Fundamentals of Corporate Finance
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To my parents, whose life-long support and commitment to education inspired me to become an educator, and to my wife, Emily, for her unending support.

THOMAS BATES
To my wife, Emi, and our daughters, Abigail and Lillian. Your support, patience, fun, and friendship make me a better educator, scholar, and person.

STUART GILLAN
To the memory of my father, and to my family for their never-ending support and encouragement.

DAVID KIDWELL
To my parents, Dr. William and Margaret Kidwell, for their endless support of my endeavors; to my son, David Jr., of whom I am very proud; and to my wife, Jillinda, who is the joy of my life.
A member of the faculty at University of Texas since 1992, Dr. Parrino teaches courses in regular degree and executive education programs at the University of Texas, as well as in customized executive education courses for industrial, financial, and professional firms. He has also taught at the University of Chicago, University of Rochester, and IMA-DEC University in Vienna. Dr. Parrino has received numerous awards for teaching excellence at the University of Texas from students, faculty, and the Texas Exes (alumni association).

Dr. Parrino has been involved in advancing financial education outside of the classroom in a variety of ways. As a Chartered Financial Analyst (CFA) charterholder, he has been very active with the CFA Institute, having been a member of the candidate curriculum committee, served as a regular speaker at the annual Financial Analysts Seminar, spoken at over 20 Financial Analyst Society meetings, and served as a member of the planning committee for the CFA Institute’s Annual Meeting. In addition, Dr. Parrino is the founding director of the Hicks, Muse, Tate & Furst Center for Private Equity Finance at the University of Texas. The center sponsors conferences and other educational activities in areas related to private equity finance. Dr. Parrino was Vice President for Financial Education of the Financial Management Association (FMA) from 2008 to 2010 and an academic director of the FMA from 2011 to 2013. In 2017 he was elected to be VP-Program for the 2019 FMA annual meeting.

Dr. Parrino also co-founded the Financial Research Association and is Associate Editor of the *Journal of Corporate Finance*. Dr. Parrino’s research focus includes corporate governance, financial policies, restructuring, mergers and acquisitions, and private equity markets. He has published his research in a number of journals, including the *Journal of Finance*, *Journal of Financial Economics*, *Journal of Financial and Quantitative Analysis*, *Journal of Law and Economics*, *Journal of Portfolio Management*, and *Financial Management*. Dr. Parrino has won a number of awards for his research, including the 2013–2014 Career Award for Outstanding Research Contributions at the McCombs School of Business.

Dr. Parrino has experience in the application of corporate finance concepts in a variety of business situations. Since entering the academic profession, he has been retained as an advisor on valuation issues concerning businesses with enterprise values ranging to more than $1 billion and has consulted in areas such as corporate financing, compensation, and corporate governance. Dr. Parrino was previously President of Sprigg Lane Financial, Inc., a financial consulting firm with offices in Charlottesville, Virginia, and New York City. While at Sprigg Lane, he was on the executive, banking, and portfolio committees of the holding company that owns Sprigg Lane. Before joining Sprigg Lane, Dr. Parrino was on the Corporate Business Planning and Development staff at Marriott Corporation. At Marriott, he conducted fundamental business analyses and preliminary financial valuations of new business development opportunities and potential acquisitions. Dr. Parrino holds a B.S. in chemical engineering from Lehigh University, an MBA degree from The College of William and Mary, and M.S. and Ph.D. degrees in applied economics and finance, respectively, from the University of Rochester.
Dr. Bates is the Chair of the Department of Finance and Dean’s Council of 100 Distinguished Scholar at the W. P. Carey School of Business, Arizona State University. He has also taught courses in finance at the University of Delaware, the Ivey School of Business at the University of Western Ontario, and the University of Arizona where he received the Scrivner teaching award. During his career as an educator, Professor Bates has taught corporate finance to students in undergraduate, MBA, executive MBA, and Ph.D. programs, as well as in custom corporate educational courses.

Professor Bates is a regular contributor to the academic finance literature in such journals as the *Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis*, and *Financial Management*. His research addresses a variety of issues in corporate finance including the contracting environment in mergers and acquisitions, corporate liquidity decisions and cash holdings, and the governance of corporations. In practice, Dr. Bates has worked with companies and legal firms as an advisor on issues related to the valuation of companies and corporate governance. Dr. Bates received a B.A. in Economics from Guilford College and his doctorate in finance from the University of Pittsburgh.

Dr. Gillan is Associate Professor of Finance in the Terry College of Business at the University of Georgia. His industry experience includes time as Associate Chief Economist at the United States Securities and Exchange Commission (SEC) and Senior Research Fellow with TIAA, a New York-based financial services company.

Before joining the University of Georgia, he held academic positions at Arizona State University, the University of Delaware, the University of Hong Kong, the University of Otago, and Texas Tech University. He has also been a visiting scholar at the Chinese University of Hong Kong, University of Canterbury, the Hong Kong Polytechnic University, and a William Evans Fellow at the University of Otago. In addition to teaching corporate finance classes to undergraduate, masters, MBA and Executive MBA students, Dr. Gillan has taught in several customized executive education and corporate programs. In recognition of his teaching, he also received a Terry College of Business Hugh O. Nourse Outstanding MBA Teacher Award.

Additionally, Dr. Gillan has served as Co-Editor of the *Journal of Corporate Finance*, Associate Editor at the *Review of Financial Studies*, Associate Editor at *Accounting and Finance*, and on the editorial advisory board of the *Journal of Applied Corporate Finance*. He has written and published extensively on corporate finance and corporate governance including topics such as corporate restructuring, executive compensation, shareholder activism, shareholder voting, and the structure and activity of corporate boards. His research has been published in the *Journal of Finance, Journal of Financial Economics, Review of Financial Studies, Journal of Corporate Finance, Journal of Risk and Insurance, Financial Management*, and the *Journal of Applied Corporate Finance*, amongst others. His has also received best paper awards from academic finance groups including the Financial Management Association International, the Indian School of Business Center for Analytical Finance, and the Western Finance Association.

Dr. Gillan received his Ph.D. from the Graduate School of Business at the University of Texas, Austin. His Bachelor of Commerce (Honors) and Masters of Commerce degrees are from the University of Otago, New Zealand.
Dr. Kidwell has over 30 years experience in financial education, as a teacher, researcher, and administrator. He has served as Dean of the Carlson School at the University of Minnesota and of the School of Business Administration at the University of Connecticut. Prior to joining the University of Connecticut, Dr. Kidwell held endowed chairs in banking and finance at Tulane University, the University of Tennessee, and Texas Tech University. He was also on the faculty at the Krannert Graduate School of Management, Purdue University where he was twice voted the outstanding undergraduate teacher of the year.

An expert on the U.S. financial system, Dr. Kidwell is the author of more than 80 articles dealing with the U.S. financial system and capital markets. He has published his research in the leading journals, including *Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Financial Management,* and *Journal of Money, Credit, and Banking.* Dr. Kidwell has also participated in a number of research grants funded by the National Science Foundation to study the efficiency of U.S. capital markets, and to study the impact of government regulations upon the delivery of consumer financial services.

Dr. Kidwell has been a management consultant for Coopers & Lybrand and a sales engineer for Bethlehem Steel Corporation. He served on the Board of Directors for the Schwan Food Company and was the Chairman of the Audit and Risk Committee. Dr. Kidwell is the past Secretary-Treasurer of the Board of Directors of AACSB, the International Association for Management Education and is a past member of the Boards of the Minnesota Council for Quality, the Stonier Graduate School of Banking, and Minnesota Center for Corporate Responsibility. Dr. Kidwell has also served as an Examiner for the 1995 Malcolm Baldrige National Quality Award, on the Board of Directors of the Juran Center for Leadership in Quality, and on the Board of the Minnesota Life Insurance Company.

Dr. Kidwell holds an undergraduate degree in mechanical engineering from California State University at San Diego, an MBA with a concentration in finance from California State University at San Francisco, and a Ph.D. in finance from the University of Oregon.
Preface

We have written Fundamentals of Corporate Finance for use in an introductory course in corporate finance at the undergraduate level. It is also suitable for advanced undergraduate, executive development, and traditional or executive MBA courses when supplemented with cases and outside readings. The main chapters in the book assume that students are well-versed in algebra and that they have taken courses in principles of economics and financial accounting. Optional chapters covering important economic and financial accounting concepts are included for students and instructors seeking such coverage.

Balance Between Conceptual Understanding and Computational Skills

We wrote this corporate finance text for one very important reason. We want to provide students and instructors with a book that strikes the best possible balance between helping students develop an intuitive understanding of key financial concepts and providing them with problem-solving and decision-making skills. In our experience, teaching students at all levels and across a range of business schools, we have found that students who understand the intuition underlying the basic concepts of finance are better able to develop the critical judgment necessary to apply financial tools to a broad range of real-world situations. An introductory corporate finance course should provide students with a strong understanding of both the concepts and tools that will help them in their subsequent business studies and their personal and professional lives.

Market research supports our view. Many faculty members who teach the introductory corporate finance course to undergraduates want a book that bridges the gap between conceptually-focused and computationally-focused books. This text is designed to bridge this gap. Specifically, it develops the fundamental concepts underlying corporate finance in an intuitive manner while maintaining a strong emphasis on developing computational skills. This text also takes the students one step further by emphasizing the use of intuition and analytical skills in decision making.

Our ultimate goal has been to write a book and develop associated learning tools that help our colleagues succeed in the classroom—materials that are genuinely helpful in the learning process. Our book offers a level of rigor that is appropriate for finance majors and yet presents the content in a manner that both finance and non-finance students find accessible and want to read. Writing a book that is both rigorous and accessible has been one of our key objectives, and both faculty and student reviews of the previous editions suggest that we have achieved this objective.

We have also tried to provide solutions to many of the challenges facing finance faculty in the current environment, who are asked to teach ever-increasing numbers of students with limited resources. Faculty members need a book and associated learning tools that help them effectively leverage their time. The organization of this book and the supplemental materials, along with the innovative WileyPLUS Web-based interface, which offers extensive problem solving opportunities and other resources for students, provides such leverage.

A Focus on Value Creation

This book is more than a collection of ideas, equations, and chapters. It has an important integrating theme—that of value creation. This theme, which is carried throughout the book, provides a framework that helps students understand the relations between the various concepts covered in the book and makes it easier for them to learn these concepts.

The concept of value creation is the most fundamental notion in corporate finance. It is in stockholders’ best interests for value maximization to be at the heart of the financial decisions made within the firm. Thus, it is critical that students be able to analyze and make business decisions with a focus on value creation. The concept of value creation is introduced in the first chapter of the book and is further developed and applied throughout the remaining chapters.

The theme of value creation is operationalized through the net present value (NPV) concept. Once students grasp the fundamental idea that financial decision makers should only choose courses of action whose benefits exceed their costs, analysis and decision making using the NPV concept becomes second nature. By helping students better understand the economic rationale for a decision from the outset, rather than initially focusing on computational skills, our text keeps students focused on the true purpose of the calculations and the decision at hand.

Integrated Approach: Intuition, Analysis, and Decision Making

To support the focus on value creation, we have emphasized three things: (1) providing an intuitive framework for understanding fundamental finance concepts, (2) teaching students how to analyze and solve finance problems, and (3) helping students develop the ability to use the results from their analyses to make good financial decisions.

1. **An Intuitive Approach:** We believe that explaining finance concepts in an intuitive context helps students develop a richer understanding of those concepts and gain better insights into how finance problems can be approached. It is our experience that students who have a strong conceptual understanding of financial theory better
understand how things really work and are better problem solvers and decision makers than students who focus primarily on computational skills.

2. **Analysis and Problem Solving:** With a strong understanding of the basic principles of finance, students are equipped to tackle a wide range of financial problems. In addition to the many numerical examples that are solved in the text of each chapter, this book has 1,200 end-of-chapter homework and review problems that have been written with Bloom’s Taxonomy in mind. Solutions for these problems are provided in the Instructor’s Manual. We strive to help students acquire the ability to analyze and solve finance problems.

3. **Decision Making:** In the end, we want to prepare students to make sound financial decisions. To help students develop these skills, throughout the text we illustrate how the results from financial analyses are used in decision making.
In order to help students develop the skills necessary to tackle investment and financing decisions, we have arranged the book’s 21 chapters into five major building blocks, that collectively comprise the seven parts of the book, as illustrated in the accompanying exhibit and described below.

### Introduction

**Part 1**, which consists of Chapter 1, provides an introduction to corporate finance. It describes the role of the financial manager, the types of fundamental decisions that financial managers make, alternative forms of business organization, the goal of the firm, agency conflicts and how they arise, and the importance of ethics in financial decision-making. These discussions set the stage and provide a framework that students can use to think about key concepts as the course progresses.

### Foundations

**Part 2** of the text consists of Chapters 2 through 4. These chapters present the basic institutional, economic, and accounting knowledge and tools that students should understand before they begin the study of financial concepts. Most of the material in these chapters is typically taught in other courses. Since students come to the corporate finance course with varying academic backgrounds, and because the time that has elapsed since students have taken particular prerequisite courses also varies, the chapters in Part 2 can help the instructor ensure that all students have the same base level of knowledge early in the course. Depending on the educational background of the students, the instructor might not find it necessary to cover all or any of the material in these chapters. Some or all of these chapters might, instead, be assigned as supplemental readings.

Chapter 2 describes the services financial institutions provide to businesses, how domestic and international financial markets work, the concept of market efficiency, how firms use financial markets, and how interest rates are determined in the economy. Chapter 3 describes the key financial statements and how they are related, as well as how these statements are related to cash flows to investors. Chapter 4 discusses ratio analysis and other tools used to evaluate financial statements. Throughout Part 2, we emphasize the importance of cash flows to get students thinking about cash flows as a critical component of all valuation calculations and financial decisions.

### Basic Concepts and Tools

**Part 3** presents basic financial concepts and tools and illustrates their application. This part of the text, which consists of Chapters 5 through 9, introduces time value of money and risk and return concepts and then applies these concepts to bond and stock valuation. These chapters provide students with basic financial intuitions and computational tools that will serve as the building blocks for analyzing investment and financing decisions in subsequent chapters.
Analysis

Parts 4 and 5 of the text focus on investment and financing decisions. Part 4 covers capital budgeting. Chapter 10 introduces the concept of net present value and illustrates its application as the principle tool for evaluating capital projects. It also discusses alternative capital budgeting decision rules, such as internal rate of return, payback period, and accounting rate of return, and compares them with the net present value criterion. Finally, Chapter 10 also discusses investment decisions with capital rationing. The discussions in Chapter 10 provide a framework that will help students in the rest of Part 4 as they learn the nuances of capital budgeting analysis in realistic settings.

Chapters 11 and 12 follow with in-depth discussions of how cash flows are calculated and forecast. The cash flow calculations are presented in Chapter 11 using a valuation framework that helps students think about valuation concepts in an intuitive way and that prepares them for the extension of these concepts to business valuation in Chapter 18. Chapter 12 covers analytical tools—such as breakeven, sensitivity, scenario, and simulation analysis—that give students a better appreciation for how they can deal with the uncertainties associated with cash flow forecasts.

Chapter 13 explains how the discount rates used in capital budgeting are estimated. This chapter uses an innovative concept—that of the finance balance sheet—to help students develop an intuitive understanding of the relations between the costs of the individual components of capital and the firm’s overall weighted average cost of capital. It also provides a detailed discussion of methods used to estimate the costs of the individual components of capital that are used to finance a firm’s investments and how these estimates are used in capital budgeting.

Part 5 covers working capital management and financing decisions. It begins, in Chapter 14, with an introduction to how firms manage their working capital and the implications of working capital management decisions for financing decisions and firm value. This is followed, in Chapters 15 and 16, with discussions of how firms raise capital to fund their real activities and the factors that affect how firms choose among the various sources of capital available to them. Chapter 16 also includes an extensive appendix on leasing concepts and buy vs. lease analysis. Chapter 17 rounds out the discussion of financing decisions with an introduction to dividends, stock repurchases, stock dividends and splits, and payout policy.

Integration

Part 6, which consists of Chapters 18 and 19, brings together many of the key concepts introduced in the earlier parts of the text. Chapter 18 covers financial aspects of business formation and growth and introduces students to business valuation concepts for both private and public firms. The discussions in this chapter integrate the investment and financing concepts discussed in Parts 4 and 5 to provide students with a more complete picture of how all the financial concepts fit together. Chapter 19 covers concepts related to financial planning, forecasting, and managing growth.

Part 7 introduces students to some important issues that managers must deal with in applying the concepts covered in the text to real-world problems. Chapter 20 introduces call and put options and discusses how they relate to investment and financing decisions. It describes options that are embedded in the securities that firms issue. It also explains, at an accessible level, the idea behind real options and why traditional NPV analysis does not take such options into account. In addition, the chapter discusses agency costs of debt and equity and the implications of these costs for investment and financing decisions. Finally, Chapter 20 illustrates the use of options in risk management. Instructors can cover the topics in Chapter 20 near the end of the course or insert them at the appropriate points in Parts 4 and 5. Chapter 21 examines how international considerations affect the application of concepts covered in the book.

Unique Chapters

Chapter on Business Formation, Growth, and Valuation
We wrote Chapter 18 in response to students’ heightened interest in new business formation (entrepreneurship) and in order to draw together, in a comprehensive way, the key concepts from capital budgeting, working capital management, and financial policy. This capstone chapter provides an overview of practical finance issues associated with forecasting cash flows and capital requirements for a new business, preparing a business plan, and business valuation. The discussion of business valuation extends far beyond that found in other introductory corporate finance textbooks.

Chapter on Options and Corporate Finance
Many other corporate finance textbooks have a chapter that introduces students to financial options and how they are valued. This chapter goes further. It provides a focused discussion of the different types of financial and non-financial options that are of concern to financial managers, including options embedded in debt and equity securities, real options and their effect on project analysis, how option-like payoff functions faced by stockholders, bond holders, and managers affect agency relationships, and the use of options in risk management.
The Sears department store chain had a rough time from 2012 to 2016. Its revenues declined from $41.57 billion to $25.10 billion, and the company’s operating income, excluding unusual items, fell from $0.65 billion to $1.36 billion. Sears’s managers did not stand still over this period. They worked very hard to restructure the company in an effort to turn it around and make it the growing and profitable business that it had once been. Unfortunately, these efforts did not appear to be working by early 2017. The company was shrinking; its total assets had dropped from $21.38 billion in 2012 to $11.61 billion by the beginning of February 2017. During the five years leading up to February 1, 2017, Sears’s stock price fell from $52.58 to $6.96.

The challenges faced by Sears were not affecting everyone in its industry equally. For example, Wal-Mart’s sales grew from $446.95 billion in 2012 to $482.13 billion in 2016. While Wal-Mart’s operating income did decline modestly during this period, from $26.55 billion to $24.11 billion, the company remained quite profitable, and its assets increased from $193.41 billion to $199.58 billion. During the five years leading up to February 1, 2017, Wal-Mart’s stock price rose from $59.08 to $68.02.

This chapter discusses risk, return, and the relation between them. The difference in the returns earned by Sears and Wal-Mart stockholders from February 2012 to February 2017 illustrates a challenge faced by all investors. The shares of both of these companies were viewed as risky investments in 2012 and yet someone who invested in Sears stock on February 1, 2012, lost 86.8 percent ($6.96 − $52.58)/$52.58 = −0.868, or 86.8 percent) of that investment over the following five years, while an investor who bought Wal-Mart stock earned 15.1 percent ($68.02 − $59.08)/$59.08 = 0.151, or 15.1 percent). How should investors

**Learning Objectives**

1. Explain the relation between risk and return.
2. Describe the two components of a total holding period return, and calculate this return for an asset.
3. Explain what an expected return is and calculate the expected return for an asset.
4. Explain what the standard deviation of returns is and why it is useful in finance, and calculate it for an asset.
5. Explain what an arithmetic average return is and what a geometric return is, and calculate these returns for an asset.
6. Explain the concept of diversification.
7. Discuss which type of risk matters to investors and why.
8. Describe what the Capital Asset Pricing Model (CAPM) tells us and how to use it to evaluate whether the expected return of an asset is sufficient to compensate an investor for the risks associated with that asset.
Learning by Doing Applications

Along with a generous number of in-text examples, most chapters include several Learning by Doing Applications. These applications contain quantitative problems with step-by-step solutions to help students better understand how to apply their intuition and analytical skills to solve important problems. By including these exercises, we provide students with additional practice in the application of the concepts, tools, and methods that are discussed in the text.

Building Intuition

Students must have an intuitive understanding of a number of important principles and concepts to successfully master the finance curriculum. Throughout the book, we emphasize these important concepts by presenting them in Building Intuition boxes. These boxes provide a statement of an important finance concept, such as the relationship between risk and expected return, along with an intuitive example or explanation to help the student “get” the concept. These boxes help the students develop finance intuition. Collectively the Building Intuition boxes cover the most important concepts in corporate finance.

More Risk Means a Higher Expected Return

The greater the risk associated with an investment, the greater the return investors expect from it. A corollary to this idea is that investors want the highest return for a given level of risk or the lowest risk for a given level of return. When choosing between two investments that have the same level of risk, investors prefer the investment with the higher return. Alternatively, if two investments have the same expected return, investors prefer the less risky alternative.

Example 7.2 | Choosing between Two Investments

Situation You are trying to decide whether to invest in one or both of two different stocks. Stock 1 has a beta of 0.8 and an expected return of 7.0 percent. Stock 2 has a beta of 1.2 and an expected return of 9.5 percent. You remember learning about the CAPM in school and believe that it does a good job of telling you what the appropriate expected return should be for a given level of risk. Since the risk-free rate is 4 percent and the market risk premium is 6 percent, the CAPM tells you that the appropriate expected rate of return for an asset with a beta of 0.8 is 8.8 percent. The corresponding return for an asset with a beta of 1.2 is 11.2 percent. Should you invest in either or both of these stocks?

Decision You should not invest in either stock. The expected returns for both of them are below the line in Exhibit 7.11. This implies that they are both overpriced.

Decision-Making Examples

Throughout the book, we emphasize the role of the financial manager as a decision maker. To that end, twenty chapters include Decision-Making Examples. These examples, which emphasize the decision-making process rather than computation, provide students with experience in financial decision making. Each Decision-Making Example outlines a scenario and asks the student to make a decision based on the information presented.
Summary of Learning Objectives

1. Explain the relationship between risk and return.
   Investors require higher rates of return for taking greater risk. They price the investment with the highest possible return for a given level of risk or the investment with the lowest risk for a given level of return.

2. Describe the two components of a total holding period return, and calculate this return for an asset.
   The total holding period return on an investment consists of a capital appreciation component and an income component. This return is calculated using Equation 7.1. It is important to recognize that investors do not care whether they receive a dollar of return through capital appreciation or a cash dividend. Investors value both sources of return equally.

3. Explain what an expected return is, and calculate the expected return for an asset.
   The expected average return is the expected return earned in an average period while the geometric average return is the average compounded return earned over an investment period. Equations 7.4 and 7.5 are used to calculate these returns.

4. Explain the concept of diversification.
   Diversification entails reducing risk by investing in two or more assets whose values do not always move in the same direction at the same time. Investing in a portfolio containing assets whose prices do not move together will reduce risk.

Summary of Key Equations

<table>
<thead>
<tr>
<th>Equation</th>
<th>Description</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1</td>
<td>Total holding period return</td>
<td>( R_t = R_{C,t} + R_A )</td>
</tr>
<tr>
<td>7.2</td>
<td>Expected return on an asset</td>
<td>( E(R_{C}) = \sum_{i} (p_i \times R_i) )</td>
</tr>
<tr>
<td>7.3</td>
<td>Variance of return on an asset</td>
<td>( \text{Var}(R) = \sum_{i} [p_i \times ( R_i - E(R) )^2] )</td>
</tr>
</tbody>
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Self-Study Problems

7.1 Kaaran made a friendly wager with a colleague that involves the return from flipping a coin. If heads comes up, Kaaran must pay his colleague $15; otherwise, his colleague will pay Kaaran $15. What is Kaaran’s expected cash flow, and what is the variance of that cash flow if the coin has an equal probability of coming up heads or tails? Suppose Kaaran’s colleague is willing to handicap the bet by paying her $20 if heads comes up. What is Kaaran’s expected cash flow, and what is the variance of that cash flow if the coin has an equal probability of coming up heads or tails?

Solutions to Self-Study Problems

7.1 Part 1: E(cash flow) = \((0.5 \times -15) + (0.5 \times 15) = 0 \) 
7.1 Part 2: E(cash flow) = \((0.5 \times -15) + (0.5 \times 20) = 2.50 \)
7.2 The expected return for CFY based on today’s stock price is \((312 - 315)/315 \times 100\% = -1\%\), which is lower than 20 percent. Since the stock price one year from today is fixed, the only way that you will generate a 20 percent return is if the price of the stock drops today. Consequently, the price of the stock today must drop to $30. It is found by solving the following: \(0.3 = (312 - x)/x\), or \(x = 30.9\)
7.3 Since you know that 1.65 standard deviations from the expected return captures 90 percent of the distribution, you can set up either of the following equations: \(40 \times 50 = 1.645x\) or \(50 \times 50 = 1.645x\) and solve for \(x\). Doing this with either equation yields:
    \( x = 30.07\% \) and \( x = 30.85\% \)
7.4 The value in 2015 is:
    \( V_{2015} = \frac{51}{(1 + 0.0625)} \times (1 + 0.025) \times (1 + 0.4507) \times (1 + 0.0239) \times (1 + 0.0346) \)
    \( = 61.646 \)
    Substituting into Equation 7.4 and solving for the geometric average yield:
    \( R_{	ext{average}} = \left( 1 + R_2 \right)^{1/2} - 1 \)
    \( = (51.646)^{1/2} - 1 \)
    \( = 0.1046, \text{ or } 10.46 \text{ per year} \)

Discussion Questions

At least ten qualitative questions, called Discussion Questions, require students to think through their understanding of key concepts and apply those concepts to a problem.

7.1 Suppose that you know the risk and the expected return for two stocks. Discuss the process you might utilize to determine which of the two stocks will be a better buy. You may assume that the two stocks are the only assets held in your portfolio.

7.2 What is the difference between the expected rate of return and the required rate of return? What does it mean when these two rates are different? Discuss the implications of these two concepts for a particular asset at a particular point in time.

7.3 Suppose that the standard deviation of the returns on the shares of stock at two different companies is exactly the same. Does this mean that these two companies have the same risk? Do companies with identical variances necessarily have identical risk?

7.4 The expected rate of return on stocks A and B is -0.50. If the expected rate of return on stock C is 0.50, what is the expected rate of return on a portfolio consisting of 50% of stock A and 50% of stock B? What is the expected rate of return on a portfolio consisting of 50% of stock A and 50% of stock C? What is the expected rate of return on a portfolio consisting of 50% of stock B and 50% of stock C?

7.5 Which investment category included in Exhibit 7.3 has shown the greatest degree of risk in the United States since 1926? Explain why. Which investment category is likely to be more sensitive to changes in market conditions than the price of a corporate bond?

7.6 You are concerned about one of the investments in your fully diversified portfolio. You just have an uneasy feeling about the CFO, Jim Shifty, of that particular firm. Do you believe, however, that the firm makes a good product and that it is appropriately priced by the market. Should you be concerned about the effect on your portfolio if Shifty embraces a portion of the firm’s cash?

7.7 The CAPM is used to price the risk (estimate the expected return) for any asset. Our examples have focused on stocks, but we could also use CAPM to estimate the expected return for bonds. Explain why.

7.8 In recent years, investors have agreed that the market portfolio consists of more than just a group of U.S. stocks and bonds. If you are
Questions and Problems

The Questions and Problems, numbering 26 to 48 per chapter, are primarily quantitative and are classified as Basic, Intermediate, or Advanced.

Excel Problems

Nearly all problems can be solved using Excel templates within WileyPLUS.

Sample Test Problems

Finally, five or more Sample Test Problems call for straightforward applications of the chapter concepts. These problems are intended to be representative of the kind of problems that may be used in a test, and instructors can encourage students to solve them as if they were taking a quiz. Solutions are provided in the Instructor’s Manual.

CFA Problems

4.38 Common-size analysis is used in financial analysis to:
   a. evaluate changes in a company’s operating cycle over time.
   b. predict changes in a company’s capital structure using regression analysis.
   c. compare companies of different sizes or compare a company with itself over time.
   d. relate each element in a company’s financial statement as a percentage of total revenue.

4.40 DuPont analysis involves breaking return-on-assets ratios into:
   a. profit components.
   b. margin and average components.
   c. operating and financing components.
   d. profit margin and turnover components.

4.41 If a company’s net profit margin is 5 percent, its total asset turnover is 2.0. What is its return on assets?

Sample Test Problems

7.1 Given the following information from Captive Corporation, what price would the CAPM predict that the company’s stock will trade for one year from today?

- Risk-free rate: 3%
- Market risk premium: 8%
- Beta: 0.65
- Current stock price: $64.61
- Annual dividend: $1.92

7.2 You are considering investing in a mutual fund. The fund is expected to earn a return of 15 percent in the next year. If its annual return is normally distributed with a standard deviation of 6.5 percent, what return can you expect the fund to beat 95 percent of the time?

7.3 You have just invested in a portfolio of three stocks. The amount of money that you invested in each stock and its beta are summarized below. Calculate the beta of the portfolio and use the Capital Asset Pricing Model (CAPM) to compute the expected rate of return for the portfolio. Assume that the expected rate of return on the market is 15 percent and that the risk-free rate is 7 percent.

<table>
<thead>
<tr>
<th>Stock</th>
<th>Investment</th>
<th>Beta</th>
</tr>
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7.4 What would you recommend to an investor who is considering making an investment in a stock that plots below the Security Market Line (SML)? Explain.

7.5 Why does an investor want a diversified portfolio? Can an investor eliminate all risk?

Ethics Cases

Ethics is an important topic in Finance. Key concepts are discussed in Chapter 1 and eight cases are included throughout this book to help students better understand how to analyze ethical dilemmas. Real company examples are presented, including timeless cases about Arthur Anderson and Martha Stewart’s scandal involving ImClone, and more timely topics such as the controversy surrounding drug price increases at firms like Mylan (EpiPen) and the cross-selling scandal at Wells Fargo. Each case includes questions for follow-up discussion in class or as an assignment.
In revising Fundamentals of Corporate Finance we have improved the presentation and organization of key topics, added important new content, updated the text to reflect changes in market and business conditions since the third edition was written, improved key in-chapter pedagogical features, and added to the number and quality of the end-of-chapter problem sets.

Improved Content, Presentation, and Organization

In preparing this edition of Fundamentals of Corporate Finance, we extensively edited discussions throughout the text and added new content to improve the depth and effectiveness of the presentation. We also substantially modified the layout of the text to enhance the accessibility of the content in on line applications, such as WileyPLUS. The changes that we made to the content and writing are too numerous to discuss in detail here. However, examples include the addition of more in-text calculations related to cash flows associated with working capital and long term investments in Chapter 3, the addition of a new section on arithmetic versus geometric returns in Chapter 7, and streamlining of some of bond calculation discussions in Chapter 8. Throughout the text we added callouts for the Learning by Doing Applications and Decision Making Examples to improve the flow of the presentation. We also added two new ethics cases, one on pricing in the pharmaceutical industry and a second on the controversy at Wells Fargo regarding the establishment of new accounts without customer permission. These new cases, along with updated versions of six of the ethics cases from the previous edition, provide the instructor with a broad range ethical issues from which to choose.

Current Financial Market and Business Information

Throughout the text, all financial market and business information for which more current data are available have been updated. Not only have the exhibits been updated, but financial values such as interest rates, risk premia, and foreign currency exchange rates have been updated throughout the discussions in text, in-text examples, and end-of-chapter problems. In addition, all of the chapter opener vignettes have either been replaced or updated. Six of these examples are from 2016 and 15 are from 2017. All of the chapter openers provide timely examples of how the material covered in the chapter is relevant to financial decision-making.

In-Chapter Features

The Learning Objectives at the beginning of each chapter have been revised to more fully reflect the important content in the associated sections of the chapters.

New Building Intuition Boxes have been added where appropriate and existing Building Intuition Boxes have been edited to ensure clarity.

All Learning by Doing Applications have been reviewed and, where appropriate, updated or replaced.

All Decision-Making Examples have been reviewed and updated where necessary.

The Summary of Learning Objectives and Key Equations at the end of each chapter have been updated to reflect changes in the chapter text and to improve the pedagogical value of these features.

Refined and Extended Problem Sets

We have carefully edited the end-of-chapter questions and problems throughout the book to ensure that the examples are current and clearly presented. New Self-Study Problems, Discussion Questions, and Questions and Problems have been added to ensure appropriate coverage of key concepts at all levels of difficulty. The total number of end-of-chapter questions and problems, including self-study problems and test questions, for the entire text has increased to 1,200.

Engaging Digitally

Fundamentals of Corporate Finance, Fourth Edition, is completely integrated with WileyPLUS, featuring a suite of teaching and learning resources developed under the close review of the authors. Driven by the same basic beliefs as the textbook, WileyPLUS allows students to create a personalized study plan, assess their progress along the way, and access the content and resources needed to master the material. WileyPLUS provides immediate insight to student strengths and problem areas with visual reports that highlight what’s most important for both the instructor and student.

Many dynamic resources are integrated into the course to help students build their knowledge and understanding, stay motivated, and prepare for decision making in a real-world context. WileyPLUS also includes Orion, an integrated adaptive practice that helps students build proficiency and use their study time most effectively. Additional features of the WileyPLUS course include:

Chapter 0 Math and Skills Review offering students adaptive review and practice for essential math topics necessary to master Corporate Finance. Built to serve as a refresher of remedial content, this chapter includes reading content, algorithmic practice, and Figuring Finance Interactive Tutorials built to improve student retention and help connect difficult math and finance concepts.

Learning by Doing Interactive Tutorials containing quantitative problems with step-by-step solutions to help students better understand how to apply their intuition and analytical skills to solve problems.

Solution Walkthrough Lightboard Videos featuring the authors working through a 1–3 of end of chapter problems per chapter, offering 24/7 just-in-time homework assistance and problem solving techniques.

Excel Templates and Excel Function Videos providing students with step-by-step examples of how to use specific Excel functions as it applies to Corporate Finance. Excel templates will be available for all applicable end of chapter question while videos feature select end-of-chapter problems to support Excel function examples.
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<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>PREFACE</strong></td>
<td>ix</td>
</tr>
<tr>
<td>1</td>
<td>The Financial Manager and the Firm</td>
<td>1-1</td>
</tr>
<tr>
<td>2</td>
<td>The Financial System and the Level of Interest Rates</td>
<td>2-1</td>
</tr>
<tr>
<td>3</td>
<td>Financial Statements, Cash Flows, and Taxes</td>
<td>3-1</td>
</tr>
<tr>
<td>4</td>
<td>Analyzing Financial Statements</td>
<td>4-1</td>
</tr>
<tr>
<td>5</td>
<td>The Time Value of Money</td>
<td>5-1</td>
</tr>
<tr>
<td>6</td>
<td>Discounted Cash Flows and Valuation</td>
<td>6-1</td>
</tr>
<tr>
<td>7</td>
<td>Risk and Return</td>
<td>7-1</td>
</tr>
<tr>
<td>8</td>
<td>Bond Valuation and the Structure of Interest Rates</td>
<td>8-1</td>
</tr>
<tr>
<td>9</td>
<td>Stock Valuation</td>
<td>9-1</td>
</tr>
<tr>
<td>10</td>
<td>The Fundamentals of Capital Budgeting</td>
<td>10-1</td>
</tr>
<tr>
<td>11</td>
<td>Cash Flows and Capital Budgeting</td>
<td>11-1</td>
</tr>
<tr>
<td>12</td>
<td>Evaluating Project Economics</td>
<td>12-1</td>
</tr>
<tr>
<td>13</td>
<td>The Cost of Capital</td>
<td>13-1</td>
</tr>
<tr>
<td>14</td>
<td>Working Capital Management</td>
<td>14-1</td>
</tr>
<tr>
<td>15</td>
<td>How Firms Raise Capital</td>
<td>15-1</td>
</tr>
<tr>
<td>16</td>
<td>Capital Structure Policy</td>
<td>16-1</td>
</tr>
<tr>
<td>17</td>
<td>Dividends, Stock Repurchases, and Payout Policy</td>
<td>17-1</td>
</tr>
<tr>
<td>18</td>
<td>Business Formation, Growth, and Valuation</td>
<td>18-1</td>
</tr>
<tr>
<td>19</td>
<td>Financial Planning and Managing Growth</td>
<td>19-1</td>
</tr>
<tr>
<td>20</td>
<td>Options and Corporate Finance</td>
<td>20-1</td>
</tr>
<tr>
<td>21</td>
<td>International Financial Management</td>
<td>21-1</td>
</tr>
<tr>
<td></td>
<td><strong>APPENDIX A</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Future Value and Present Value Tables</td>
<td>A-1</td>
</tr>
<tr>
<td></td>
<td><strong>APPENDIX B</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Solutions to Odd Problems</td>
<td>B-1</td>
</tr>
<tr>
<td></td>
<td><strong>GLOSSARY / SUBJECT INDEX / COMPANY INDEX</strong></td>
<td></td>
</tr>
</tbody>
</table>
# Contents

## 1 The Financial Manager and the Firm 1-1

### 1.1 The Role of the Financial Manager 1-2
- Stakeholders 1-2
- It's All About Cash Flows 1-2
- Three Fundamental Decisions in Financial Management 1-4

### 1.2 Forms of Business Organization 1-6
- Sole Proprietorships 1-7
- Partnerships 1-8
- Corporations 1-8

### 1.3 Managing the Financial Function 1-10
- Organizational Structure 1-10
- Positions Reporting to the CFO 1-11
- External Auditor 1-11
- The Audit Committee 1-12
- The Compliance and Ethics Director 1-12

### 1.4 The Goal of the Firm 1-12
- What Should Management Maximize? 1-12
- Why Not Maximize Profits? 1-13
- Maximize the Value of the Firm's Stock 1-13
- Can Management Decisions Affect Stock Prices? 1-14

### 1.5 Agency Conflicts: Separation of Ownership and Control 1-15
- Ownership and Control 1-16
- Agency Relationships 1-16
- Do Managers Really Want to Maximize Stock Price? 1-16
- Aligning the Interests of Managers and Stockholders 1-17
- Sarbanes-Oxley and Other Regulatory Reforms 1-18

### 1.6 The Importance of Ethics in Business 1-21
- Business Ethics 1-21
- Are Business Ethics Different from Everyday Ethics? 1-21
- Types of Ethical Conflicts in Business 1-22
- The Importance of an Ethical Business Culture 1-23

**Summary of Learning Objectives / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems**

## 2 The Financial System and the Level of Interest Rates 2-1

### 2.1 The Financial System 2-2
- The Financial System at Work 2-3
- How Funds Flow through the Financial System 2-3

### 2.2 Direct Financing 2-4
- A Direct Market Transaction 2-5
- Investment Banks and Direct Financing 2-5

### 2.3 Types of Financial Markets 2-7
- Primary and Secondary Markets 2-7
- Exchanges and Over-the-Counter Markets 2-8
- Money and Capital Markets 2-8
- Public and Private Markets 2-9
- Futures and Options Markets 2-10

### 2.4 Market Efficiency 2-10
- Efficient Market Hypotheses 2-11

### 2.5 Financial Institutions and Indirect Financing 2-12
- Indirect Market Transactions 2-12
- Financial Institutions and Their Services 2-13
- Corporations and the Financial System 2-14

### 2.6 The Determinants of Interest Rate Levels 2-16
- The Real Rate of Interest 2-16
- Loan Contracts and Inflation 2-18
- The Fisher Equation and Inflation 2-18
- Cyclical and Long-Term Trends in Interest Rates 2-20

**Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems**

## 3 Financial Statements, Cash Flows, and Taxes 3-1

### 3.1 Financial Statements and Accounting Principles 3-2
- The Annual Report 3-2
- Generally Accepted Accounting Principles 3-3
- Fundamental Accounting Principles 3-3
- International GAAP 3-4
- Illustrative Company: Diaz Manufacturing 3-5

### 3.2 The Balance Sheet 3-5
- Current Assets and Liabilities 3-7
- Long-Term Assets and Liabilities 3-8
- Equity 3-9

### 3.3 Market Value versus Book Value 3-11
- A More Informative Balance Sheet 3-11
- A Market-Value Balance Sheet 3-12

### 3.4 The Income Statement and the Statement of Retained Earnings 3-14
- The Income Statement 3-14
- The Statement of Retained Earnings 3-16

### 3.5 The Statement of Cash Flows 3-17
- Sources and Uses of Cash 3-17

### 3.6 Tying Together the Financial Statements 3-20

**Summary of Learning Objectives / Summaries of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems**
### CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.7</td>
<td>Cash Flow to Investors</td>
<td>3-22</td>
</tr>
<tr>
<td></td>
<td>Net Income versus the Cash Flow to Investors</td>
<td>3-22</td>
</tr>
<tr>
<td></td>
<td>Cash Flow to Investors: Putting It All Together</td>
<td>3-26</td>
</tr>
<tr>
<td>3.8</td>
<td>Federal Income Tax</td>
<td>3-27</td>
</tr>
<tr>
<td></td>
<td>Corporate Income Tax Rates</td>
<td>3-27</td>
</tr>
<tr>
<td></td>
<td>Average versus Marginal Tax Rates</td>
<td>3-28</td>
</tr>
<tr>
<td></td>
<td>Unequal Treatment of Dividends and Interest Payments</td>
<td>3-28</td>
</tr>
<tr>
<td></td>
<td>Summary of Learning Objectives</td>
<td>Summary of Key Equations</td>
</tr>
<tr>
<td>4.1</td>
<td>Background for Financial Statement Analysis</td>
<td>4-2</td>
</tr>
<tr>
<td></td>
<td>Perspectives on Financial Statement Analysis</td>
<td>4-2</td>
</tr>
<tr>
<td></td>
<td>Guidelines for Financial Statement Analysis</td>
<td>4-3</td>
</tr>
<tr>
<td>4.2</td>
<td>Common-Size Financial Statements</td>
<td>4-4</td>
</tr>
<tr>
<td></td>
<td>Common-Size Balance Sheets</td>
<td>4-4</td>
</tr>
<tr>
<td></td>
<td>Common-Size Income Statements</td>
<td>4-6</td>
</tr>
<tr>
<td>4.3</td>
<td>Financial Ratios and Firm Performance</td>
<td>4-7</td>
</tr>
<tr>
<td></td>
<td>Why Ratios are Better Measures</td>
<td>4-7</td>
</tr>
<tr>
<td></td>
<td>Short-Term Liquidity Ratios</td>
<td>4-8</td>
</tr>
<tr>
<td></td>
<td>Efficiency Ratios</td>
<td>4-11</td>
</tr>
<tr>
<td></td>
<td>Leverage Ratios</td>
<td>4-14</td>
</tr>
<tr>
<td></td>
<td>Profitability Ratios</td>
<td>4-18</td>
</tr>
<tr>
<td></td>
<td>Market-Value Indicators</td>
<td>4-21</td>
</tr>
<tr>
<td></td>
<td>Concluding Comments on Ratios</td>
<td>4-22</td>
</tr>
<tr>
<td>4.4</td>
<td>The DuPont System: A Diagnostic Tool</td>
<td>4-22</td>
</tr>
<tr>
<td></td>
<td>An Overview of the DuPont System</td>
<td>4-22</td>
</tr>
<tr>
<td></td>
<td>The ROA Equation</td>
<td>4-23</td>
</tr>
<tr>
<td></td>
<td>The ROE Equation</td>
<td>4-24</td>
</tr>
<tr>
<td></td>
<td>The DuPont Equation</td>
<td>4-25</td>
</tr>
<tr>
<td></td>
<td>Applying the DuPont System</td>
<td>4-25</td>
</tr>
<tr>
<td></td>
<td>Is Maximizing ROE an Appropriate Goal?</td>
<td>4-27</td>
</tr>
<tr>
<td>4.5</td>
<td>Selecting a Benchmark</td>
<td>4-27</td>
</tr>
<tr>
<td></td>
<td>Trend Analysis</td>
<td>4-27</td>
</tr>
<tr>
<td></td>
<td>Industry Analysis</td>
<td>4-28</td>
</tr>
<tr>
<td></td>
<td>Peer Group Analysis</td>
<td>4-28</td>
</tr>
<tr>
<td>4.6</td>
<td>Using Financial Ratios</td>
<td>4-30</td>
</tr>
<tr>
<td></td>
<td>Performance Analysis of Diaz Manufacturing</td>
<td>4-30</td>
</tr>
<tr>
<td></td>
<td>Limitations of Financial Statement Analysis</td>
<td>4-33</td>
</tr>
<tr>
<td></td>
<td>Summary of Learning Objectives</td>
<td>Summary of Key Equations</td>
</tr>
<tr>
<td>Ethics Case: A Sad Tale: The Demise of Arthur Andersen</td>
<td>4-45</td>
<td></td>
</tr>
</tbody>
</table>

### 5 The Time Value of Money | 5-1

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1</td>
<td>The Time Value of Money</td>
<td>5-2</td>
</tr>
<tr>
<td></td>
<td>Consuming Today or Tomorrow</td>
<td>5-2</td>
</tr>
<tr>
<td></td>
<td>Time Lines as Aids to Problem Solving</td>
<td>5-3</td>
</tr>
<tr>
<td></td>
<td>Financial Calculator</td>
<td>5-3</td>
</tr>
<tr>
<td>5.2</td>
<td>Future Value and Compounding</td>
<td>5-4</td>
</tr>
<tr>
<td></td>
<td>Single-Period Investment</td>
<td>5-4</td>
</tr>
<tr>
<td></td>
<td>Two-Period Investment</td>
<td>5-5</td>
</tr>
<tr>
<td></td>
<td>The Future Value Equation</td>
<td>5-6</td>
</tr>
<tr>
<td></td>
<td>Using a Calculator to Compute the Future Value Factor</td>
<td>5-8</td>
</tr>
<tr>
<td></td>
<td>Future Value Factor Tables</td>
<td>5-8</td>
</tr>
<tr>
<td></td>
<td>Applying the Future Value Formula</td>
<td>5-8</td>
</tr>
<tr>
<td></td>
<td>Calculator Tips for Future Value Problems</td>
<td>5-13</td>
</tr>
<tr>
<td>5.3</td>
<td>Present Value and Discounting</td>
<td>5-16</td>
</tr>
<tr>
<td></td>
<td>Single-Period Investment</td>
<td>5-16</td>
</tr>
<tr>
<td></td>
<td>Multiple-Period Investment</td>
<td>5-17</td>
</tr>
<tr>
<td></td>
<td>The Present Value Equation</td>
<td>5-17</td>
</tr>
<tr>
<td></td>
<td>Future and Present Value Equations Are the Same</td>
<td>5-17</td>
</tr>
<tr>
<td></td>
<td>Applying the Present Value Formula</td>
<td>5-18</td>
</tr>
<tr>
<td></td>
<td>The Relations Among Time, the Discount Rate, and Present Value</td>
<td>5-20</td>
</tr>
<tr>
<td></td>
<td>Calculator Tips for Present Value Problems</td>
<td>5-20</td>
</tr>
<tr>
<td></td>
<td>Future Value Versus Present Value</td>
<td>5-21</td>
</tr>
<tr>
<td>5.4</td>
<td>Additional Concepts and Applications</td>
<td>5-22</td>
</tr>
<tr>
<td></td>
<td>Finding the Interest Rate</td>
<td>5-23</td>
</tr>
<tr>
<td></td>
<td>Finding How Many Periods It Takes an Investment to Grow a Certain Amount</td>
<td>5-24</td>
</tr>
<tr>
<td></td>
<td>The Rule of 72</td>
<td>5-25</td>
</tr>
<tr>
<td></td>
<td>Compound Growth Rates</td>
<td>5-25</td>
</tr>
<tr>
<td></td>
<td>Concluding Comments</td>
<td>5-27</td>
</tr>
<tr>
<td></td>
<td>Summary of Learning Objectives</td>
<td>Summary of Key Equations</td>
</tr>
</tbody>
</table>

### 6 Discounted Cash Flows and Valuation | 6-1

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1</td>
<td>Multiple Cash Flows</td>
<td>6-2</td>
</tr>
<tr>
<td></td>
<td>Future Value of Multiple Cash Flows</td>
<td>6-2</td>
</tr>
<tr>
<td></td>
<td>Present Value of Multiple Cash Flows</td>
<td>6-5</td>
</tr>
<tr>
<td>6.2</td>
<td>Level Cash Flows: Annuities and Perpetuities</td>
<td>6-9</td>
</tr>
<tr>
<td></td>
<td>Present Value of an Annuity</td>
<td>6-9</td>
</tr>
<tr>
<td></td>
<td>Future Value of an Annuity</td>
<td>6-18</td>
</tr>
<tr>
<td></td>
<td>Perpetuities</td>
<td>6-20</td>
</tr>
<tr>
<td></td>
<td>Annuities Due</td>
<td>6-21</td>
</tr>
<tr>
<td>6.3</td>
<td>Cash Flows That Grow at a Constant Rate</td>
<td>6-24</td>
</tr>
<tr>
<td></td>
<td>Growing Annuity</td>
<td>6-24</td>
</tr>
<tr>
<td></td>
<td>Growing Perpetuity</td>
<td>6-25</td>
</tr>
<tr>
<td>6.4</td>
<td>The Effective Annual Interest Rate</td>
<td>6-26</td>
</tr>
<tr>
<td></td>
<td>Why the Confusion?</td>
<td>6-26</td>
</tr>
<tr>
<td></td>
<td>Calculating the Effective Annual Interest Rate</td>
<td>6-26</td>
</tr>
<tr>
<td></td>
<td>Comparing Interest Rates</td>
<td>6-27</td>
</tr>
<tr>
<td></td>
<td>Consumer Protection Acts and Interest Rate Disclosure</td>
<td>6-29</td>
</tr>
<tr>
<td></td>
<td>The Appropriate Interest Rate Factor</td>
<td>6-29</td>
</tr>
<tr>
<td></td>
<td>Summary of Learning Objectives</td>
<td>Summary of Key Equations</td>
</tr>
</tbody>
</table>
7 Risk and Return 7-1

7.1 Risk and Return 7-2
7.2 Quantitative Measures of Return 7-3
    Holding Period Returns 7-3
    Expected Returns 7-4

7.3 Variance and Standard Deviation as Measures of Risk 7-8
    Calculating Variance and Standard Deviation 7-8
    Interpreting Variance and Standard Deviation 7-9
    Historical Market Performance 7-12
    Arithmetic Average and Geometric (Compounded) Average Returns 7-15

7.4 Risk and Diversification 7-17
    Single-Asset Portfolios 7-17
    Portfolios with More Than One Asset 7-19
    The Limits of Diversification 7-25

7.5 Systematic Risk 7-26
    Why Systematic Risk Is All That Matters 7-27
    Measuring Systematic Risk 7-27

7.6 Compensation for Bearing Systematic Risk 7-30

7.7 The Capital Asset Pricing Model 7-31
    The Security Market Line 7-32
    The Capital Asset Pricing Model and Portfolio Returns 7-33

Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

8 Bond Valuation and the Structure of Interest Rates 8-1

8.1 Corporate Bonds 8-2
    Market for Corporate Bonds 8-2
    Bond Price Information 8-3
    Types of Corporate Bonds 8-3

8.2 Bond Valuation 8-4
    The Bond Valuation Formula 8-5
    Calculator Tip: Bond Valuation Problems 8-6
    Par, Premium, and Discount Bonds 8-7
    Semiannual Compounding 8-9
    Zero Coupon Bonds 8-10

8.3 Bond Yields 8-12
    Yield to Maturity 8-12
    Effective Annual Yield 8-13
    Realized Yield 8-15

8.4 Interest Rate Risk 8-15
    Bond Theorems 8-16
    Bond Theorem Applications 8-17

8.5 The Structure of Interest Rates 8-18
    Marketability 8-19
    Call Provision 8-19
    Default Risk 8-19
    The Term Structure of Interest Rates 8-21

Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

Ethics Case: America's Ailing Drug Prices 6-38

7 Risk and Return 7-1

9 Stock Valuation 9-1

9.1 The Market for Stocks 9-2
    Secondary Markets 9-2
    Secondary Markets and Their Efficiency 9-3
    Stock Market Indexes 9-5
    Reading the Stock Market Listings 9-5
    Common and Preferred Stock 9-6
    Preferred Stock: Debt or Equity? 9-7

9.2 Common Stock Valuation 9-8
    A One-Period Model 9-8
    A Perpetuity Model 9-9
    The General Dividend-Valuation Model 9-11
    The Growth Stock Pricing Paradox 9-11

9.3 Stock Valuation: Some Simplifying Assumptions 9-12
    Zero-Growth Dividend Model 9-13
    Constant-Growth Dividend Model 9-13
    Computing Future Stock Prices 9-16
    The Relation between R and g 9-17
    Mixed (Supernormal) Growth Dividend Model 9-18

9.4 Valuing Preferred Stock 9-21
    Preferred Stock with a Fixed Maturity 9-22
    Preferred Stock with No Maturity 9-23

Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

Ethics Case: The Subprime Mortgage Market Meltdown: How Did It Happen? 8-29

10 The Fundamentals of Capital Budgeting 10-1

10.1 An Introduction to Capital Budgeting 10-2
    The Importance of Capital Budgeting 10-2
    The Capital Budgeting Process 10-3
    Sources of Information 10-4
    Classification of Investment Projects 10-4
    Basic Capital Budgeting Terms 10-5
# 10 Net Present Value 10-6
- Valuation of Real Assets 10-6
- NPV—The Basic Concept 10-6
- NPV and Value Creation 10-7
- Framework for Calculating NPV 10-8
- Net Present Value Techniques 10-9
- Concluding Comments on NPV 10-13

# 10.2 Net Present Value 10-6
- Valuation of Real Assets 10-6
- NPV—The Basic Concept 10-6
- NPV and Value Creation 10-7
- Framework for Calculating NPV 10-8
- Net Present Value Techniques 10-9
- Concluding Comments on NPV 10-13

# 10.3 The Payback Period 10-14
- Computing the Payback Period 10-14
- How the Payback Period Performs 10-15
- Discounted Payback Period 10-16
- Evaluating the Payback Rule 10-17

# 10.4 The Accounting Rate of Return 10-18

# 10.5 Internal Rate of Return 10-19
- Calculating the IRR 10-20
- When the IRR and NPV Methods Agree 10-21
- When the NPV and IRR Methods Disagree 10-23
- Modified Internal Rate of Return (MIRR) 10-26
- IRR versus NPV: A Final Comment 10-28

# 10.6 Investment Decisions with Capital Rationing 10-29
- Capital Rationing in a Single Period 10-30
- Capital Rationing across Multiple Periods 10-32

# 10.7 Capital Budgeting in Practice 10-33
- Practitioners’ Methods of Choice 10-33
- Postaudit and Periodic Reviews 10-34

# Sample Test Problems

# 11 Cash Flows and Capital Budgeting 11-1

## 11.1 Calculating Project Cash Flows 11-2
- Incremental After-Tax Free Cash Flows 11-3
- The FCF Calculation 11-3
- Cash Flows from Operations 11-5
- Cash Flows Associated with Capital Expenditures and Net Working Capital 11-6
- The FCF Calculation: An Example 11-6
- FCF versus Accounting Earnings 11-8

## 11.2 Estimating Cash Flows in Practice 11-10
- Five General Rules for Incremental After-Tax Free Cash Flow Calculations 11-11
- Nominal versus Real Cash Flows 11-14
- Tax Rates and Depreciation 11-16
- Computing the Terminal-Year FCF 11-19
- Expected Cash Flows 11-22

## 11.3 Forecasting Free Cash Flows 11-23
- Cash Flows from Operations 11-24
- Cash Flows Associated with Capital Expenditures and Net Working Capital 11-24

## 11.4 Special Cases (Optional) 11-26
- Projects with Different Lives 11-26

When to Replace an Existing Asset 11-28
The Cost of Using an Existing Asset 11-29
When to Harvest an Asset 11-30

# Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

# Ethics Case: Unilever’s Sustainable Living Plan 11-37

# 12 Evaluating Project Economics 12-1

## 12.1 Variable Costs, Fixed Costs, and Project Risk 12-2
- Cost Structure and Sensitivity of EBITDA to Revenue Changes 12-3
- Cost Structure and Sensitivity of EBIT to Revenue Changes 12-5

## 12.2 Calculating Operating Leverage 12-9
- Degree of Pretax Cash Flow Operating Leverage 12-9
- Degree of Accounting Operating Leverage 12-10

## 12.3 Break-Even Analysis 12-11
- Pretax Operating Cash Flow Break-Even 12-12
- Accounting Operating Profit (EBIT) Break-Even 12-13

## 12.4 The Economic Break-Even Point 12-15

## 12.5 Risk Analysis 12-19
- Sensitivity Analysis 12-20
- Scenario Analysis 12-20
- Simulation Analysis 12-21

# Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

# 13 The Cost of Capital 13-1

## 13.1 The Firm’s Overall Cost of Capital 13-2
- The Finance Balance Sheet 13-3
- Estimating a Firm’s Cost of Capital 13-5

## 13.2 The Cost of Debt 13-7
- Key Concepts for Estimating the Cost of Debt 13-7
- Estimating the Current Cost of a Bond or an Outstanding Loan 13-8
- Taxes and the Cost of Debt 13-10
- Estimating the Cost of Debt for a Firm 13-11

## 13.3 The Cost of Equity 13-13
- Common Stock 13-13
- Preferred Stock 13-19

## 13.4 Using the WACC in Practice 13-21
- Calculating WACC: An Example 13-21
- Limitations of WACC as a Discount Rate for Evaluating Projects 13-23
- Alternatives to Using WACC for Evaluating Projects 13-26

# Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems
17.4 Stock Dividends and Stock Splits 17-16
Stock Dividends 17-17
Stock Splits 17-17
Reasons for Stock Dividends and Splits 17-18
17.5 Setting a Dividend Payout 17-19
What Managers Tell Us 17-19
Practical Considerations in Setting a Dividend Payout 17-19
Summary of Learning Objectives / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

18 Business Formation, Growth, and Valuation 18-1
18.1 Starting a Business 18-2
Making the Decision to Proceed 18-3
Choosing the Right Organizational Form 18-3
Financial Considerations 18-5
18.2 The Role of the Business Plan 18-10
Why Business Plans Are Important 18-10
The Key Elements of a Business Plan 18-10
18.3 Valuing a Business 18-11
Fundamental Business Valuation Principles 18-12
Business Valuation Approaches 18-13
18.4 Important Issues in Valuation 18-26
Public versus Private Companies 18-26
Young (Rapidly Growing) versus Mature Companies 18-27
Controlling Interest versus Minority Interest 18-28
Key People 18-28
Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

19 Financial Planning and Managing Growth 19-1
19.1 Financial Planning 19-2
The Planning Documents 19-2
Concluding Comments 19-5
19.2 Financial Planning Models 19-5
The Sales Forecast 19-5
Building a Financial Planning Model 19-6
A Simple Planning Model 19-7
19.3 A Better Financial Planning Model 19-11
The Blackwell Sales Company 19-11
The Income Statement 19-12
The Balance Sheet 19-12
The Preliminary Pro Forma Balance Sheet 19-15
The Final Pro Forma Balance Sheet 19-17
19.4 Beyond the Basic Planning Models 19-18
Improving Financial Planning Models 19-18
19.5 Managing and Financing Growth 19-20
External Funding Needed 19-21
A Graphical View of Growth 19-23
The Sustainable Growth Rate 19-25
Growth Rates and Profits 19-27
Growth as a Planning Goal 19-27
Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

20 Options and Corporate Finance 20-1
20.1 Financial Options 20-2
Call Options 20-2
Put Options 20-4
American, European, and Bermudan Options 20-5
More on the Shapes of Option Payoff Functions 20-5
20.2 Option Valuation 20-6
Limits on Option Values 20-6
Variables That Affect Option Values 20-8
The Binomial Option Pricing Model 20-9
Put-Call Parity 20-12
Valuing Options Associated with the Financial Securities That Firms Issue 20-13
20.3 Real Options 20-15
Options to Defer Investment 20-15
Options to Make Follow-On Investments 20-16
Options to Change Operations 20-17
Options to Abandon Projects 20-17
Concluding Comments on NPV Analysis and Real Options 20-18
20.4 Agency Costs 20-19
Agency Costs of Debt 20-19
Agency Costs of Equity 20-21
20.5 Options and Risk Management 20-22
Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

21 International Financial Management 21-1
21.1 Introduction to International Financial Management 21-2
Globalization of the World Economy 21-3
The Rise of Multinational Corporations 21-3
Factors Affecting International Financial Management 21-3
Goals of International Financial Management 21-6
Basic Principles Remain the Same 21-6
21.2 Foreign Exchange Markets 21-7
Market Structure and Major Participants 21-8
21.5 International Banking 21-24
Risks Involved in International Bank Lending 21-25
Eurocredit Bank Loans 21-26

Summary of Learning Objectives / Summary of Key Equations / Self-Study Problems / Solutions to Self-Study Problems / Discussion Questions / Questions and Problems / Sample Test Problems

APPENDIX A Future Value and Present Value Tables A-1
APPENDIX B Solutions to Odd Problems B-1

GLOSSARY / SUBJECT INDEX / COMPANY INDEX