS IN MANAGERIAL FINANCE 109**

**CHAPTER 4**  
**RISK AND RATES OF RETURN 111**

A Managerial Perspective 111 Defining and Measuring Risk 113 Expected Rate of Return 115 Portfolio Risk and the Capital Asset Pricing Model 123 The Relationship between Risk and Rates of Return 137 Physical Assets versus Securities 143 A Word of Caution 144 *International* The Risk of Foreign Investment 144 Summary 145 **Appendix 4A Calculating Beta Coefficients 155**

**CHAPTER 5**  
**TIME VALUE OF MONEY 161**

A Managerial Perspective 161 Future Value 163 Present Value 167 Future Value versus Present Value 170 Solving for Time and Interest Rates 171 Future Value of an Annuity 173 Present Value of an Annuity 176 Perpetuities 179 Present Value of an Uneven Series of Payments 180 A Further Discussion on Determining Interest Rates 182 Semiannual and Other Compounding Periods 184 Continuous Compounding and Discounting 188 Amortized Loans 190 Summary 191

**CHAPTER 6**  
**BOND AND STOCK VALUATION 209**

A Managerial Perspective 209 Bond Valuation 210 Preferred Stock Valuation 226 Common Stock Valuation 227 Stock Market Equilibrium 240 *Small Business* Valuation of Small Firms 250 Summary 251

**PART THREE**  
**FINANCIAL ANALYSIS, PLANNING, AND CONTROL 267**

**CHAPTER 7**  
**FINANCIAL ANALYSIS 269**

A Managerial Perspective 269 Financial Statements and Reports 271 Ratio Analysis 285 Comparative Ratios 301 Uses and Limitations of Ratio Analysis 303 *Small Business* Financial Analysis in the Small Firm 305 Summary 306

**CHAPTER 8**  
**FINANCIAL FORECASTING 323**

A Managerial Perspective 323 Sales Forecasts 324 Forecasting Financial Requirements: The Percentage of Sales Method 327 Forecasting Financial Requirements When the Balance Sheet Ratios Are Subject to Change 335 Modifying the Forecast of Additional Funds Needed 338 Computerized Financial Planning Models 340 *International* Currency Exchange Rates 342 Summary 343 **Appendix 8A Microcomputers and Financial Forecasting 356**



## CHAPTER 9

**FINANCIAL PLANNING AND CONTROL 361**

A Managerial Perspective 361 Financial Planning and Control Processes 362  
Breakeven Analysis 364 Operating Leverage 369 Cash Breakeven  
Analysis 374 The Cash Budget 375 Control in Multidivisional Companies 380  
*Small Business* Nonlinear Breakeven Analysis 383 Summary 385

## PART FOUR

**WORKING CAPITAL MANAGEMENT 397**

## CHAPTER 10

**WORKING CAPITAL POLICY 399**

A Managerial Perspective 399 Working Capital Terminology 400 Importance of  
Working Capital Management 402 Requirement for External Working Capital  
Financing 403 The Working Capital Cash Flow Cycle 404 Working Capital  
Investment and Financing Policies 407 Advantages and Disadvantages of Short-  
Term Credit 412 *Small Business* Growth and Working Capital Needs 416  
Summary 417

## CHAPTER 11

**CASH AND MARKETABLE SECURITIES MANAGEMENT 427**

A Managerial Perspective 427 Cash Management 428 Increasing the Efficiency of  
Cash Management 430 Compensating Banks for Services 437 Matching the  
Costs and Benefits of Cash Management 439 Marketable Securities 441 The  
Baumol Model for Balancing Cash and Marketable Securities 447 *International*  
*International Cash Management* 451 Summary 451

## CHAPTER 12

**CREDIT MANAGEMENT 461**

A Managerial Perspective 461 The Accumulation of Receivables 462 Credit  
Policy 464 Monitoring the Receivables Position 472 The Role of the Credit  
Manager 474 Use of Computers in Credit Management 475 Analyzing Changes  
in the Credit Policy Variables 476 *International* International Credit  
Management 480 Summary 481

## CHAPTER 13

**INVENTORY MANAGEMENT 489**

A Managerial Perspective 489 Inventory 490 Determining the Inventory  
Investment 491 Inventory Costs 494 The Optimal Ordering Quantity 497  
*International* Inventory Management in the Multinational Corporation 506  
Summary 508

## CHAPTER 14

**SHORT-TERM FINANCING 515**

A Managerial Perspective 515 Accruals 516 Accounts Payable, or Trade  
Credit 516 Short-Term Bank Loans 522 Commercial Paper 533 Use of  
Security in Short-Term Financing 534 *Small Business* Receivables Financing by  
a Small Firm 542 Summary 543