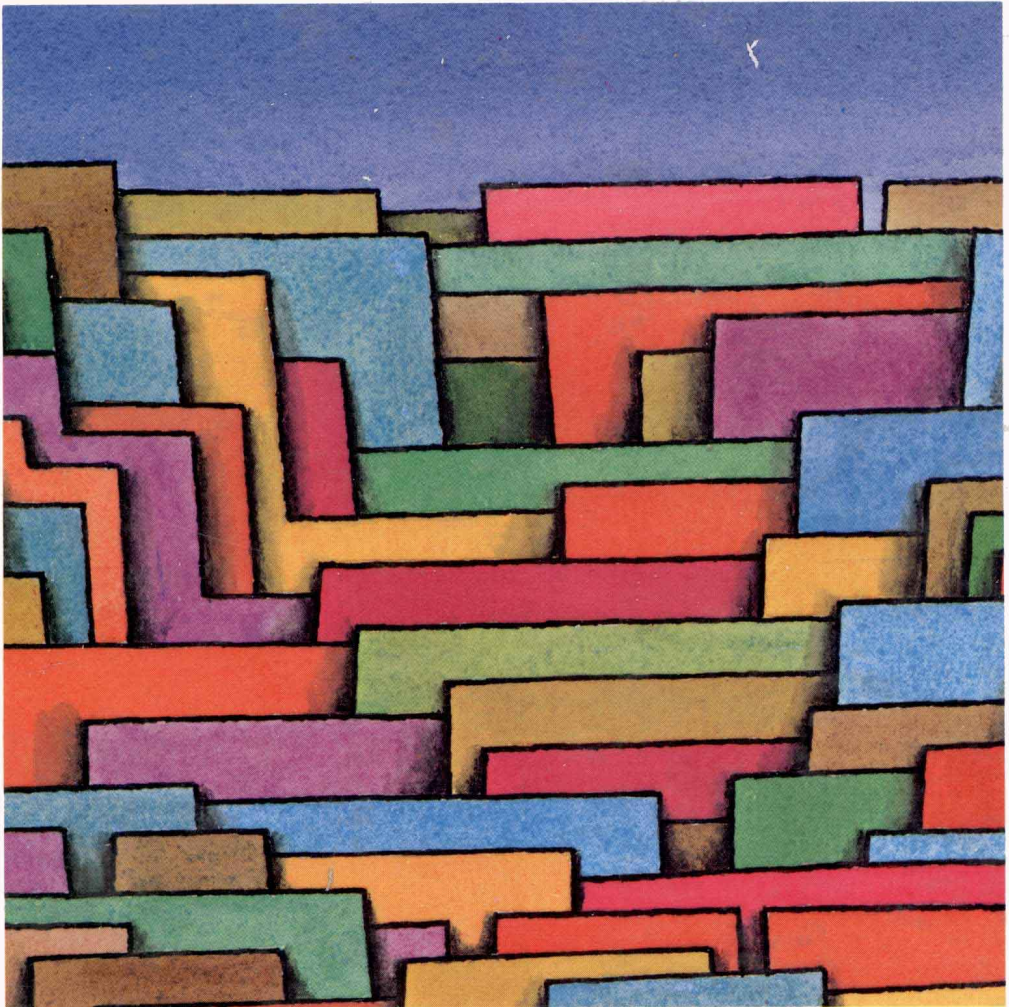


Principles of Managerial Finance

Third Edition

Lawrence J. Gitman



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Wright State University



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To my wife, Robin, our son Zachary,
and our daughter, Jessica

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PREFACE

The field of managerial finance and the environment in which financial decisions are made have undergone many changes since publication of the second edition of *Principles of Managerial Finance*. The financial literature has continued to grow; existing theories and concepts have been challenged and refined; and additional tools and techniques have been developed. At the same time, new and modified financial institutions have evolved in response to a changing regulatory environment; interest rates have reached record highs and have become more volatile; inflation continues to challenge all participants in the economy; and there has been a major revision in the federal tax structure. These changes, coupled with my continuing commitment to convey up-to-date knowledge about the discipline, have prompted this significantly revised edition of *Principles of Managerial Finance*.

The text is designed primarily for the introductory course at the undergraduate level. It may also be used with good results in the core MBA finance course, in management development programs, and in executive study programs. It is intended to make factual material as easily digestible as possible, so that the professor may concentrate on highlighting the theories, concepts, tools, and techniques that will help the student make reasonable real-world financial decisions. Examples that simplify concepts or catch interest are liberally included in the text. In addition, to make it readable, the book has been written and revised with the student constantly in mind. The payoff of readability accrues not only to the student but to the professor, who finds the job of teaching greatly simplified and considerably more rewarding.

Changes in the Third Edition

A variety of sources contributed toward the revision plan for the new edition. Mail questionnaires, personal interviews, written reviews, feedback from adopters, col-

leagues, and students, and observations from my own use of the text provided valuable information. On-line financial managers scrutinized the plan to ensure that the real-world activities described truly reflect financial management as it is practiced today.

MAJOR CHANGES

Topic sequence. The results of our research reaffirmed that the teachability of *Principles of Managerial Finance* is responsible for the book's widespread acceptance. Yet the research also confirmed my observation that a shift is occurring in the structure of the managerial finance course. As the linkages between risk, return, and value have been refined in the literature, a trend toward a modern and theoretically correct structuring of the first course has solidified among academicians. In the past, the "traditional balance sheet approach" has clearly been preferred. It presented material in a digestible way, with the simpler accounting-oriented material handled early and the more rigorous risk and valuation topics later. The first two editions of this text followed the balance sheet approach.

Market research supported my belief that a modified structure that reflected the main concerns of current financial thought would enhance students' understanding of managerial finance and could be achieved without sacrificing pedagogical effectiveness. *This edition, therefore, comprises a major restructuring that offers a more modern and theoretically correct organization yet retains the positive features of the traditional approach to managerial finance.* Two key financial topics—the time value of money (Chapter 4) and risk, return, and value (Chapter 5)—are introduced early in the text. Those who choose to assign them in that sequence can build on these topics through the remainder of the course. However, their coverage can be delayed by those who prefer a more traditional sequence.

Despite the restructuring, I have preserved the text's strong coverage of working capital management. An understanding of working capital management remains a prerequisite to effective financial management, and continuing periods of high interest rates make this topic especially important. Therefore, *the text continues to place equal emphasis on short-term and long-term financial management.*

Tax law revisions. The third edition of the text fully describes the major tax revisions resulting from the *Economic Recovery Act of 1981*. This legislation has had, and will continue to have, major impact on financial decision-making—especially as it relates to depreciation. *The impact of this act is reflected in all applicable text discussions as well as in the supporting end-of-chapter and ancillary materials.*

Information on the federal tax structure in Chapter 2 has been completely overhauled to reflect fully the *Economic Recovery Act of 1981*. The accelerated cost recovery system (ACRS) of asset depreciation as well as changes in tax rates and credits are clearly explained. The chapter on fixed-asset management and capital budgeting fundamentals (Chapter 14) completely illustrates the use of the ACRS normal recovery periods and depreciation percentages in determining investment cash flows. Additionally, the coverage of capital budgeting techniques under both certainty and risk (Chapter 15) has been revised to permit use of a continuing example that illustrates (in a fashion consistent with the new legislation) the application of various capital budgeting and risk techniques to investment decisions.

Multinational finance. Another important feature of the third edition is coverage of multinational finance. Rather than include a separate chapter on that topic, I have taken heed of Arthur I. Stonehill, who suggested that the best way to address multinational finance in the first course is to integrate it into relevant managerial finance discussions.* *Ten chapters now include a section discussing the multinational dimensions of the chapter topic.* For convenience in finding them, these sections are highlighted with gray, as are their supporting end-of-chapter materials.

OTHER STRUCTURAL AND CONTENT CHANGES

A number of other, less sweeping changes have also been made:

- 1 Financial intermediaries and markets now appear as Chapter 3. Early introduction of this topic provides a good understanding of the institutional financial environment in this country.
- 2 Coverage of the time value of money in Chapter 4 has been shortened and tightened, and the algebraic notation used for that material has been standardized.
- 3 Chapter 5, a completely new chapter, discusses the concepts of risk and return and then introduces them into the valuation process for bonds, preferred stock, and, most important, common stock.
- 4 In Chapter 6, the material on leverage—operating, financial, and total—has been streamlined by shortening the discussion of breakeven analysis.
- 5 Source and use of funds and ratio analysis are now grouped in a separate chapter (Chapter 7) concerned with the analysis of financial statements. The number of financial ratios presented has been reduced; only those ratios most often used in real-world financial management are shown.
- 6 Cash budgets and pro forma statements have been merged into one chapter (Chapter 8) dealing with financial planning. Only the practical approaches to pro forma statement preparation are included in this edition.
- 7 Discussion of cash and marketable security management in Chapter 10 now includes descriptions of yield curves and money market mutual funds.
- 8 Accounts receivable and inventory are covered in a single chapter (Chapter 11) that places primary emphasis on receivables. Redundant material has thus been eliminated.
- 9 Discussion of fixed- and floating-rate notes has been incorporated into coverage of sources of unsecured short-term financing in Chapter 12.
- 10 As noted earlier, Chapters 14 and 15 were updated to reflect the changes resulting from the *Economic Recovery Act of 1981*. In addition, Chapter 14 now includes discussion of the investment tax credit.
- 11 Capital budgeting techniques under conditions of both certainty and risk now are presented in a single chapter (Chapter 15). A discussion and illustration of the application of the annualized net present value (ANPV) method for comparing unequal-lived projects appears as part of the coverage of capital budgeting techniques in this chapter.

*See Arthur I. Stonehill, "Internationalizing the Business Core: The Finance Component," *Journal of Financial Education*, Fall 1978, pp. 7-12.

- 12 The cost of capital presentation in Chapter 16 has been revised, and the discussion of weighting schemes considerably shortened, to develop and illustrate the fundamental concepts more clearly.
- 13 The discussion of capital structure has been replaced by a completely new chapter (Chapter 17) that describes and illustrates the capital structure decision using a valuation framework.
- 14 The dividend policy chapter (Chapter 18) now follows the discussion of capital structure and ties the residual theory of dividends back to capital budgeting and cost of capital decision-making.
- 15 Coverage of leasing (Chapter 21), which now follows chapters on long-term debt and preferred and common stock, has been revised to reflect the full impact of FASB No. 13. The lease-purchase discussions in this chapter fully recognize the impact of the *Economic Recovery Act of 1981* on the estimation of purchase cash flows.
- 16 The discussion of failure, reorganization, and liquidation in Chapter 24 includes a description of the *Bankruptcy Reform Act of 1978* and illustrates the application of this law to reorganization and liquidation of the failed firm.

In conclusion, although the third edition has been updated to include new material from the financial literature and changes in the regulatory environment within a more modern topic sequence, its proven pedagogical effectiveness has been retained.

Pedagogical Features

ORGANIZATION

The text's organization conceptually links the firm's actions and its value as determined in the securities markets. Housed within this broad framework is a simple balance sheet structure that serves as a basis for analyzing many of the decisions confronting the financial manager. Each major decision area is presented in terms of both risk and return factors and their potential impact on the owner's wealth, as reflected by share value.

In organizing each chapter, I adhered to a managerial decision-making perspective. That is, I have not merely described a concept, such as present value or operating leverage, but have also related it to the financial manager's overall goal of wealth maximization. Once a particular concept has been developed, its application is illustrated. Thus, the student is not left with just an abstract definition, but truly senses the decision-making considerations and consequences of each financial action. New terms are defined when first used and the definitions are sometimes repeated in subsequent discussions to help the reader master the vocabulary of finance. Also, the comprehensive glossary at the back of the text makes terms and definitions accessible in another way.

The third edition of *Principles of Managerial Finance* has been shortened to twenty-four chapters. It is intended to be read as a continuous stream of thought, but almost any chapter can be taken out of sequence and studied as a self-contained unit. Since each professor has particular topic preferences, the topic coverage in the book has deliberately been made both extensive and flexible. The more manageable size of the book makes it

suitable for a variety of course lengths, from one quarter to two full semesters, and each professor will want to adjust the breadth of coverage to fit his or her own time parameters.

EXAMPLES

Numerous well-marked examples occur throughout the text to demonstrate potentially troublesome concepts. The examples are detailed, and quite often the reason for using a particular approach is given, along with the demonstration. Reviewers and users of the earlier editions of the book felt that the content, quality, placement, and method of presentation of the examples are all crucial—both to good teaching and to good learning of the material.

QUESTIONS AND PROBLEMS

I am a strong believer in the use of many problems in all phases of the first finance course, at whatever level it is taught. Therefore, a comprehensive set of questions and problems at the ends of chapters serves as a review guide by which students may test their understanding of the material presented within the chapters. More than one problem is provided for each concept, to ensure students multiple self-testing opportunities and to give professors a wide choice of assignable materials. In the third edition, a short title at the beginning of each problem identifies the concept that the problem has been designed to test. Answers to selected end-of-chapter problems appear in Appendix B; these check figures help students evaluate their progress in preparing detailed problem solutions.

SUPPORT ITEMS

A complete set of financial tables for percentage rates between 1 and 50 percent is included in Appendix A. Also included for students' convenience is a removable, laminated present-value table card that can be used in working problems. Another student aid is found on the endpapers inside the front and back cover of the text. It illustrates procedures for doing routine financial calculations using a simple calculator. With a little practice, use of these procedures should improve the speed and accuracy of many of the financial calculations described in the text.

Supplementary Materials

A number of additional materials are available to aid and enrich the learning and teaching processes.

STUDY GUIDE

The student review manual, *Study Guide to accompany Principles of Managerial Finance*, Third Edition, co-authored with J. Markham Collins of The University of Tulsa,

has been completely revised. Each chapter of the study guide contains a chapter summary, a chapter outline, a programmed self-test, and problems and detailed solutions. Each of these elements has been amended to reflect all text revisions.

INSTRUCTOR'S MANUAL

The comprehensive instructor's manual enables the professor to use the text easily and effectively in the classroom. It includes not only detailed answers/solutions to all text questions and problems, but also approximately 1200 multiple-choice questions, with answers, and over 100 exam problems, with solutions.

COMPUTER-BASED TEST BANK

A computer-based test bank is available to those adopting the book. Containing the 1200 multiple-choice questions printed in the instructor's manual, it enables the professor to customize exams by choosing specific questions. Tests can be prepared by the campus computer center or ordered through the publisher. The system is known as ACCESS; adopters should contact Harper & Row for details on how to utilize this support service.

TRANSPARENCIES

A pack of over 100 transparencies of the more conceptually difficult material is also available to adopters. Many of the key text tables and figures appear as transparencies.

Acknowledgments

Numerous people have made significant contributions to this edition as well as to earlier editions. Without their classroom experience, guidance, and advice, this book would not have been written or revised. Receiving continual feedback from students, colleagues, and practitioners helps me create a truly teachable textbook. If you or your students are moved to write me about any matters pertaining to this text package, please do. I welcome constructive criticism and suggestions for the book's further improvement.

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Lawrence J. Gitman

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