

# Contents

1. Introduction	1
1.1. Financial Management: Analysis and Planning . . . .	1
1.1.1. Basic Definitions . . . . .	1
1.1.2. Objectives of Financial Management . . . . .	2
1.1.3. Planning Horizon Classification . . . . .	2
1.2. Objectives and Philosophy of the Book . . . . .	3
1.3. Structure of the Book . . . . .	4
Problem Set . . . . .	8
References for Chapter 1 . . . . .	8
<b>Part 1 Information and Methodology for Financial Analysis</b>	<b>11</b>
2. Accounting Information, Regression Analysis, and Financial Management	13
2.1. Introduction . . . . .	13
2.2. Financial Statements: A Brief Review . . . . .	14
2.2.1. Balance Sheet . . . . .	14
2.2.2. Statement of Earnings (Income Statement) . .	17
2.2.3. Statement of Equity . . . . .	18
2.2.4. Statement of Cash Flows . . . . .	18
2.2.5. Annual vs Quarterly Financial Data . . . . .	27
2.3. Critique of Accounting Information . . . . .	28
2.3.1. Criticism . . . . .	28
2.3.2. Method for Improvement . . . . .	29
2.3.2.1. Use of Alternative Information . . .	30
2.3.2.2. Statistical Adjustments . . . . .	30

2.3.2.3.	Application of Finance and Economic Theories . . . . .	30
2.4.	Static-Ratio Analysis and Its Extension . . . . .	31
2.4.1.	Static Determination of Financial Ratios . . . . .	32
2.4.2.	Liquidity Ratios . . . . .	32
2.4.3.	Leverage Ratios . . . . .	32
2.4.4.	Activity Ratios . . . . .	34
2.4.5.	Profitability Ratios . . . . .	34
2.4.6.	Estimation of the Target of a Ratio . . . . .	35
2.4.7.	Dynamic Analysis of Financial Ratios . . . . .	36
2.4.7.1.	Single-Equation Dynamic Adjustment Process . . . . .	36
2.4.7.2.	Simultaneous Determination of Financial Ratios . . . . .	40
2.4.8.	Statistical Distribution of Financial Ratios . . . . .	41
2.5.	Cost-Volume-Profit Analysis and Its Applications . . . . .	43
2.5.1.	Deterministic Analysis . . . . .	44
2.5.2.	Stochastic Analysis . . . . .	46
2.6.	Accounting Income vs Economic Income . . . . .	48
2.7.	Summary . . . . .	49
	Problem Set . . . . .	50
	Appendix 2.A. Simple Regression and Multiple Regression . . . . .	56
2.A.1.	Introduction . . . . .	56
2.A.2.	Simple Regression . . . . .	57
2.A.3.	Variance of $\hat{b}$ . . . . .	60
2.A.4.	Multiple Regression . . . . .	61
	Appendix 2.B. Instrumental Variables and Two-Stage Least Squares . . . . .	66
2.B.1.	Errors-in-Variable Problem . . . . .	66
2.B.2.	Instrumental Variables . . . . .	68
2.B.3.	Two-Stage, Least-Square . . . . .	70
	References for Appendix 2 . . . . .	71
	References for Chapter 2 . . . . .	71
3.	Discriminant Analysis and Factor Analysis: Theory and Method . . . . .	73
3.1.	Introduction . . . . .	73
3.2.	Important Concepts of Linear Algebra . . . . .	74

3.3.	Two-Group Discriminant Analysis . . . . .	82
3.4.	$k$ -Group Discriminant Analysis . . . . .	88
3.5.	Factor Analysis and Principal-Component Analysis . . . . .	90
3.6.	Summary . . . . .	92
	Notes . . . . .	92
	Problem Set . . . . .	92
	Appendix 3.A. Relationship between Discriminant Analysis and Dummy Regression Analysis . . . . .	93
	3.A.1. Derivation of the Discriminant Function . . . . .	93
	Appendix 3.B. Principal-Component Analysis . . . . .	98
	3.B.1. Introduction . . . . .	98
	References for Chapter 3 . . . . .	101
4.	Application of Discriminant Analysis and Factor Analysis in Financial Management . . . . .	103
4.1.	Introduction . . . . .	103
4.2.	Credit Analysis . . . . .	103
4.3.	Bankruptcy and Financial Distress Analysis . . . . .	107
4.4.	Applications of Factor Analysis to Select Useful Financial Ratios . . . . .	113
4.5.	Bond Rating Forecasting . . . . .	116
4.6.	Bond Quality Ratings and the Change of Quality Ratings for the Electric Utility Industry . . . . .	123
4.7.	Ohlson's and Shumway's Methods for Estimating Default Probability . . . . .	123
4.8.	Summary . . . . .	127
	Problem Set . . . . .	127
	Appendix 4.A. Jackknife Method and its Application in MDA Analysis . . . . .	128
	References for Appendix 4 . . . . .	131
	References for Chapter 4 . . . . .	131
5.	Determination and Applications of Nominal and Real Rates-of-Return in Financial Analysis . . . . .	135
5.1.	Introduction . . . . .	135
5.2.	Theoretical Justification of Paying Interest . . . . .	136
5.3.	Rate-of-Return Measurements and Types of Averages . . . . .	137

- 5.3.1. Discrete Rates-of-Return and Continuous Rates-of-Return . . . . . 137
- 5.3.2. Types of Averages . . . . . 138
- 5.3.3. Power Means . . . . . 142
- 5.4. Theories of the Term Structure and Their Application 142
- 5.5. Interest Rate, Price-Level Changes, and Components of Risk Premium . . . . . 148
  - 5.5.1. Imperfect-Foresight Case . . . . . 149
  - 5.5.2. Perfect-Foresight Case . . . . . 151
- 5.6. Three Hypotheses about Inflation and the Value of the Firm: A Review . . . . . 155
  - 5.6.1. The Debtor-Creditor Hypothesis . . . . . 155
  - 5.6.2. The Tax-Effects Hypothesis . . . . . 157
  - 5.6.3. Operating-Income Hypothesis . . . . . 158
  - 5.6.4. The Relationship among the Three Hypotheses . . . . . 159
- 5.7. Summary and Concluding Remarks . . . . . 160
- Problem Set . . . . . 161
- Appendix 5.A. Compounding and Discounting Processes and Their Applications . . . . . 166
  - 5.A.1. Single-Value Case . . . . . 166
    - 5.A.1.1. Compound Future Sum (Terminal Value) . . . . . 166
    - 5.A.1.2. Present Value . . . . . 168
  - 5.A.2. Annuity Case . . . . . 169
    - 5.A.2.1. Compound Future Sum of An Annuity . . . . . 169
    - 5.A.2.2. Present Value of An Annuity 170
- Appendix 5.B. Taylor Series Expansion and Its Applications to Rates-of-Return Determination . . . . . 171
- References for Chapter 5 . . . . . 175

**Project I Analyses of Accounting, Market and Economic Data 179**

**Part 2 Alternative Financial Theories and Cost of Capital 179**

6. Valuation and Capital Structure: A Review and Integration 181

6.1.	Introduction . . . . .	181
6.1.1.	Components of Capital Structure . . . . .	182
6.1.2.	Opportunity Cost, Required Rate-of-Return, and the Cost of Capital . . . . .	183
6.2.	Bond Valuation . . . . .	184
6.2.1.	Perpetuity . . . . .	185
6.2.2.	Term Bonds . . . . .	185
6.2.3.	Preferred Stock . . . . .	188
6.3.	Common-Stock Valuation . . . . .	188
6.3.1.	Valuation . . . . .	188
6.3.2.	Inflation and Common Stock Valuation . . . . .	191
6.3.3.	Growth Opportunity and Common-Stock Valuation . . . . .	193
6.4.	Financial Leverage and Its Effect on EPS . . . . .	195
6.4.1.	Measurement . . . . .	195
6.4.2.	Effect . . . . .	196
6.5.	Degree of Financial Leverage and Combined Effect . . . . .	200
6.6.	Optimal Capital Structure . . . . .	201
6.6.1.	Overall Discussion . . . . .	201
6.6.2.	Arbitrage Process and the Proof of M&M Proposition I . . . . .	204
6.7.	Possible Reasons for Optimal Capital Structure . . . . .	212
6.7.1.	The Traditional Approach of Optimal Capital Structure . . . . .	213
6.7.2.	Bankruptcy Costs . . . . .	213
6.7.3.	Agency Costs . . . . .	216
6.7.4.	Imperfect Markets . . . . .	217
6.8.	Summary and Remarks . . . . .	218
	Questions and Problems . . . . .	219
	Appendix 6.A. Convertible-Security Valuation Theory . . . . .	228
	Appendix 6.B. Derivation of DOL, DFL, and CML . . . . .	235
	6.B.1. DOL . . . . .	235
	6.B.2. DFL . . . . .	236
	6.B.3. DCL . . . . .	237
	Appendix 6.C. Derivation of Dividend Discount Model . . . . .	237
	6.C.1. Summation of Infinite Geometric Series . . . . .	237
	6.C.2. Dividend Discount Model . . . . .	238
	References for Appendix 6 . . . . .	239
	References for Chapter 6 . . . . .	239

- 7. Risk Estimation and Diversification . . . . . 243
  - 7.1. Introduction . . . . . 243
  - 7.2. Risk Classification . . . . . 243
    - 7.2.1. Business Risk . . . . . 244
    - 7.2.2. Financial Risk . . . . . 246
    - 7.2.3. Total Risk . . . . . 248
  - 7.3. Portfolio Analysis and Application . . . . . 249
    - 7.3.1. Expected Rate of Return on a Portfolio . . . . . 249
    - 7.3.2. Variance and Standard Deviation of a Portfolio . . . . . 250
    - 7.3.3. The Two-asset Case . . . . . 251
    - 7.3.4. The *N*-asset Case . . . . . 252
    - 7.3.5. The Efficient Portfolios . . . . . 253
    - 7.3.6. Corporate Application of Diversification . . . . . 256
  - 7.4. The Market Rate of Return and Market Risk Premium . . . . . 257
    - 7.4.1. The Risk Premium . . . . . 258
  - 7.5. Determination of Commercial Lending Rates . . . . . 259
  - 7.6. The Dominance Principle and Performance Evaluation . . . . . 262
  - 7.7. Summary . . . . . 264
- Questions and Problems . . . . . 264
- Appendix 7.A. Estimation of Market Risks Premium . . . . . 271
- Appendix 7.B. The Normal Distribution . . . . . 272
- Appendix 7.C. Derivation of Minimum-Variance Portfolio . . . . . 276
- Appendix 7.D. Sharpe Performance Approach to Derive  
Optimal Weight . . . . . 277
- References for Appendix 7 . . . . . 281
- References for Chapter 7 . . . . . 281
  
- 8. Risk and Return Trade-Off Analysis . . . . . 283
  - 8.1. Introduction . . . . . 283
  - 8.2. Capital Market Line, Efficient–Market Hypothesis  
and Capital Asset Pricing Model . . . . . 283
    - 8.2.1. Lending, Borrowing, and the Market Portfolio . . . . . 284
    - 8.2.2. The Capital Market Line . . . . . 286
    - 8.2.3. The Efficient-Market Hypothesis . . . . . 287
    - 8.2.4. Weak-Form Efficient-Market Hypothesis . . . . . 287
    - 8.2.5. Semistrong-Form Efficient-Market Hypothesis . . . . . 288
    - 8.2.6. Strong-Form Efficient-Market Hypothesis . . . . . 288
    - 8.2.7. The Capital Asset Pricing Model . . . . . 288

8.3.	The Market Model and Beta Estimation . . . . .	291
8.4.	Empirical Evidence for the Risk–Return Relationship . . . . .	294
8.5.	Why Beta is Important in Financial Management . . . . .	296
8.6.	Systematic Risk Determination . . . . .	297
8.6.1.	Business Risk and Financial Risk . . . . .	299
8.6.2.	Other Financial Variables . . . . .	299
8.6.3.	Capital Labor Ratio . . . . .	300
8.6.4.	Fixed Costs and Variable Costs . . . . .	301
8.6.5.	Market-Based versus Accounting-Based Beta Forecasting . . . . .	302
8.7.	Some Applications and Implications of the Capital Asset Pricing Model . . . . .	303
8.7.1.	Applications . . . . .	303
8.8.	Liquidity and Capital Asset Pricing Model . . . . .	306
8.9.	Arbitrage Pricing Theory . . . . .	307
8.10.	Intertemporal CAPM . . . . .	307
8.11.	Summary . . . . .	308
	Questions and Problems . . . . .	308
	Appendix 8.A. Mathematical Derivation of the Capital Asset Pricing Model . . . . .	314
	Appendix 8.B. Arbitrage Pricing Model . . . . .	315
	References for Chapter 8 . . . . .	318
	Note . . . . .	320
9.	Options and Option Strategies . . . . .	321
9.1.	Introduction . . . . .	321
9.2.	The Option Market and Related Definitions . . . . .	322
9.2.1.	What is an Option? . . . . .	322
9.2.2.	Types of Options and Their Characteristics . . . . .	322
9.2.3.	Relationships Between the Option Price and the Underlying Asset Price . . . . .	324
	Sample Problem 9.1 . . . . .	327
9.2.4.	Additional Definitions and Distinguishing Features . . . . .	328
9.2.5.	Types of Underlying Asset . . . . .	329
9.2.6.	Institutional Characteristics . . . . .	330
9.3.	Put-Call Parity . . . . .	331
9.3.1.	European Options . . . . .	331

Sample Problem 9.2 . . . . .	334
9.3.2. American Options . . . . .	334
Sample Problem 9.3 . . . . .	335
9.3.3. Future Options . . . . .	335
9.3.4. Market Application . . . . .	337
9.4. Risk-Return Characteristics of Options . . . . .	338
9.4.1. Long Call . . . . .	338
9.4.2. Short Call . . . . .	339
9.4.3. Long Put . . . . .	342
9.4.4. Short Put . . . . .	344
9.4.5. Long Straddle . . . . .	345
Sample Problem 9.4 . . . . .	346
9.4.6. Short Straddle . . . . .	348
Sample Problem 9.5 . . . . .	349
9.4.7. Long Vertical (Bull) Spread . . . . .	350
Sample Problem 9.6 . . . . .	351
9.4.8. Short Vertical (Bear) Spread . . . . .	352
9.4.9. Calendar (Time) Spreads . . . . .	353
9.5. Examples of Alternative Option Strategies . . . . .	355
9.5.1. Protective Put . . . . .	355
9.5.2. Covered Call . . . . .	355
9.5.3. Collar . . . . .	359
9.6. Summary . . . . .	359
Questions and Problems . . . . .	360
References for Chapter 9 . . . . .	365
10. Option Pricing Theory and Firm Valuation . . . . .	367
10.1. Introduction . . . . .	367
10.2. Basic Concepts of Options . . . . .	367
10.2.1. Option Price Information . . . . .	371
10.3. Factors Affecting Option Value . . . . .	374
10.3.1. Determining the Value of a Call Option before the Expiration Date . . . . .	374
10.4. Determining the Value of Options . . . . .	383
10.4.1. Expected Value Estimation . . . . .	383
10.4.2. The Black–Scholes Option Pricing Model . . . . .	384
10.4.3. Taxation of Options . . . . .	389
10.4.4. American Options . . . . .	390

10.5.	Option Pricing Theory and Capital Structure . . . . .	391
10.5.1.	Proportion of Debt in Capital Structure . . . . .	393
10.5.2.	Riskiness of Business Operations . . . . .	395
10.5.3.	Option Pricing Approach to Determine the Optimal Capital Structure . . . . .	396
10.6.	Warrants . . . . .	396
10.7.	Summary . . . . .	400
	Questions and Problems . . . . .	400
	Appendix 10.A. Applications of the Binomial Distribution to Evaluate Call Options . . . . .	405
	10.A.1. What is an Option? . . . . .	405
	10.A.2. The Simple Binomial Option Pricing Model . . . . .	405
	10.A.3. The Generalized Binomial Option Pricing Model . . . . .	408
	References for Chapter 10 . . . . .	413
<b>Project II Application of Useful Finance Theories</b>		<b>415</b>
<b>Part 3 Capital Budgeting and Leasing Decisions</b>		<b>415</b>
11.	Alternative Cost of Capital Analysis and Estimation	417
11.1.	Introduction . . . . .	417
11.2.	Overview of Cost of Capital . . . . .	417
11.3.	Average Earnings Yield Versus Current Earnings Yield Method . . . . .	419
11.4.	Discounting Cash-Flow Method . . . . .	420
11.5.	Weighted-Average Cost of Capital . . . . .	422
11.5.1.	Theoretical Justification of the WACC . . . . .	427
11.6.	The CAPM Method . . . . .	430
11.7.	M&M's Cross-Sectional Method . . . . .	433
11.7.1.	The Cost of Capital . . . . .	433
11.7.2.	Regression Formulation and Empirical Results . . . . .	435
11.8.	Chase Cost of Capital . . . . .	441
11.9.	Summary and Concluding Remarks . . . . .	446
	Problem Set . . . . .	446

Appendix 11.A. Derivative of the Basic Equilibrium	
Market Price of Stock and Its Implications . . .	452
References for Appendix 11 . . . . .	453
References for Chapter 11 . . . . .	453
12. Capital Budgeting Under Certainty	457
12.1. Introduction . . . . .	457
12.2. Cash-Flow Evaluation of Alternative . . . . .	457
12.2.1. Investment Projects . . . . .	457
12.3. Alternative Capital-Budgeting Methods . . . . .	461
12.3.1. Accounting Rate-of-Return . . . . .	462
12.3.2. Internal Rate-of-Return . . . . .	462
12.3.3. Payback Method . . . . .	463
12.3.4. Net Present Value Method . . . . .	464
12.3.5. Profitability Index . . . . .	465
12.4. Comparison of the NPV and IRR Method . . . . .	466
12.4.1. Theoretical Criteria . . . . .	466
12.4.2. Multiple Rates-of-Return . . . . .	468
12.4.3. Reinvestment Rate Problem . . . . .	469
12.4.3.1. Separability of Projects . . . . .	470
12.4.4. Practical Perspective . . . . .	471
12.5. Equivalent Annual NPV and Equivalent Annual Cost .	472
12.5.1. Mutually Exclusive Investment Projects with Different Lives . . . . .	472
12.6. Capital-Rationing Decision . . . . .	476
12.6.1. Basic Concepts of Linear Programming . . . .	476
12.6.2. Capital Rationing . . . . .	477
12.7. Summary . . . . .	480
Problem Set . . . . .	480
Appendix 12.A. NPV and Break-Even Analysis . . . . .	485
Appendix 12.B. Managers' View on Alternative Capital-Budgeting Methods . . . . .	490
Appendix 12.C. Derivation of Crossover Rate . . . . .	495
References for Appendix 12 . . . . .	497
References for Chapter 12 . . . . .	498
13. Capital Budgeting Under Uncertainty	501
13.1. Introduction . . . . .	501

13.2.	Risk-Adjusted Discount-Rate Method . . . . .	502
13.3.	Certainty Equivalent Method . . . . .	503
13.4.	The Relationship of the Risk-Adjusted Discount-Rate Method to the Certainty-Equivalent Method . . . . .	505
13.5.	Three Other Related Stochastic Approaches to Capital Budgeting . . . . .	508
13.5.1.	The Statistical Distribution Method . . . . .	509
13.5.2.	The Decision-Tree Method . . . . .	515
13.5.3.	Simulation Analysis . . . . .	520
13.5.4.	Comparison of the Three Alternative Stochastic Methods . . . . .	524
13.6.	Inflationary Effects in the Capital-Budgeting Procedure	525
13.7.	Multiperiod Capital Budgeting . . . . .	535
13.7.1.	Overall Discussion . . . . .	535
13.7.2.	The CAPM and Multi-Period Capital-Budgeting Decision-Making . . . . .	537
13.8.	Summary and Concluding Remarks . . . . .	543
	Problem Set . . . . .	544
	Appendix 13.A. Time-State Preference and the Real option Approaches for Capital Budgeting Under Uncertainty . . . . .	550
	References for Appendix 13 . . . . .	555
	References for Chapter 13 . . . . .	555
14.	Leasing: Practices and Theoretical Developments	559
14.1.	Introduction . . . . .	559
14.2.	Types of Leasing Arrangements and Accounting Treatments . . . . .	560
14.2.1.	Three Leasing Forms . . . . .	560
14.2.1.1.	Direct Leasing . . . . .	561
14.2.1.2.	Sale and Leaseback . . . . .	561
14.2.1.3.	Leveraged Leasing . . . . .	562
14.2.2.	Accounting for Leases . . . . .	562
14.2.2.1.	Capital Lease Treatment . . . . .	563
14.2.2.2.	Accounting for Operating Leases . . . . .	568
14.2.2.3.	Accounting for Leases from the Lessor's Standpoint . . . . .	571

- 14.3. Cash-Flow Estimation and Valuation Methods . . . . . 571
- 14.4. The Modigliani and Miller Propositions  
and the Theoretical Considerations of Leasing . . . . . 575
- 14.5. Leases-Versus-Buy Decisions Under Uncertainty:  
The CAPM Approach . . . . . 582
- 14.6. Summary and Conclusions . . . . . 586
- Problem Set . . . . . 588
- Appendix 14.A. APV Method and Application  
to Leasing Decision . . . . . 590
  - 14.A.1 Myers Adjusted-Present-Value Method 590
  - 14.A.2 Myers Adjusted-Present-Value Method  
to Leasing . . . . . 591
- References for Appendix 14 . . . . . 593
- References for Chapter 14 . . . . . 593
  
- Project III Capital Budgeting and Leasing Decisions 597**
  
- Part 4 Corporate Policies and Their Interrelationships 597**
  
- 15. Mergers: Theory and Evidence 599
  - 15.1. Introduction . . . . . 599
  - 15.2. Overview of Mergers . . . . . 599
  - 15.3. Classification of Business Combinations . . . . . 600
    - 15.3.1. Classification by Corporate Structure . . . . . 600
    - 15.3.2. Classification by Economic Relationship . . . . . 600
  - 15.4. Methods of Business Combination . . . . . 602
  - 15.5. Merger Accounting and Tax Effects . . . . . 611
    - 15.5.1. Tax Implications . . . . . 611
    - 15.5.2. Accounting Treatment of Business  
Combinations . . . . . 612
  - 15.6. Economic Theories and Evidence . . . . . 615
    - 15.6.1. Economic Theories . . . . . 615
    - 15.6.2. Market Power . . . . . 615
  - 15.7. Financial Theories and Evidence . . . . . 617
    - 15.7.1. Diversification and Debt Capacity . . . . . 617
  - 15.8. Integration and Summary . . . . . 628
  - Problem Set . . . . . 631
  - Appendix 15.A. Effects of Divestiture on Firm Valuation . . . . . 634
  - References for Chapter 15 . . . . . 636

16.	Dividend Policy and Empirical Evidence	641
16.1.	Introduction	641
16.2.	The Value of Dividend Policy to the Firm	642
16.2.1.	Methods of Determining the Relevance of Dividends	642
16.2.1.1.	The Discounted Cash-Flow Approach	647
16.2.1.2.	The Investment Opportunities Approach	647
16.2.1.3.	Stream-of-Dividends Approach	648
16.2.1.4.	Stream-of-Earnings Approach	649
16.3.	Issues Marring the Dividend Problem	650
16.3.1.	The Classical CAPM	651
16.3.2.	Brennan's CAPM with Taxes	651
16.3.3.	The Litzenberger and Ramaswamy CAPM with Taxes	653
16.3.4.	Empirical Evidence	657
16.3.4.1.	Gordon's Empirical Work and Its Extensions	657
16.3.4.2.	M&M Empirical Work	662
16.3.4.3.	CAPM Approach	663
16.4.	Behavioral Considerations of Dividend Policy	666
16.4.1.	Partial Adjustment and Information Content Models	666
16.4.2.	An Integration Model	670
16.5.	Summary and Conclusions	672
	Problem Set	673
	References for Chapter 16	675
17.	Interaction of Financing, Investment and Dividend Policies	679
17.1.	Introduction	679
17.2.	Investment and Dividend Interactions: The Internal-Versus-External Financing Decision	680
17.2.1.	Internal Financing	680
17.2.2.	External Financing	681
17.3.	Interactions Between Dividend and Financing Policies	684
17.3.1.	Cost of Equity Capital and Dividend Policy	684
17.3.2.	Default Risk and Dividend Policy	687

17.4.	Interactions Between Financing and Investment	
	Decisions . . . . .	689
	17.4.1. Risk-Free Debt Case . . . . .	690
	17.4.2. Risky Debt Case . . . . .	693
17.5.	Implications of Financing and Investment Interactions for Capital Budgeting . . . . .	694
	17.5.1. Equity-Residual Method . . . . .	695
	17.5.2. After-Tax, Weighted-Average Cost of Capital Method . . . . .	696
	17.5.3. Arditti and Levy Method . . . . .	697
	17.5.4. Myers Adjusted-Present-Value Method . . . . .	697
17.6.	Debt Capacity and Optimal Capital Structure . . . . .	703
17.7.	Implications of Different Policies on the Beta Coefficient Determination . . . . .	715
	17.7.1. Impact of Financing Policy on Beta Coefficient Determination . . . . .	716
	17.7.2. Impact of Production Policy on Beta Coefficient Determination . . . . .	716
	17.7.3. Impact of Dividend Policy on Beta Coefficient Determination . . . . .	718
17.8.	Summary and Conclusion . . . . .	718
	Problem Set . . . . .	720
	Appendix 17.A. Stochastic Dominance and Its Applications to Capital-Structure Analysis with Default Risk . . . . .	723
	17.A.1. Introduction . . . . .	723
	17.A.2. Concepts and Theorems of Stochastic Dominance . . . . .	723
	17.A.3. Stochastic-Dominance Approach to Investigating the Capital-Structure Problem with Default Risk . . . . .	726
	17.A.4. Summary . . . . .	728
	References for Appendix 17 . . . . .	728
	References for Chapter 17 . . . . .	728

<b>Project IV</b>	<b>Analyses of Investment, Financing and Dividend Policies</b>	<b>733</b>
<b>Part 5</b>	<b>Financial Planning and Forecasting</b>	<b>733</b>
18.	Short-Term Financial Analysis and Planning	735
18.1.	Introduction . . . . .	735
18.2.	The Components of Working Capital . . . . .	736
18.3.	The Concept of Cash Flow . . . . .	737
18.4.	Cash Flow versus Funds Flow . . . . .	738
18.5.	Organizing for Short-Term Financial Planning . . . . .	740
18.5.1.	Short-Term Financial Planning Principles . . . . .	740
18.6.	The Cash Flow Cycle and Its Calculation . . . . .	742
18.7.	Cash Flow Forecasting, Budgeting, and Planning . . . . .	746
18.8.	The Cash Budget . . . . .	747
18.9.	Demand-Driven, Capital-Driven, and Cost-Driven Cash Budgets . . . . .	750
18.10.	Users of Cash Forecasts and Business Plans . . . . .	751
18.11.	Planning Horizons and Time Intervals of Cash Budgets . . . . .	752
18.12.	From Forecasting to Budgeting to Planning . . . . .	755
18.13.	Summary . . . . .	759
	Questions and Problems . . . . .	761
	Appendix 18.A. Time-Series Components of Sales . . . . .	766
	18.A.1 The Contribution of Each Component . . . . .	770
	18.A.2 Interpretation . . . . .	771
	References for Chapter 18 . . . . .	771
19.	Credit Management	773
19.1.	Introduction . . . . .	773
19.2.	Trade Credit . . . . .	774
19.3.	The Cost of Trade Credit . . . . .	778
19.3.1.	The Seller's Perspective . . . . .	778
19.3.2.	The Buyer's Perspective . . . . .	780

- 19.4. Financial Ratios and Credit Analysis . . . . . 781
  - 19.4.1. Financial Ratio Analysis . . . . . 782
  - 19.4.2. Numerical Credit Scoring . . . . . 782
  - 19.4.3. Benefits of Credit-Scoring Models . . . . . 786
  - 19.4.4. Outside Sources of Credit Information . . . . . 787
- 19.5. Credit Decision and Collection Policies . . . . . 789
  - 19.5.1. Collection Policy . . . . . 790
  - 19.5.2. Factoring and Credit Insurance . . . . . 791
- 19.6. Summary . . . . . 792
- Questions and Problems . . . . . 793
- References for Chapter 19 . . . . . 795
  
- 20. Cash, Marketable Securities, and Inventory Management 797
  - 20.1. Introduction . . . . . 797
  - 20.2. The Baumol and Miller–Orr Model . . . . . 798
    - 20.2.1. Baumol’s EOQ Model . . . . . 798
    - 20.2.2. Miller–Orr Model . . . . . 801
  - 20.3. Cash Management Systems . . . . . 805
    - 20.3.1. Float . . . . . 805
    - 20.3.2. Cash Collection and Transference Systems . . . . . 806
    - 20.3.3. Cash Transference Mechanism and Scheduling . . . . . 808
  - 20.4. Credit Lines and Bank Relations . . . . . 811
    - 20.4.1. Bank Relations . . . . . 813
  - 20.5. Marketable Securities Management . . . . . 814
    - 20.5.1. Investment Criteria for Surplus  
Cash Balances . . . . . 814
    - 20.5.2. Types of Marketable Securities . . . . . 816
    - 20.5.3. Hedging Considerations . . . . . 818
  - 20.6. Inventory Management . . . . . 819
    - 20.6.1. Inventory Loans . . . . . 820
    - 20.6.2. Economic Order Quantity . . . . . 820
  - 20.7. Summary . . . . . 821
  - Questions and Problems . . . . . 822
  - Appendix 20.A. Derivation of Eq. (20.1) . . . . . 825
  - References for Chapter 20 . . . . . 825
  
- 21. Elementary Applications of Programming Techniques  
in Working-Capital Management 827

21.1.	Introduction . . . . .	827
21.2.	Linear Programming . . . . .	828
21.3.	Working-Capital Model and Short-Term Financial Planning . . . . .	830
21.3.1.	Questions to be Answered . . . . .	831
21.3.2.	Model Specification and Its Solution . . . . .	832
21.3.3.	Which Constraints are Causing Bottlenecks? . . . . .	834
21.3.4.	How Much More Profit is Being Lost Because of Constraints? . . . . .	834
21.3.5.	How do the Constraints Affect the Solution? . . . . .	835
21.3.6.	Duality and Shadow Prices . . . . .	836
21.3.7.	Short-Term Financial Planning . . . . .	838
21.4.	Goal Programming . . . . .	839
21.4.1.	Introduction . . . . .	839
21.4.2.	Application of GP to Working-Capital Management . . . . .	841
21.4.3.	Summary and Remarks on Goal Programming . . . . .	846
21.5.	Programming Approach to Cash Transfer and Concentration . . . . .	847
21.5.1.	Transfer Mechanisms . . . . .	847
21.5.2.	Cash-Transfer Scheduling: Contemporary Practice . . . . .	848
21.5.2.1.	Managing About a Target . . . . .	848
21.5.2.2.	Anticipation . . . . .	850
21.5.3.	Weekend Timing and Dual Balances . . . . .	851
21.5.4.	Limitations of the Popular Techniques . . . . .	852
21.5.5.	Mathematical-Programming Formulation . . . . .	853
21.5.5.1.	The Objective Function . . . . .	853
21.5.5.2.	Constraints on Transfers Include: Average Balance, Flow Balance, Minimum Balance, and Maximum Transfer . . . . .	854
21.5.5.3.	Formulation Summary . . . . .	857
21.5.5.4.	Deposit Variation . . . . .	857
21.5.6.	Relation of Model Formulation to Current Practice . . . . .	858
21.5.6.1.	Implementation Tests . . . . .	860
21.5.6.2.	Field Concentration Tests . . . . .	860
21.5.6.3.	Lockbox Concentration . . . . .	861

- 21.6. Summary and Concluding Remarks . . . . . 861
- Problem Set . . . . . 862
- Appendix 21.A. The Simplex Algorithm for Solving Eq. (21.8) 862
- Appendix 21.B. Mathematical Formulation  
of Goal Programming . . . . . 865
- References for Chapter 21 . . . . . 868
  
- 22. Long-Range Financial Planning — A  
Linear-Programming Modeling Approach . . . . . 871
- 22.1. Introduction . . . . . 871
- 22.2. Carleton’s Model . . . . . 872
- 22.3. Brief Discussion of Data Inputs . . . . . 875
- 22.4. Objective-Function Development . . . . . 878
- 22.5. The Constraints . . . . . 880
  - 22.5.1. Definitional Constraints . . . . . 881
  - 22.5.2. Sources and Uses Definition . . . . . 888
  - 22.5.3. Policy Constraints . . . . . 891
- 22.6. Analysis of Overall Results . . . . . 900
- 22.7. Summary and Conclusion . . . . . 907
- Problem Set . . . . . 907
- Appendix 22.A. Carleton’s Linear-Programming Model: General  
Mills as a Case Study . . . . . 908
  - 22.A.1 Problem Specification . . . . . 908
  - 22.A.2 Solution . . . . . 909
- Appendix 22.B. General Mills’ Actual Key Financial Data . . 911
- References for Chapter 22 . . . . . 912
  
- 23. Simultaneous-Equation Models for Financial Planning . . . . . 913
- 23.1. Introduction . . . . . 913
- 23.2. Warren and Shelton Model . . . . . 913
- 23.3. Anheuser–Busch Companies, Inc. As A Case Study . . 918
  - 23.3.1. Data Sources and Parameter Estimations . . . 918
  - 23.3.2. Procedure for Calculating WS Model . . . . . 928
- 23.4. Francis and Rowell (FR) Model . . . . . 934
  - 23.4.1. The FR Model Specification . . . . . 939
    - 23.4.1.1. Sector One: Industry Sales . . . . . 941
    - 23.4.1.2. Sector Two: Company Sales  
and Production . . . . . 942

23.4.1.3.	Sector Three: Fixed Capital-Stock Requirements . . . . .	943
23.4.1.4.	Sector Four: Pricing . . . . .	944
23.4.1.5.	Sector Five: Production Costs . . . . .	944
23.4.1.6.	Sector Six: Income . . . . .	944
23.4.1.7.	Sector Seven: New Financing Required . . . . .	945
23.4.1.8.	Sector Eight: Risk . . . . .	945
23.4.1.9.	Sector Nine: Cost of Financing . . . . .	947
23.4.1.10.	Sector Ten: Common Stock Valuation . . . . .	947
23.4.2.	A Brief Discussion of FR's Empirical Results . . . . .	948
23.5.	Summary . . . . .	948
	Problem Set . . . . .	948
	Appendix 23.A. Procedure of Using Microsoft Excel to Run FINPLAN Program . . . . .	949
	Appendix 23.B. Program of FINPLAN with an Example . . . . .	949
	References for Chapter 23 . . . . .	959
24.	Time-Series: Analysis, Model, and Forecasting . . . . .	961
24.1.	Introduction . . . . .	961
24.2.	The Classical Time-Series Component Model . . . . .	961
24.2.1.	The Trend Component . . . . .	962
24.2.2.	The Seasonal Component . . . . .	963
24.2.3.	The Cyclical Component and Business Cycles . . . . .	963
24.2.4.	The Irregular Component . . . . .	966
24.3.	Moving Average and Seasonally Adjusted Time Series . . . . .	968
24.3.1.	Moving Average . . . . .	968
24.3.2.	Seasonal Index and Seasonally Adjusted Time Series . . . . .	969
24.4.	Linear and Log-Linear Time Trend Regressions . . . . .	976
24.5.	Exponential Smoothing and Forecasting . . . . .	980
24.5.1.	Simple Exponential Smoothing and Forecasting . . . . .	980
24.5.2.	The Holt–Winters Forecasting Model for Non-Seasonal Series . . . . .	985
24.6.	Autoregressive Forecasting Model . . . . .	989
24.7.	Summary . . . . .	993

Problem Set . . . . .	994
Appendix 24.A. The X-11 Model for Decomposing Time-Series Components . . . . .	1008
Appendix 24.B. The Holt–Winters Forecasting Model for Seasonal Series . . . . .	1014
References for Chapter 24 . . . . .	1020
25. Econometric Approach to Financial Analysis, Planning, and Forecasting . . . . .	1021
25.1. Introduction . . . . .	1021
25.2. Simultaneous Nature of Financial Analysis, Planning, and Forecasting . . . . .	1022
25.2.1. Basic Concepts of Simultaneous Econometric Models . . . . .	1022
25.2.2. Interrelationship of Accounting Information . . . . .	1022
25.2.3. Interrelationship of Financial Policies . . . . .	1023
25.3. The Simultaneity and Dynamics of Corporate-Budgeting Decisions . . . . .	1023
25.3.1. Definitions of Endogenous and Exogenous Variables . . . . .	1023
25.3.2. Model Specification and Applications . . . . .	1024
25.4. Applications of SUR Estimation Method in Financial Analysis and Planning . . . . .	1038
25.4.1. The Role of Firm-Related Variables in Capital-Asset Pricing . . . . .	1038
25.4.2. The Role of Capital Structure in Corporate-Financing Decisions . . . . .	1043
25.5. Applications of Structural Econometric Models in Financial Analysis and Planning . . . . .	1045
25.5.1. A Brief Review . . . . .	1045
25.5.2. AT&T's Econometric Planning Model . . . . .	1045
25.6. Programming vs Simultaneous vs Econometric Financial Models . . . . .	1047
25.7. Financial Analysis and Business Policy Decisions . . . . .	1049
25.8. Summary . . . . .	1051
Problem Set . . . . .	1051
Appendix 25.A. Johnson & Johnson as a Case Study . . . . .	1052
25.A.1 Introduction . . . . .	1052

25.A.2	Study of the Company's Operations . . . . .	1052
25.A.2.1	Consumer . . . . .	1052
25.A.2.2	Pharmaceuticals . . . . .	1052
25.A.2.3	Medical Devices and Diagnostics . . . . .	1053
25.A.3	Analysis of the Company's Financial Performance . . . . .	1053
25.A.4	Variables and Time Horizon . . . . .	1061
25.A.5	Model and Empirical Results . . . . .	1062
	References for Appendix 25 . . . . .	1069
	References for Chapter 25 . . . . .	1069

**Project V Analyses of Financial Planning  
and Forecasting 1073**

Author Index	1075
Subject Index	1083