B R I E F  C O N T E N T S

Part 1

Introduction to Financial Management, 1
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

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
## 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
- 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
Contents

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

INSIGHTS: 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
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
Contents

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

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

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

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