# Contents

## PART 1 | INTRODUCTION

1 The Goals and Functions of Financial Management 4  
  The Field of Finance 5  
  Evolution of the Field of Finance 5  
  Modern Issues in Finance 6  
  The Impact of the Internet 6  
  Functions of Financial Management 7  
    Forms of Organization 8  
    Sole Proprietorship 8  
    Partnership 8  
    Corporation 9  
  Corporate Governance 10  
  Sarbanes-Oxley Act 11  
  Goals of Financial Management 11  
    A Valuation Approach 12  
    Maximizing Shareholder Wealth 12  
    Management and Stockholder Wealth 13  
    Social Responsibility and Ethical Behavior 13  
  The Role of the Financial Markets 15  
    Structure and Functions of the Financial Markets 15  
    Allocation of Capital 16  
    Institutional Pressure on Public Companies to Restructure 17  
    Internationalization of the Financial Markets 17  
    The Internet and Changes in the Capital Markets 18  
  Format of the Text 19  
    Parts 19  
    1. Introduction 19  
    2. Financial Analysis and Planning 19  
    3. Working Capital Management 19  
    4. The Capital Budgeting Process 20  
    5. Long-Term Financing 20  
    6. Expanding the Perspective of Corporate Finance 20  
  List of Terms 20  
  Discussion Questions 21  
  Web Exercise 21

## PART 2 | FINANCIAL ANALYSIS AND PLANNING

2 Review of Accounting 26  
  Income Statement 27  
    Return to Capital 27  
    Price-Earnings Ratio Applied to Earnings per Share 28  
    Limitations of the Income Statement 29  
  Balance Sheet 30  
    Interpretation of Balance Sheet Items 30  
    Concept of Net Worth 32  
    Limitations of the Balance Sheet 32  
  Statement of Cash Flows 33  
    Developing an Actual Statement 34  
    Determining Cash Flows from Operating Activities 34  
    Determining Cash Flows from Investing Activities 36  
    Determining Cash Flows from Financing Activities 36  
    Combining the Three Sections of the Statement 38  
  Depreciation and Funds Flow 39  
  Free Cash Flow 39  
  Income Tax Considerations 40  
    Corporate Tax Rates 41  
    Cost of a Tax-Deductible Expense 42  
    Depreciation as a Tax Shield 42  
  Summary 43  
  List of Terms 44  
  Discussion Questions 44  
  Practice Problems and Solutions 44  
  Problems 45  
  Web Exercise 53  
  S&P Problems 53

3 Financial Analysis 55  
  Ratio Analysis 56  
    Classification System 57  
    The Analysis 58  
      A. Profitability Ratios 58  
      B. Asset Utilization Ratios 61  
      C. Liquidity Ratios 62  
      D. Debt Utilization Ratios 62  
  List of Terms 50  
  Discussion Questions 51  
  Web Exercise 51
### Contents

- **A Decision Process** 174
  - Introducing Varying Conditions 175
  - Expected Value 175
- **Shifts in Asset Structure** 176
- **Toward an Optimal Policy** 177
- **Summary** 179
- **List of Terms** 179
- **Discussion Questions** 180
- **Practice Problems and Solutions** 180
- **Problems** 181
- **Web Exercise** 187
- **S&P Problems** 187

### 7 Current Asset Management 189

- **Cash Management** 190
  - Reasons for Holding Cash Balances 190
  - Cash Flow Cycle 190
- **Collections and Disbursements** 193
  - Float 194
  - Improving Collections 194
  - Extending Disbursements 194
  - Cost-Benefit Analysis 195
  - Electronic Funds Transfer 195
  - International Cash Management 197
- **Marketable Securities** 198
- **Management of Accounts Receivable** 202
  - Accounts Receivable as an Investment 202
  - Credit Policy Administration 202
    - Credit Standards 202
    - Terms of Trade 204
    - Collection Policy 206
  - An Actual Credit Decision 207
- **Inventory Management** 208
  - Level versus Seasonal Production 208
  - Inventory Policy in Inflation (and Deflation) 209
  - The Inventory Decision Model 209
    - Carrying Costs 209
    - Ordering Costs 209
  - Economic Ordering Quantity 210
  - Safety Stock and Stockouts 211
  - Just-in-Time Inventory Management 212
    - Cost Savings from Lower Inventory 212
    - Other Benefits 213
    - The Downside of JIT 213
- **Summary** 214
- **List of Terms** 215

### 8 Sources of Short-Term Financing 224

- **Trade Credit** 225
  - Payment Period 225
  - Cash Discount Policy 225
  - Net Credit Position 226
- **Bank Credit** 226
  - Prime Rate and LIBOR 227
  - Compensating Balances 228
  - Maturity Provisions 229
  - Cost of Commercial Bank Financing 230
  - Interest Costs with Compensating Balances 230
  - Rate on Installment Loans 231
  - Annual Percentage Rate 231
  - The Credit Crunch Phenomenon 232
- **Financing through Commercial Paper** 233
  - Advantages of Commercial Paper 234
  - Limitations on the Issuance of Commercial Paper 235
- **Foreign Borrowing** 236
  - Use of Collateral in Short-Term Financing 236
- **Accounts Receivable Financing** 237
  - Pledging Accounts Receivable 237
  - Factoring Receivables 237
  - Asset-Backed Public Offerings 238
- **Inventory Financing** 239
  - Stages of Production 240
  - Nature of Lender Control 240
    - Blanket Inventory Liens 240
    - Trust Receipts 240
    - Warehousing 240
  - Appraisal of Inventory Control Devices 240
- **Hedging to Reduce Borrowing Risk** 241
- **Summary** 243
- **List of Terms** 244
- **Discussion Questions** 244
- **Practice Problems and Solutions** 245
- **Problems** 246
- **Comprehensive Problem** 250
- **Web Exercise** 251
PART 4  |  THE CAPITAL BUDGETING PROCESS

9 The Time Value of Money  255
   Relationship to the Capital Outlay Decision  256
   Future Value—Single Amount  256
   Present Value—Single Amount  257
   Future Value—Annuity  258
   Present Value—Annuity  260
   Graphical Presentation of Time Value Relationships  262
      The Relationship between Present Value and Future Value  262
      The Relationship between the Present Value of a Single Amount and the Present Value of an Annuity  265
      Future Value Related to the Future Value of an Annuity  267
   Determining the Annuity Value  268
      Annuity Equaling a Future Value  268
      Annuity Equaling a Present Value  268
   Determining the Yield on an Investment  270
      Yield—Present Value of a Single Amount  270
      Yield—Present Value of an Annuity  271
   Special Considerations in Time Value Analysis  272
      Patterns of Payment  272
   Special Review of the Chapter  274
   List of Terms  276
   Discussion Questions  276
   Practice Problems and Solutions  277
   Problems  278
   Comprehensive Problem  284

10 Valuation and Rates of Return  285
   Valuation Concepts  286
   Valuation of Bonds  286
      Present Value of Interest Payments  287
      Present Value of Principal Payment (Par Value) at Maturity  287
      Concept of Yield to Maturity  288
      Changing the Yield to Maturity and the Impact on Bond Valuation  290
      Increase in Inflation Premium  290
      Decrease in Inflation Premium  290
      Time to Maturity  292
      Determining Yield to Maturity from the Bond Price  292
   Valuation of Preferred Stock  289
   Valuation of Common Stock  292
   Determining the Required Rate of Return (Yield) from the Market Price  292
      The Price-Earnings Ratio Concept and Valuation  293
   Summary and Review of Formulas  297
      Bonds  297
      Preferred Stock  297
      Common Stock  297
   List of Terms  300
   Discussion Questions  300
   Practice Problems and Solutions  301
   Problems  302
   Comprehensive Problem  303
   Web Exercise  303
   Appendix 10A The Bond Yield to Maturity Using Interpolation  305
   Appendix 10B Using Calculators for Financial Analysis  305
   Appendix 10C Valuation of a Supernormal Growth Firm  305

11 Cost of Capital  331
   The Overall Concept  332
   Cost of Debt  332
   Costs of Preferred Stock  335
   Cost of Common Equity  335
      Valuation Approach  336
      Required Return on Common Stock Using the Capital Asset Pricing Model  336
      Cost of Retained Earnings  337
      Cost of New Common Stock  339
      Overview of Common Stock Costs  339
   Optimal Capital Structure—Weighting Costs  340
Capital Acquisition and Investment

Decision Making 342
- Cost of Capital in the Capital Budgeting Decision 342

The Marginal Cost of Capital 344

Summary 349

Review of Formulas 350

List of Terms 350

Discussion Questions 351

Practice Problems and Solutions 351

Problems 354

Comprehensive Problems 361

Web Exercise 363

S&P Problems 363

Appendix 11A Cost of Capital and the Capital Asset Pricing Model (Optional) 364

12 The Capital Budgeting Decision 371

Administrative Considerations 372

Accounting Flows versus Cash Flows 372

Methods of Ranking Investment Proposals 375
- Payback Method 375
- Internal Rate of Return 376
- Net Present Value 378

Selection Strategy 379
- Reinvestment Assumption 380
  Modified Internal Rate of Return 381

Capital Rationing 382

Net Present Value Profile 383
- Characteristics of Investment C 384

Combining Cash Flow Analysis and Selection Strategy 386
- The Rules of Depreciation 386
- The Tax Rate 388

Actual Investment Decision 388

The Replacement Decision 389
- Sale of Old Asset 390
- Incremental Depreciation 391
- Cost Savings 392

Elective Expensing 394

Summary 394

List of Terms 394

Discussion Questions 394

Practice Problems and Solutions 395

Problems 396

Comprehensive Problem 405

Web Exercise 405

S&P Problems 406

PART 5 | LONG-TERM FINANCING

13 Risk and Capital Budgeting 407

Definition of Risk in Capital Budgeting 408

The Concept of Risk-Averse 409

Actual Measurement of Risk 409

Risk and the Capital Budgeting Process 412
- Risk-Adjusted Discount Rate 413
- Increasing Risk over Time 414
- Qualitative Measures 414
  Example—Risk-Adjusted Discount Rate 415

Simulation Models 416
- Decision Trees 417

The Portfolio Effect 418
- Portfolio Risk 419
- Evaluation of Combinations 422

The Share Price Effect 423

Summary 423

Review of Formulas 423

List of Terms 424

Discussion Questions 424

Practice Problems and Solutions 424

Problems 426

Comprehensive Problems 436

Web Exercise 439

14 Capital Markets 442

International Capital Markets 443

Competition for Funds in the U.S. Capital Markets 445
- Government Securities 446
  U.S. Government Securities 446
  Federally Sponsored Credit Agencies 446
- State and Local Securities 446

Corporate Securities 446
- Corporate Bonds 446
- Preferred Stock 447
- Common Stock 447
- Internal versus External Sources of Funds 447

The Supply of Capital Funds 448
- The Role of the Security Markets 450

The Organization of the Security Markets 451
- Traditional Organized Exchanges 451
  Listing Requirements for Firms 452
Contents

S&P Problems 520
Appendix 16A Financial Alternatives for Distressed Firms 521
Out-of-Court Settlement 521
In-Court Settlements—Formal
Bankruptcy 522
Reorganization 522
Liquidation 522
List of Terms 525
Discussion Questions 526
Problems 526
Appendix 16B Lease versus Purchase Decision 527

17 Common and Preferred Stock Financing 530
Common Stockholders' Claim to Income 531
The Voting Right 532
Cumulative Voting 533
The Right to Purchase New Shares 535
The Use of Rights in Financing 536
Rights Required 536
Monetary Value of a Right 536
Effect of Rights on Stockholder's Position 538
Desirable Features of Rights Offerings 540
Poison Pills 540
American Depository Receipts 541
Preferred Stock Financing 541
Justification for Preferred Stock 542
Investor Interest 542
Summary of Tax Considerations 543
Provisions Associated with Preferred Stock 543
1. Cumulative Dividends 543
2. Conversion Feature 544
3. Call Feature 544
4. Participation Provision 544
5. Floating Rate 544
6. Dutch Auction Preferred Stock 544
7. Par Value 545
Comparing Features of Common and Preferred Stock and Debt 545
Summary 546
Review of Formulas 547
List of Terms 548
Discussion Questions 548
Practice Problems and Solutions 549
Problems 550
Comprehensive Problems 554
Web Exercise 556

18 Dividend Policy and Retained Earnings 557
The Marginal Principle of Retained Earnings 558
Life Cycle Growth and Dividends 558
Dividends as a Passive Variable 559
An Incomplete Theory 559
Arguments for the Relevance of Dividends 560
Dividend Stability 561
Other Factors Influencing Dividend Policy 561
Legal Rules 561
Cash Position of the Firm 563
Access to Capital Markets 563
Desire for Control 564
Tax Position of Shareholders 564
Dividend Payment Procedures 564
Stock Dividend 566
Accounting Considerations for a Stock Dividend 566
Value to the Investor 566
Possible Value of Stock Dividends 567
Use of Stock Dividends 568
Stock Splits 568
Reverse Stock Splits 569
Repurchase of Stock as an Alternative to Dividends 569
Other Reasons for Repurchase 571
Dividend Reinvestment Plans 572
Summary 572
List of Terms 573
Discussion Questions 573
Practice Problems and Solutions 573
Problems 574
Comprehensive Problem 582
Web Exercise 582
S&P Problems 583

19 Convertibles, Warrants, and Derivatives 584
Convertible Securities 585
Value of the Convertible Bond 585
Is This Fool's Gold? 588
Advantages and Disadvantages to the Corporation 589
Forcing Conversion 590
Accounting Considerations with Convertibles 591
Financing through Warrants 593
Valuation of Warrants 594
Use of Warrants in Corporate Finance 596
Contents

Accounting Considerations with
   Warrants 597
Derivative Securities 598
   Options 598
   Futures 599
Summary 600
Review of Formulas 600
List of Terms 601
Discussion Questions 601
Practice Problems and Solutions 602
Problems 603
Comprehensive Problems 607
Web Exercise 608

PART 6  EXPANDING THE PERSPECTIVE OF CORPORATE FINANCE

20 External Growth through Mergers 612
   Motives for Business Combinations 613
      Financial Motives 613
      Nonfinancial Motives 615
      Motives of Selling Stockholders 615
   Terms of Exchange 617
      Cash Purchases 617
      Stock-for-Stock Exchange 618
      Portfolio Effect 619
Accounting Considerations in Mergers and Acquisitions 620
   Negotiated versus Tendered Offers 621
Premium Offers and Stock Price Movements 623
   Two-Step Buyout 624
Summary 625
List of Terms 625
Discussion Questions 625
Practice Problems and Solutions 626
Problems 627
Web Exercise 631
S&P Problems 632

21 International Financial Management 633
   The Multinational Corporation: Nature and Environment 636
      Exporter 636
      Licensing Agreement 636
      Joint Venture 636
      Fully Owned Foreign Subsidiary 636
   Foreign Exchange Rates 637
      Factors Influencing Exchange Rates 639
Inflation 639
   Interest Rates 639
   Balance of Payments 639
   Government Policies 640
   Other Factors 640
   Spot Rates and Forward Rates 640
   Cross Rates 642
Managing Foreign Exchange Risk 642
   Forward Exchange Market Hedge 644
   Money Market Hedge 644
   Currency Futures Market Hedge 645
Foreign Investment Decisions 646
   Analysis of Political Risk 648
Financing International Business Operations 649
   Funding of Transactions 650
      Eximbank (Export-Import Bank) 650
      Loans from the Parent Company or a Sister Affiliate 650
      Eurodollar Loans 652
      Eurobond Market 653
      International Equity Markets 653
      The International Finance Corporation 655
Some Unsettled Issues in International Finance 656
   Summary 656
   List of Terms 657
   Discussion Questions 658
   Practice Problems and Solutions 658
   Problems 659
   Web Exercise 660
   S&P Problems 661
Appendix 21A Cash Flow Analysis and the Foreign Investment Decision 661

Appendixes A-1

Appendix A Future Value of $1, $FV_{IF}$ A-2
Appendix B Present Value of $1, $PV_{IF}$ A-4
Appendix C Future Value of an Annuity of $1, $FV_{IFA}$ A-6
Appendix D Present Value of an Annuity of $1, $PV_{IFA}$ A-8

Glossary G

Indexes I-1