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INTRODUCTION TO

# FINANCIAL MANAGEMENT

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LAWRENCE D. GYALL

CHARLES W. NISLEY

THIRD EDITION

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# **FINANCIAL MANAGEMENT**

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**LAWRENCE D. SCHALL**

**CHARLES W. HALEY**

Professors of Finance  
University of Washington

**THIRD EDITION**

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# **INTRODUCTION TO FINANCIAL MANAGEMENT**

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# **PREFACE**

In this third edition our primary goal is again to provide students with a thorough foundation in finance. For many students the introductory course is the only exposure to finance, and we cover all the material that we believe is essential to a comprehensive understanding of financial management. Although the text covers a wide range of topics and issues, we have treated the material at an introductory level in all cases. Our method has been to explain the main issues very carefully in order to provide the student with an intuitive understanding of finance concepts and an appreciation of the way those concepts are applied in practice.

The text does not neglect students who will be taking additional courses in finance. Basic principles, techniques, and institutional aspects needed for effective analysis of business finance cases are well covered. A foundation for more advanced theoretical courses is provided in the chapter appendixes and in Chapter 6. Throughout we have tried to ensure that our approach here is consistent with current theory. Students completing a course of study using this book should be well prepared for courses in investments because of our stress on risk and return in the financial markets and our coverage of the basic characteristics of securities and markets.

The book is designed for undergraduate one-quarter or one-semester courses, although it is unlikely that all chapters can be assigned in a single course. If supplemented by cases and readings, it will be suitable as the primary text for courses extending two quarters or more. Instructors using this text for an introductory course for MBA students will find that Chapter 6 and the appendixes to Chapters 4, 5, 8, 9, and 10 enable them to approach basic finance on a more advanced level.

We have made a special effort to provide an integrated discussion of the topics covered. Nevertheless, the book has been designed to offer great flexibility in choosing the order of presentation of most chapters. Furthermore, many chapters have one or more sections that can be de-

## PREFACE

leted without any loss of continuity. Appendixes in several chapters explore major concepts in greater depth. These are intended as supplements to the basic coverage in the text and are designed for use by well-prepared undergraduate and beginning graduate students.

The first six chapters provide an introduction to the book and an introduction to finance in general. In Part 1 we examine the general nature of financial management, the financial system, taxes, the choice of business organization, compound-interest calculations, risk, and the principles of market valuation.

Parts 2 through 4 cover the basic concepts and techniques of financial management. Part 2 is concerned with long-term decisions involving investments and financing, including dividend policy. Part 3 explores techniques of financial analysis, including ratio analysis, funds flow, break-even analysis, and forecasting. Part 4 deals with the problems of managing the firm's current assets and current liabilities. The discussion in Part 4 is unusual in that the firm's working capital decisions are explicitly linked to the discussion of long-term investment and financing decisions in Part 2.

Parts 5 and 6 provide supplementary material that is often not covered in an introductory course. Part 5 offers a detailed discussion of the characteristics of the different securities issued by business firms and the procedures for issuing securities. Part 6 covers special topics including mergers and acquisitions, international financial management, and business bankruptcy.

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### CHANGES IN THE THIRD EDITION

This edition reflects several improvements over previous editions. They include:

1. *An increase in clarity and addition of new explanatory material.* The entire text was examined and changes were made to increase clarity of presentation. Some sections were substantially reduced in size or eliminated. New sections were added wherever we felt that they would significantly further the student's understanding of the subject. Major changes have been made in Chapters 2, 3, 5, 7, 10, 19, and 23.
2. *Expanded use of beta as a measure of risk.* We have added an intuitive description of beta as a risk measure in Chapter 5, showed how a firm's stock beta can be used to estimate the stock rate in Chapter 7, and discussed how financial leverage affects a stock's beta in Chapter 10. Although the sections on beta relate directly to the chapter topics, these sections can be deleted entirely without any loss of continuity since the chapters do not depend on or require the capital asset pricing model or the beta concept.
3. *Added coverage of advanced topics in valuation.* Chapter 6 is new and brings together discussions of the efficient market hypothesis, the term structure of interest rates, and the capital asset pricing model. Some of

this material was included in appendixes and in interchapter essays in the second edition. We have expanded the development of these topics and have brought them together in a single coherent treatment.

4. *Totally revised presentation of risk in capital budgeting.* (Chapter 8 in the second edition, Chapter 9 in the new edition). Chapter 9 is a completely new treatment of this topic that should be much clearer to students. It incorporates both an application of a multi-period capital asset pricing model and descriptions of various methods used in practice.
5. *Revised problems.* All problems are either new or revised for this edition.
6. *New interchapter essays.* About half the essays are new to this edition and the remaining ones have been revised.
7. *General updating.* The text reflects more recent data, laws, and management practices.

Although this book has been written to offer substantial latitude in selecting which chapters to cover and their order or presentation, we suggest that certain chapters be taught in a given order. Chapters 4, 5, 7, 8, 10, 12, 14, and 15 are prerequisites for certain other chapters. Specifically, Chapter 4 should precede Chapter 5, and Chapters 4 and 5 should precede all of Part 2 (Chapters 7 through 11). We recommend that the chapters in Part 2 be taught in sequence. However, these chapters can be partially rearranged to suit the needs of the individual instructor. A complete discussion of the possibilities for alternative sequences is included in the *Instructor's Manual* for the text. Many instructors may choose to assign Chapters 12, 13, and 14—which cover financial statement analysis, break-even analysis, and forecasting, respectively—early in the course. This can be done with no difficulty, although the discussion of financial leverage in Chapter 13 is most effectively taught if it is presented after Chapter 10. A sequence that we find quite workable in one quarter consists of Chapters 1 through 5, 7 through 10, 12, 14 through 17, and one or more of Chapters 18, 19, and 23; other chapters can be intermingled with these.

Students come to the basic finance course with a wide range of prior preparation in accounting, mathematics, and economics. We have assumed minimal background in these areas, but we do expect that students have had at least one quarter of accounting shortly before taking the class. Able students should be capable of mastering the material almost without regard to their previous formal course work. We have tried to make the book as self-contained as possible and, through extensive use of examples, to make it suitable for self-study.

As an aid to students, many instructors recommend a study guide when such is available. The *Study Guide* written by Thomas E. Stitzel serves as an excellent review and supplement to this book. It contains additional

## TEXT ORGANIZATION AND SUPPLEMENTARY MATERIALS

## PREFACE

solved problems as well as questions in a programmed learning format. We believe that many students will find this supplement helpful.

The *Instructor's Manual* includes a substantial amount of supplementary teaching material, as well as recommended course outlines, a test bank, transparency masters, and answers to text questions and problems.

## ACKNOWLEDGMENTS

Many people have aided us in this project. Our students provided us with numerous comments that have resulted in substantial improvements over earlier versions of the text. Colleagues at the University of Washington and elsewhere have reviewed drafts of the manuscripts, and we are very grateful for their help. Our thanks go to Durwood Alkire, Henry H. Barker, William J. Bertin, Zvi Bodie, Don Boyd, Gregory Breen, Stephen G. Buell, Jess Chua, John Crockett, Mark Dorfman, Eugene F. Drzymcinski, Russell Ezzell, James F. Feller, John K. Ford, Michael Giliberto, John H. Hand, David Heskell, George W. Hettenhouse, Pat Hill, Lee Hoover, Michael H. Hopewell, Donald Houthaker, James Hugon, F. Lee Hull, Richard Johnson, Ann Kremer, Gene Laber, John B. Major, Rita M. Maldonado-Bear, Robert McGee, Allen Michel, Donald A. Nast, Gerald Newbould, Robert T. Patton, Gerald W. Perritt, Herb Phillips, Arthur Rasher, Michael Rice, Ralph Ringgenberg, Rick Rivard, William Sartoris, William L. Scott, John Settle, Bernard A. Shinkel, Donald G. Simonson, Ronald Sprecher, Timothy Sullivan, Nikhil Varaiya, James A. Verbrugge, Jerry A. Viscione, Ernest W. Walker, Larry White, Roger Wong, Gene Wunder, Francis Yeager, and J. Kenton Zumwalt. We are indebted to Charles D'Ambrosio, who provided us encouragement and advice throughout the development of the book and helped us at numerous junctures. Charles Henning gave us special assistance with the international finance materials and provided us with an initial draft of Chapter 24. Betty Schall provided us with important advice and assistance in writing Chapter 25. Paul Allen, Terence Barron, Jean-Claude Bosch, Gregg Brauer, Susan Doolittle, Keith Hauschulz, Paul Makens, Thomas Munro, John Settle, Michael Sherry, and Kaj Svarrer developed many of the end-of-chapter questions and problems and provided us with helpful suggestions for the text material.

The editorial staff at McGraw-Hill has been a critical resource for us. Peggy Rehberger guided this edition from start to finish with skill and endless patience. Bonnie Lieberman also contributed to this effort in many important ways. And we remain deeply indebted to Marjorie Singer, whose numerous recommendations and suggestions were invaluable in our writing the first and second editions; her legacy lives on in the third edition. Finally, the book could not have been written without the continued support of Anne Haley.

Lawrence D. Schall  
Charles W. Haley

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# **THE ENVIRONMENT OF FINANCIAL DECISIONS**

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Part 1 consists of six chapters in which we present the general background for individual and company financial decisions. Chapter 1 is an introduction to business finance and to this text. Here we discuss the nature and objectives of financial management. In Chapter 2 we examine the American financial system: the network of financial institutions and markets that is an important part of the financial manager's environment. Chapter 3 covers other aspects of this environment, the legal form of business organizations, and the tax laws that affect financial decisions. Whereas the material in the first three chapters is largely descriptive, in Chapter 4 we develop a fundamental financial concept, the time value of money. We show here how to solve a variety of basic financial problems involving time and money. In Chapter 5 we discuss a second fundamental concept, risk, and show how risk affects the value of financial assets. Chapter 6 explores several advanced topics which relate to the valuation of assets: the Capital Asset Pricing Model, the concept of efficient markets, and the term structure of interest rates.

The material in Part 1 is important not just to the managers of business firms. Most of the topics covered are of equal importance to an individual concerned with such financial problems as borrowing money and choosing alternative ways of investing personal savings. The remainder of the text is almost exclusively concerned with problems faced by financial managers; but these first six chapters cover financial concepts that are useful to everyone.

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