# BRIEF CONTENTS



CHAPTER 1	Foundations, 1
CHAPTER 2	Financial Background: A Review of Accounting, Financial Statements, and Taxes, 24
CHAPTER 3	Cash Flows and Financial Analysis, 63
CHAPTER 4	Financial Planning, 116
CHAPTER 5	The Financial System, Corporate Governance, and Interest, 168

Introduction to Financial Management, 1

## Part 2 Discounted Cash Flow and the Value of Securities, 219

CHAPTER 6 Time Value of Money, 221
 CHAPTER 7 The Valuation and Characteristics of Bonds, 270
 CHAPTER 8 The Valuation and Characteristics of Stock, 328
 CHAPTER 9 Risk and Return, 369

# Part 3 Business Investment Decisions—Capital Budgeting, 419

CHAPTER 10 Capital Budgeting, 421
CHAPTER 11 Cash Flow Estimation, 457
CHAPTER 12 Risk Topics and Real Options in Capital Budgeting, 484
CHAPTER 13 Cost of Capital, 514

# Part 4 Long-Term Financing Issues, 547

CHAPTER 14 Capital Structure and Leverage, 549 CHAPTER 15 Dividends, 599

## Part 5 Operations, 625

CHAPTER 16 The Management of Working Capital, 627 CHAPTER 17 Corporate Restructuring, 674 CHAPTER 18 International Finance, 711

# CONTENTS



#### Preface, xxv

## Part 1

## Introduction to Financial Management, 1

CHAPTER 1 FOUNDATIONS, 3

An Overview of Finance, 3

Financial Assets, 3 Financial Markets, 4 Raising Money, 5

Financial Management, 6

The Price of Securities—A Link Between the Firm

and the Market, 7

Finance and Accounting, 7

The Importance of Cash Flow, 8

The Language of Finance, 9
Financial Theory—The Relationship with Economics, 9

Forms of Business Organization and Their Financial Impact, 10

The Proprietorship Form, 10

The Corporate Form, 11
The Truth about Limited Liability, 13

The Truth about Limited Liability, 13

S-Type Corporations and Limited Liability Companies, 14

The Goals of Management, 14

INSIGHTS: The Limited Liability Company (LLC): An Alternative

to the S-Type Corporation, 15

Stakeholders and Conflicts of Interest, 16 Conflicts of Interest—An Illustration, 16

Management—A Privileged Stakeholder Group, 16

The Agency Problem, 17

INSIGHTS: Ethics and Ethical Investing, 18

Creditors versus Stockholders—A Financially Important Conflict of Interest, 18

Securities Analysis and Thomson ONE—Business School Edition, 20

Questions, 20

Business Analysis, 21

Problems, 22

Internet Problem, 22

Thomson ONE, 22

CHAPTER 2 FINANCIAL BACKGROUND: A REVIEW OF ACCOUNTING,

FINANCIAL STATEMENTS, AND TAXES, 24

Accounting Systems and Financial Statements, 24

The Nature of Financial Statements, 25

The Accounting System, 26

The Income Statement, 28

Presentation, 28

The Balance Sheet, 30

Presentation, 30

Assets, 31

Liabilities, 36

Equity, 39

The Tax Environment, 40

Taxing Authorities and Tax Bases, 40

Income Taxes—The Total Effective Tax Rate, 41

Progressive Tax Systems, Marginal and Average Rates, 42

Capital Gains and Losses, 43

Income Tax Calculations, 44

Personal Taxes, 44

Corporate Taxes, 48

INSIGHTS: The Other Purpose of the Tax System, 49

Questions, 52

Problems, 53

Internet Problem, 60

Computer Problems, 61

CHAPTER 3 CASH FLOWS AND FINANCIAL ANALYSIS, 63

Financial Information—Where Does It Come From, Who Uses It,

and What Are We Looking For?, 63

Users of Financial Information, 64

Sources of Financial Information, 64

INSIGHTS: The Devil Is in the Details . . ., 67

The Orientation of Financial Analysis, 67

INSIGHTS: The Ethics of Presenting Financial Information, 68

The Statement of Cash Flows, 70

How the Statement of Cash Flows Works—Preliminary

Examples, 70

Business Cash Flows, 73

Constructing the Statement of Cash Flows, 75

Free Cash Flows, 79

Ratio Analysis, 80

Comparisons, 80

Common Size Statements, 81

Ratios, 82

Liquidity Ratios, 83

Asset Management Ratios, 84

Debt Management Ratios, 87

Profitability Ratios, 89

Market Value Ratios, 90 Du Pont Equations, 92

INSIGHTS:

Concepts in Financial Analysis: MVA and EVA, 94

Using the Du Pont Equations, 96

Sources of Comparative Information, 96

Limitations and Weaknesses of Ratio Analysis, 97

Questions, 98

Business Analysis, 98

Problems, 99

Internet Problem, 111

Computer Problems, 111

Developing Software, 113

Thomson ONE, 114

## CHAPTER 4 FINANCIAL PLANNING, 116

## Business Planning, 116

Component Parts of a Business Plan, 117

The Purpose of Planning and Plan Information, 117

Credibility and Supporting Detail, 119

Four Kinds of Business Plan, 120

The Financial Plan as a Component of a Business

Plan, 123

## Making Financial Projections, 123

Planning for New and Existing Businesses, 124

The General Approach, Assumptions, and the Debt/Interest

Problem, 124

Plans with Simple Assumptions, 130

Forecasting Cash Needs, 132

The Percentage of Sales Method—A Formula

Approach, 132

The Sustainable Growth Rate, 135

Plans with More Complicated Assumptions, 136

A Comprehensive Example—A Complex Plan for an Existing

Business, 139

Planning at the Department Level, 146

The Cash Budget, 147

#### Management Issues in Financial Planning, 151

The Financial Plan as a Set of Goals, 151

Risk in Financial Planning in General, 152

INSIGHTS: Judgment Calls and Ethics in Business Planning, 154

Financial Planning and Computers, 155

Questions, 155

Business Analysis, 157

Problems, 159

Internet Problem, 167

## CHAPTER 5 THE FINANCIAL SYSTEM, CORPORATE GOVERNANCE, AND INTEREST, 168

## The Financial System, 168

Cash Flows Between the Sectors, 169

Savings and Investment, 169

Financial Markets, 171

## The Stock Market and Stock Exchanges, 174

Overview, 174

Trading—The Role of Brokers, 174

Exchanges, 175

Private, Public, and Listed Companies, and the

Nasdaq Market, 176

Reading Stock Quotations, 179

INSIGHTS: Efficient Financial Markets, 181

## Corporate Governance and the Sarbanes-Oxley Act of 2002, 181

The Agency Problem Revisited, 181

Executive Compensation, 181

The Moral Hazard of Stock-Based Compensation

and Wealth, 183

The Link Between Stock Price and Reported

Financial Performance, 184

The Responsibility of Auditors, Boards

of Directors, and Analysts, 185

The Victims of Self-Interest at the Top, 186

The Events of the 1990s, 187

The Provisions of the Sarbanes-Oxley Act, 187

Auditors: Conditions in the Public Accounting

Industry Before SOX, 188

The Sarbanes-Oxley Response to the Failure

of the Auditing Industry, 189

Corporate Governance: Holding CEOs Accountable, 191

The Sarbanes-Oxley Response to Claims of Ignorance

by Top Executives, 191

Deception on Wall Street: Securities Analysts

at Major Brokerage Houses, 192

INSIGHTS: Independent Analysis—A Vanishing Alternative?, 193

Life After Sarbanes-Oxley, 194

#### Interest, 194

The Relationship Between Interest and the Stock Market, 194

Interest and the Economy, 195

Debt Markets, 196

## The Components of an Interest Rate, 198

Components of the Base Rate, 198

Risk Premiums, 199

Putting the Pieces Together, 201

Federal Government Securities, Risk-Free and Real Rates, 202 Yield Curves—The Term Structure of Interest Rates, 205

INSIGHTS: The Implications of an Inverted Yield Curve, 206

Questions, 208

Business Analysis, 209

Problems, 211

Internet Problem, 214

Appendix 5A: Can There Be Interest without Money? The Desert Island, 214

## Part 2

## Discounted Cash Flow and the Value of Securities, 219

CHAPTER 6 TIME VALUE OF MONEY, 221

Outline of Approach, 222

Amount Problems, 223

The Future Value of an Amount, 223

Financial Calculators, 227

The Expression for the Present Value of an Amount, 228

Annuity Problems, 230

Annuities, 230

The Future Value of an Annuity—Developing

a Formula, 231

The Future Value of an Annuity—Solving Problems, 234 Compound Interest and Non-Annual Compounding, 236 The Present Value of an Annuity—Developing a Formula, 242 The Present Value of an Annuity—Solving Problems, 243

The Lottery: Congratulations, You're Rich—But Not as Rich

as You Thought, 245

The Annuity Due, 250

Perpetuities, 253

Multipart Problems, 256

Uneven Streams and Imbedded Annuities, 259

Questions, 261

**INSIGHTS:** 

Business Analysis, 262

Problems, 262

Internet Problem, 267

Computer Problems, 268

Developing Software, 269

CHAPTER 7 THE VALUATION AND CHARACTERISTICS

OF BONDS, 270

The Basis of Value, 270

Investing, 271

Return, 271

#### Bond Valuation, 272

Bond Terminology and Practice, 272 Bond Valuation—Basic Ideas, 273 Determining the Price of a Bond, 274

Maturity Risk Revisited, 280

Finding the Yield at a Given Price, 281

Call Provisions, 283

INSIGHTS: Can a Bond Be a Bond Without Paying Interest?, 284

Risky Issues, 288

#### Convertible Bonds, 289

Advantages of Convertible Bonds, 291

Forced Conversion, 292

Valuing (Pricing) Convertibles, 292

Effect on Earnings Per Share—Diluted EPS, 295

Other Convertible Securities, 297

#### Institutional Characteristics of Bonds, 298

Registration, Transfer Agents, and Owners of Record, 298

Kinds of Bonds, 298

Bond Ratings—Assessing Default Risk, 299

INSIGHTS: Even the Safest Companies Can Default on Bonds—The Perils of

Utility Deregulation in California, 301

Bond Indentures—Controlling Default Risk, 302

INSIGHTS: Ethical Debt Management, 303

Questions, 304

Business Analysis, 304

Problems, 305

Internet Problem, 309

Computer Problems, 309

Appendix 7A: Lease Financing, 310

### **CHAPTER 8** THE VALUATION AND CHARACTERISTICS

OF STOCK, 328

Common Stock, 328

The Return on an Investment in Common Stock, 328

The Nature of Cash Flows from Common

Stock Ownership, 329

The Basis of Value, 331

#### Growth Models of Common Stock Valuation, 332

Developing Growth-Based Models, 332

The Constant Growth Model, 335

The Expected Return, 337 Two-Stage Growth, 337

Practical Limitations of Pricing Models, 340

INSIGHTS: Reconciling Valuation Theory and Practice, 341

## Some Institutional Characteristics of Common Stock, 342

Corporate Organization and Control, 342

**INSIGHTS:** 

Corporate Governance in Large Companies: The Role

of Boards of Directors, 343

Voting Rights and Issues, 344

Stockholders' Claims on Income and Assets, 345

## Preferred Stock, 345

Valuation of Preferred Stock, 346

Characteristics of Preferred Stock, 347

## Securities Analysis, 348

## Options and Warrants, 349

Options in General, 350

Stock Options, 350

Call Options, 350

Intrinsic Value, 351

Options and Leverage, 353

Trading in Options, 354

Writing Options, 355

Put Options, 357

Option Pricing Models, 358

Warrants, 358

Employee Stock Options, 359

## Questions, 361

Business Analysis, 362

Problems, 362

Internet Problem, 366

Computer Problems, 366

Developing Software, 367

Thomson ONE, 368

#### CHAPTER 9 RISK AND RETURN, 369

## Why Study Risk and Return? 369

The General Relationship Between Risk and Return, 370

The Return on an Investment, 371

Risk—A Preliminary Definition, 372

## Portfolio Theory, 373

Review of the Concept of a Random Variable, 373

The Return on a Stock Investment

as a Random Variable, 378

Risk Redefined as Variability, 379

Risk Aversion, 382

Decomposing Risk—Systematic (Market)

and Unsystematic (Business-Specific) Risk, 385

Portfolios, 386

Diversification—How Portfolio Risk is Affected When

Stocks are Added, 387

Measuring Market Risk—The Concept of Beta, 390

INSIGHTS: Is It Investing or Gambling?, 392

INSIGHTS: Just How Risky Is AT&T—Really? A Problem with Betas, 395

Using Beta—The Capital Asset Pricing Model (CAPM), 396

INSIGHTS: Beta in Practice, 405

The Validity and Acceptance of the CAPM

and Its SML, 405

Questions, 406

Business Analysis, 407

Problems, 407

Internet Problem, 414

Computer Problems, 414

Developing Software, 415

Thomson ONE, 416

## Part 3

## Business Investment Decisions—Capital Budgeting, 419

## CHAPTER 10 CAPITAL BUDGETING, 421

Characteristics of Business Projects, 421

Project Types and Risk, 421

Stand-Alone and Mutually Exclusive Projects, 422

Project Cash Flows, 422

The Cost of Capital, 423

## Capital Budgeting Techniques, 424

Payback Period, 424

Net Present Value (NPV), 426

Internal Rate of Return (IRR), 430

Comparing IRR and NPV, 435

NPV and IRR Solutions Using Financial Calculators

and Spreadsheets, 436

Projects with a Single Outflow and Regular Inflows, 438

Profitability Index (PI), 439

Comparing Projects with Unequal Lives, 440

INSIGHTS: Which Methods Do Businesses Prefer?, 441

Capital Rationing, 444

Questions, 445

Business Analysis, 447

Problems, 448

Calculator Problems, 451

Internet Problem, 454

Computer Problems, 455

#### CHAPTER 11 CASH FLOW ESTIMATION, 457

Cash Flow Estimation, 457

Capital Budgeting Processes, 457

Project Cash Flows—An Overview and Some Specifics, 458

The General Approach to Cash Flow Estimation, 458

A Few Specific Issues, 459

Estimating New Venture Cash Flows, 462

Terminal Values, 466

Accuracy and Estimates, 467

MACRS—A Note on Depreciation, 468

Estimating Cash Flows for Replacement Projects, 469

INSIGHTS: Ethics in Cash Flow Estimation, 473

Question, 473

Business Analysis, 473

Problems, 475

Internet Problem, 482

Computer Problems, 482

CHAPTER 12 RISK TOPICS AND REAL OPTIONS IN CAPITAL

BUDGETING, 484

Risk in Capital Budgeting—General Considerations, 484

Cash Flows as Random Variables, 484

The Importance of Risk in Capital Budgeting, 485

Incorporating Risk into Capital Budgeting—Numerical and

Computer Methods, 487

Scenario/Sensitivity Analysis, 487

Computer (Monte Carlo) Simulation, 489

Decision Tree Analysis, 490

Real Options, 495

Real Options in Capital Budgeting, 495

Valuing Real Options, 498

INSIGHTS: Volatile Energy Prices and Real Options Thinking Can Lead

to Big Profits on Inefficient Facilities, 499

Designing Real Options into Projects, 499

Incorporating Risk into Capital Budgeting—The Theoretical Approach and Risk-Adjusted Rates of Return, 500

Estimating Risk-Adjusted Rates Using CAPM, 502

Problems with the Theoretical Approach—Finding the Right

Beta and Concerns about the Appropriate Risk Definition, 504

Questions, 506

Business Analysis, 507

Problems, 508

CHAPTER 13 COST OF CAPITAL, 514

The Purpose of the Cost of Capital, 514

## Cost of Capital Concepts, 515

Capital Components, 515

Capital Structure, 515

INSIGHTS:

The Cost of Capital—Intuitively, 516

Returns on Investments and the Costs

of Capital Components, 516

The Weighted Average Calculation—The WACC, 517

Capital Structure and Cost—Book versus Market Value, 518

## Calculating the WACC, 520

Developing Market-Value-Based Capital Structures, 520

Calculating Component Costs of Capital, 521 Putting the Weights and Costs Together, 528

## The Marginal Cost of Capital (MCC), 528

The Break in MCC When Retained Earnings Run Out, 528

The MCC Schedule, 529

## The Cost of Capital—A Comprehensive Example, 531

A Potential Mistake—Handling Separately Funded Projects, 536

INSIGHTS: Revisiting EVA, 537

Questions, 538

Business Analysis, 539

Problems, 540

Internet Problem, 546

# Part 4

## Long-Term Financing Issues, 547

## CHAPTER 14 CAPITAL STRUCTURE AND LEVERAGE, 549

Background, 549

The Central Issue, 550

Risk in the Context of Leverage, 550

Leverage and Risk—Two Kinds of Each, 551

Our Approach to Leverage, 552

#### Financial Leverage, 552

The Effect of Financial Leverage, 552

Financial Leverage and Financial Risk, 558

Putting the Ideas Together—The Effect on Stock Price, 559

INSIGHTS: AOL Time Warner (Time Warner INC.): The Perils of Leverage, 561

The Degree of Financial Leverage (DFL)—A Measurement, 562

EBIT-EPS Analysis, 565

#### Operating Leverage, 567

Terminology and Definitions, 567

Breakeven Analysis, 568

Breakeven Diagrams, 568

The Effect of Operating Leverage, 571

The Degree of Operating Leverage (DOL)—A Measurement, 574

Comparing Operating and Financial Leverage, 575

The Compounding Effect of Operating

and Financial Leverage, 576

## Capital Structure Theory, 577

Background—The Value of the Firm, 578

INSIGHTS: Leverage and Business Strategy, 578

The Early Theory by Modigliani and Miller, 581 Relaxing the Assumptions—More Insights, 584 An Insight into Mergers and Acquisitions, 588

Questions, 589

Business Analysis, 590

Problems, 592

Internet Problem, 597 Thomson ONE, 597

## CHAPTER 15 DIVIDENDS, 599

Background, 599

Dividends as a Basis for Value, 599

Understanding the Dividend Decision, 600

## The Dividend Controversy, 601

Dividend Irrelevance, 601 Dividend Preference, 604 Dividend Aversion, 604

Other Theories and Ideas, 605

Conclusion, 606

## Practical Considerations, 607

Legal and Contractual Restrictions on Dividends, 607

INSIGHTS: The Painful Decision to Cut Dividends, 608

Dividend Policy, 609

The Mechanics of Dividend Payments, 610

Stock Splits and Dividends, 611

## Stock Repurchases, 615

Repurchase as an Alternative to a Dividend, 615

Other Repurchase Issues, 616

Questions, 618

Business Analysis, 618

Problems, 619

Internet Problem, 622

# Part 5 Operat

## Operations, 625

# CHAPTER 16 THE MANAGEMENT OF WORKING CAPITAL, 627 Working Capital Basics, 627

Working Capital, Funding Requirements, and the Current Accounts, 628

INSIGHTS: Going Broke Profitably, 628

The Objective of Working Capital Management, 630

Operations—The Cash Conversion Cycle, 630 Permanent and Temporary Working Capital, 632

Financing Net Working Capital, 632

Working Capital Policy, 635

## Sources of Short-Term Financing, 636

Spontaneous Financing, 636

Unsecured Bank Loans, 638

Revolving Credit Agreement, 638

Commercial Paper, 640

Short-Term Credit Secured by Current Assets, 641

## Cash Management, 645

Definitions and Objectives, 645

Marketable Securities, 646

Check Disbursement and Collection Procedures, 647

Accelerating Cash Receipts, 648

INSIGHTS: Technology Is Speeding Up the Check Clearing Process: "Check 21,"

the Check Clearing for the 21st Century Act, 649

Managing Cash Outflow, 651

Evaluating the Cost of Cash Management Services, 651

INSIGHTS: Ethical Cash Management, 652

#### Managing Accounts Receivable, 653

Objectives and Policy, 653

Determinants of the Receivables Balance, 653

INSIGHTS: A Practical Management Warning, 655

INSIGHTS: How Lafarge's Western Region Controls Receivables—Sharing

Responsibility for Collections with Sales, 657

## Inventory Management, 657

Who Is Responsible for Inventories?, 658

The Benefits and Costs of Carrying Inventory, 658

Inventory Control and Management, 659

The Economic Order Quantity (EOQ) Model, 660 Safety Stocks, Reorder Points, and Lead Times, 662 Tracking Inventories—The ABC System, 664 Just In Time (JIT) Inventory Systems, 664

Questions, 665

Business Analysis, 667

Problems, 668

Internet Problem, 673

## CHAPTER 17 CORPORATE RESTRUCTURING, 674

Mergers and Acquisitions, 674

Basic Definitions, Terminology, and Procedure, 674

The Antitrust Laws, 678

The Reasons Behind Mergers, 679

Holding Companies, 681

The History of Merger Activity in the United States, 681

Merger Analysis and the Price Premium, 685

INSIGHTS: How a Trendy Soft Drink Gave Cereal Giant Quaker

Oats a \$1.4 Billion Case of Indigestion, 692

Defensive Tactics, 693

Other Kinds of Takeovers-LBOs and Proxy Fights, 695

Leveraged Buyouts (LBOs), 695

Proxy Fights, 696

Divestitures, 696

The Reasons for Divestitures, 696

Methods of Divesting Operations, 696

Bankruptcy and the Reorganization of Failed Businesses, 697

Failure and Insolvency, 697

Bankruptcy—Concept and Objectives, 698 Bankruptcy Procedures—Reorganization,

Restructuring, Liquidation, 698

INSIGHTS: Has Bankruptcy Been Too Easy For Too Long?

The Bankruptcy Reform Act of 2005, 701

Questions, 703

Business Analysis, 704

Problems, 706

Internet Problem, 710

**CHAPTER 18** INTERNATIONAL FINANCE, 711

Currency Exchange, 712

The Foreign Exchange Market, 712

Exchange Rates, 712

Changing Exchange Rates and Exchange Rate Risk, 714

European Currencies in the Twenty-First

Century—The Euro, 716

Supply and Demand—The Source of Exchange Rate Movement, 716

Governments and the International

Monetary System, 719

International Capital Markets, 721

The Eurodollar Market, 722

The International Bond Market, 722

Political Risk, 723

Transaction and Translation Risks, 723

INSIGHTS: The Foreign Corrupt Practices Act— A Legal/Ethical

Dilemma for U.S. Companies, 724

# Current Issues in International Trade: Globalization, Outsourcing, Immigration, and China's Currency, 726

Background: Free Trade, the Theory of Comparative

Advantage, and Protectionism, 726

Globalization, 727

Anti-Globalization, 728

The Migration of Jobs—Outsourcing, 728

Labor Migration and Illegal Immigration, 729

The Balance of Trade with China and Its

Inconvertible Currency, 730

Questions, 730

Business Analysis, 731

Problems, 732

Internet Problem, 734

APPENDIX A FINANCIAL TABLES, 738

Glossary, 746

Index, 756