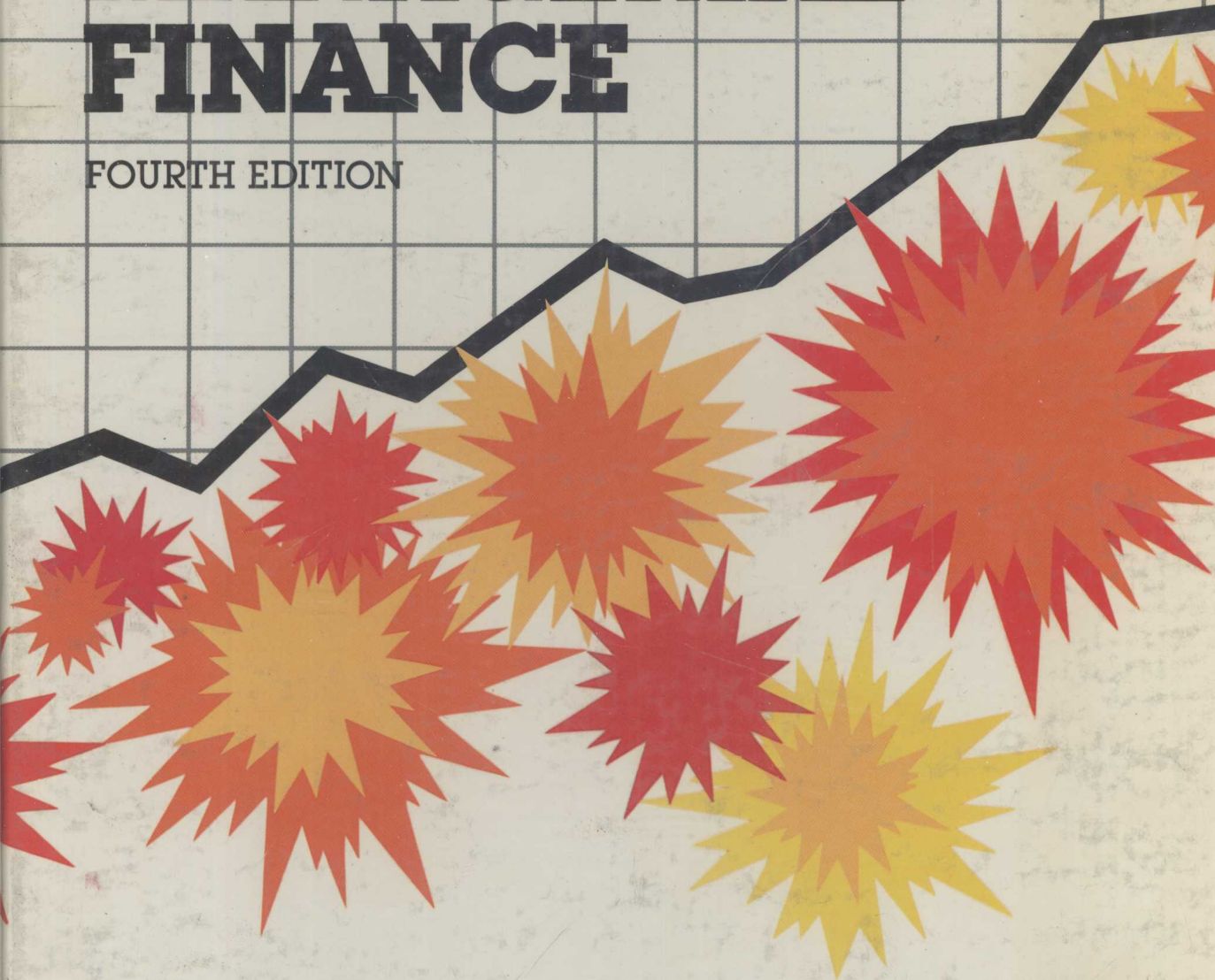


# **PRINCIPLES OF MANAGERIAL FINANCE**

FOURTH EDITION



**Lawrence J. Gitman**

# **Principles of Managerial Finance**

Fourth Edition

**Lawrence J. Gitman**

Wright State University



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# Preface

Managerial finance is an interesting, exciting, and dynamic area of study, and its importance to the long-run success of today's business is unquestioned. But in recent years the environment created by the interaction of government, financial institutions, business firms, and individuals—both domestically and internationally—has been in a state of flux. The body of financial literature has continued to grow; existing theories and concepts have been challenged and refined; and new decision-making 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 declined from record levels and remain quite volatile; inflation has moderated but continues to challenge all participants in the economy; there have been continuing and significant revisions in the federal tax structure; and the personal microcomputer has become widely accepted and available to business people and students of managerial finance. These changes, coupled with my continuing commitment to convey up-to-date knowledge about the discipline, have prompted this significantly revised fourth 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 and catch the reader's interest are liberally provided throughout 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 also to the professor, who will find the job of teaching greatly simplified and considerably more rewarding.

## Changes in the Fourth Edition

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

adopters, colleagues, 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 managerial finance as it is practiced today.

## MAJOR CHANGES

**Topic Sequence.** Our research reconfirmed that the teachability of *Principles of Managerial Finance* is the primary reason for the book's widespread acceptance. The research also supported my sense that a shift is occurring in the structure of the managerial finance course. Today, most professors prefer to immediately follow the coverage of basic financial concepts (the time value of money, risk and return, and valuation) with such long-term financial decision topics as capital budgeting, cost of capital, leverage and capital structure, and dividend policy. The benefits of such a sequence seem to be threefold: (1) the long-term topics encompass applications of basic financial concepts just studied and should logically come right after them rather than later; (2) this sequence is consistent with the widely accepted "strategic approach" that begins with long-term policies and ends with short-term operational activities; and (3) given the limited time available in many courses, many professors prefer to fully develop the long-term *conceptual framework* first in order to assure that it receives adequate coverage, and then cover — often quickly — operational and descriptive material as time permits in the latter part of the course.

In order to provide early coverage of long-term financial concepts, this fourth edition's organizational structure is as follows:

- Part I The Financial Environment
- Part II Techniques of Financial Analysis and Planning
- Part III Basic Financial Concepts
- Part IV Long-Term Investment Decisions: Capital Budgeting
- Part V Cost of Capital, Leverage, Capital Structure, and Dividends
- Part VI The Management of Working Capital
- Part VII Sources of Long-Term Financing
- Part VIII Expansion and Failure

Two changes were made to arrive at this sequence. First, the discussion of techniques of financial analysis and planning (Part II), now precedes the discussion of basic financial concepts (Part III). This shift encourages students to gain a sound footing in financial analysis and planning before exploring major financial management concepts. Early coverage of these topics also provides a logical transition from the study of accounting to the study of finance. The second structural change was to place the coverage of long-term investment decisions, cost of capital, leverage, capital structure, and dividends *after* the presentation of basic financial concepts for the three reasons cited above. The restructuring allows financial analysis and planning and capital budgeting — two of the most likely areas of entry-level managerial finance employment — to be covered early in the course.

Despite the change in sequence, the text's strong coverage of working capital

management has been preserved. Continuing periods of volatile and relatively high interest rates make this topic especially important. Consequently, *the text continues to place equal emphasis on short-term and long-term financial management.*

**Tax Law Revisions.** This edition fully describes the major tax revisions resulting from the *Economic Recovery Tax Act of 1981*, the *Tax Equity and Fiscal Responsibility Act of 1982*, and the *Tax Reform Act of 1984*. These acts have had, and will continue to have, major influence on financial decision making, especially as it relates to depreciation. The impact of these acts is dealt with frequently, both in text discussions and in end-of-chapter and ancillary materials. Information on the federal tax structure (in Chapter 2) has been completely revised to reflect these changes; the accelerated cost recovery system (ACRS) of asset depreciation, as well as changes in tax rates and credits, are clearly explained there. Chapter 9 illustrates the use of the ACRS normal recovery periods and depreciation percentages in determining investment cash flows. Chapter 10 has been revised to include a continuing example that illustrates the application of various capital budgeting techniques to investment decisions in a fashion consistent with the new legislation.

**New Pedagogical Devices.** In addition to the pedagogical features in earlier editions, a number of new devices have been integrated into the fourth edition of *Principles of Managerial Finance* to further strengthen its pedagogical effectiveness.

*Learning Objectives:* Each chapter begins with six learning objectives that guide the student's understanding of the material presented.

*Boxed Essays:* Each chapter contains two or more boxed essays describing real-world events or actual company situations that demonstrate text concepts.

*Summary in List Format:* Each chapter summary is now presented as a bulleted list of major points that can be quickly reviewed.

*Key Terms:* At the end of each chapter a list of key terms defined within the chapter (as well as in the glossary) is presented.

*Expanded and Integrative Problems:* All end-of-chapter problems have been carefully reviewed and revised, with many new problems included. A number of new and longer integrative problems have been added.

*Computer Disk Keyed To Text:* The use of *The Gitman Disk*—a user-friendly menu-driven personal computer disk containing 11 problem-solving routines (described in detail later)—is flagged in pertinent text discussions and before end-of-chapter problems that can be solved using the disk. These passages are identified by this symbol:



## OTHER STRUCTURAL AND CONTENT CHANGES

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

1. Discussions of the changing role of financial intermediaries and interest rates, risk premiums, and required returns were added to Chapter 3 in

order to establish early the concept of the fundamental tradeoff between risk and return.

2. An expanded review of basic financial statements begins Chapter 4 (on the analysis of financial statements). In addition, the concept of leverage is described, and the DuPont system of analysis is clearly explained.
3. The discussion of pro forma statements in Chapter 5 (on financial planning) has been clarified to include the use of both percent-of-sales and judgmental approaches for estimating external funds required.
4. The loan amortization process is now demonstrated by an example as part of the discussion of time value of money in Chapter 6.
5. There is now a separate chapter on risk and return—Chapter 7—that includes new discussions of the concepts of return, risk preferences, and normal probability distributions and an expanded discussion of correlation, diversification, risk, and return.
6. Valuation is now discussed in a separate chapter (Chapter 8). This chapter includes new material on the basic valuation concept and model, bond value behavior and yield to maturity, and common stock variable growth models.
7. Chapter 9 (on capital budgeting and cash flow principles) offers an expanded discussion of the capital budgeting process that includes a discussion of terminal cash flow and the effect, if any, of changes in net working capital.
8. Chapter 10, on capital budgeting techniques, includes new illustrated discussions of *NPV* and *IRR*, as well as a comprehensive problem that demonstrates the entire capital budgeting process for two mutually exclusive projects.
9. A new chapter on capital budgeting refinements and risk—Chapter 11—has been added. It includes comparisons of projects with unequal lives, using both the least common life and the annualized net present value approaches, and covers capital rationing, inflation in capital budgeting, and approaches for dealing with project risk, with particular emphasis given to the conceptual and practical aspects of certainty equivalents and risk-adjusted discount rates.
10. Chapter 13, on leverage and capital structure, begins with discussion of basic leverage concepts—breakeven analysis, operating leverage, financial leverage, and total leverage. This is followed by a discussion of capital structure that uses the debt ratio as a basis for evaluating both the theoretical and operational aspects of optimal capital structure decisions.
11. Discussion of dividend reinvestment plans has been added to the coverage of dividend policy in Chapter 14.
12. Chapter 16, on cash and marketable securities management, has been significantly revised to reflect the state of the art in cash management and explore the currently most popular marketable security investments.
13. An introductory illustrated discussion of credit scoring is now included in Chapter 17 (on accounts receivable and inventory management).
14. A single chapter, Chapter 18, is now devoted to sources of short-term financing. It covers all sources—spontaneous, unsecured (including

- commercial paper), and secured — and includes a table summarizing the key features of each source at the end of the chapter.
15. In addition to coverage of long-term debt, Chapter 19 now includes material on investment banking. New discussions of deep discount and variable-rate bonds have been added, and a table summarizing the characteristics of popular types of bonds is included.
  16. Chapter 21, on leasing, has been streamlined to better reflect current legal and accounting requirements for leases. Also, a brief discussion of leveraged leases is now included.
  17. A discussion of the basic features of options — their markets, the logic of trading them, and their role in managerial finance — is now included in Chapter 22 (on convertibles, warrants, and options).
  18. Chapter 23, on consolidations, mergers, and holding companies, includes a new multinational finance section concerned with international combinations.
  19. In Chapter 24, on failure, reorganization, and liquidation, the discussion of priority of claims has been revised to better demonstrate the priorities for distributing funds in liquidation.

## **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 list of key terms at the end of each chapter and the comprehensive glossary with chapter references at the back of the text make terms and definitions accessible in another way.

The fourth edition of *Principles of Managerial Finance* contains twenty-four chapters. It is designed to be read in sequence, 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 manageable size of the book makes it suitable for courses of various lengths, from one quarter to two full semesters, and each professor will be able to adapt the text to fit his or her own teaching schedule.

## EXAMPLES

Many 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 of this edition and users of earlier editions of this book have remarked that the content, quality, placement, and method of presenting the examples contribute greatly to teaching this material well and to learning it well.

## QUESTIONS AND PROBLEMS

I am a strong believer in the use of many problems during all phases of the first finance course, at whatever level it is taught. Therefore, a comprehensive set of questions and problems at the end of each chapter serves as a review by which students may test their understanding of the material presented within the chapters. More than one problem is provided for each concept, to assure students multiple self-testing opportunities and to give professors a wide choice of assignable material. New integrative problems tying together related topics are included in this edition. A short caption 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 answers help students evaluate their progress in preparing detailed problem solutions.



## MULTINATIONAL FINANCE

Another important feature of this fourth edition is its coverage of multinational finance. Rather than including a separate chapter on that topic, I continue to integrate it into relevant managerial finance discussions. *Eleven chapters include a section discussing the multinational dimensions of the chapter topic.* To aid the reader, these sections (and related end-of-chapter materials) are highlighted with a multinational globe symbol like the one shown above.

## 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, which illustrate procedures for performing routine financial calculations using a simple calculator. With a little practice, students following these procedures should improve their speed and accuracy in doing 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*, Fourth Edition, coauthored 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. Where appropriate, discussions and problems are keyed to *The Gitman Disk*. In addition, material from the *Study Guide* will be available on *Study-Aid*, an interactive microcomputer program for use on the Apple II, II+, IIe, and IIfx and on the IBM-PC.

## CASEBOOK

A completely new casebook, *Casebook in Managerial Finance*, has been designed to accompany this text. Prepared by Bernard J. Winger of the University of Dayton, it includes analytical exercises and provides forms related to the cases in a study guide format. This new pedagogical approach to cases strengthens students' understanding of and facility with the case method. A separate instructor's manual accompanies this casebook.

## INSTRUCTOR'S MANUAL

The comprehensive instructor's manual enables the professor to use the text easily and effectively in the classroom. Prepared by Cherie Mazer of Wright State University and me, it includes chapter outlines and detailed answers and solutions to all text questions and problems. Great care has been taken to ensure the accuracy of all answers and solutions.

## QUIZ/EXAM FILE

Also prepared by Cherie Mazer and me, this supplement includes a quiz for each chapter and a prototype midterm and final examination, all with answers.

## TEST BANK (BOTH IN PRINTED AND COMPUTER SOFTWARE DISK FORM)

A test bank containing 1200 multiple-choice questions and 200 problems with worked-out solutions has been developed by Douglas A. Hibbert of Fayetteville Technical Institute and Walter J. Reinhart of Loyola College in Maryland and is available in a separate test-bank manual and on MICROTEST, which is a microcomputer test-generation system that produces customized tests and carries a comprehensive set of descriptors for each multiple-choice question, including chapter number, item number, item type, level of difficulty, cognitive type, and page number in the text on which the correct answer is found. In addition, the available exam problems are also available on MICROTEST. MICROTEST is compatible with the Apple IIe and II+ and the IBM-PC.

## ACETATE TRANSPARENCIES

A pack of 100 transparency acetates of key exhibits and problem solutions is available to adoptors.



## THE GITMAN DISK

A new and unique computerized supplement for use with the Apple II and the IBM-PC, *The Gitman Disk* has been specifically developed by Frederick Rexroad to accompany this text. All routines are written in BASIC and can be transferred easily to other computers with little or no modification. *The Gitman Disk* includes 11 short programs, presented in a user-friendly menu-driven format, for use in solving financial problems. Applicability of the disk throughout the text and study guide is always keyed by a printed disk symbol like that shown above. Each routine on the disk includes page references to the text discussion of the technique being applied. *The Gitman Disk* is available free to adoptors. A detailed description of the disk and its use is given in Appendix C.

## Acknowledgments

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LAWRENCE J. GITMAN

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