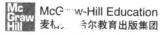




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PREFACE

Like its predecessors, the sixth edition of Analysis for Financial Management is for nonfinancial executives and business students interested in the practice of financial management. It introduces standard techniques and recent advances in a practical, intuitive way. The book assumes no prior background beyond a rudimentary and perhaps rusty familiarity with financial statements, although a healthy curiosity about what makes business tick is also useful. Emphasis throughout is on the managerial implications of financial analysis.

Analysis for Financial Management should prove valuable to individuals interested in sharpening their managerial skills and to participants in executive programs. The book has also found a home in university classrooms as the sole text in applied finance courses, as a companion text in case-oriented courses, and as a supplementary piece in more theoretical finance courses.

Analysis for Financial Management is my attempt to translate into another medium the enjoyment and stimulation I have received over the past three decades working with executives and college students. This experience has convinced me that financial techniques and concepts need not be abstract or obtuse; that recent advances in the field such as market signaling, market efficiency, and capital asset pricing are important to practitioners; and that finance has much to say about the broader aspects of company management. I also believe any activity in which so much money changes hands so quickly cannot fail to be interesting.

Part 1 looks at the management of existing resources, including the use of financial statements and ratio analysis to assess a company's financial health, its strengths, weaknesses, recent performance, and future prospects. Emphasis throughout is on the ties between a company's operating activities and its financial performance. A recurring theme is that a business must be viewed as an integrated whole and effective financial management is possible only within the context of a company's broader operating characteristics and strategies.

The rest of the book deals with the acquisition and management of new resources. Part 2 examines financial forecasting and planning with particular emphasis on managing growth and decline. Part 3 considers the financing of company operations, including a review of the principal security types, the markets in which they trade, and the proper choice of security type by the issuing company. The latter requires a close look at financial leverage and its effect on the firm and the firm's shareholders.

Part 4 deals with the use of discounted cash flow techniques, such as the net present value and the internal rate of return, to evaluate investment opportunities. It also addresses the difficult task of incorporating risk into investment appraisal. The book concludes with an examination of business valuation and company restructuring within the context of the ongoing debate over the proper roles of shareholders, boards of directors, and incumbent managers in governing America's public corporations.

As in earlier editions, an extensive glossary of financial terms and suggested answers to end-of-chapter problems follow the last chapter.

Changes in the Sixth Edition

Readers familiar with earlier editions of Analysis for Financial Management will note several changes and refinements in this edition, including

- · Selected website references at the end of each chapter.
- An Analysis for Financial Management website containing complimentary software, PowerPoint versions of selected tables and figures, supplementary end-of-chapter problems and answers, reader reviews, instructions for purchasing the book online, and errata. The complimentary software consists of three easy-to-use Excel programs which I often rely on to analyze financial statements, project financing needs, and evaluate investment opportunities. The URL is us.badm.washington.edu/higgins/book/book.htm. You can also access the Excel programs through a link on the book site at www.mhhe.com/higgins6e.
- An illustration in Chapter 3 of the virtues of computer simulation when projecting financing needs.
- A modest expansion of the appendix to Chapter 5 to include valuing stock options using information from two websites.
- A significant revision of the financing decision in Chapter 6 to sharpen the exposition and align it more closely with current thinking on the topic.

PREFACE

- An expanded discussion in Chapter 7 of the relevant costs and benefits in investment appraisal.
- · All new data in the running company example.

A word of caution: Analysis for Financial Management emphasizes the application and interpretation of analytic techniques in decision making. These techniques have proved useful for putting financial problems into perspective and for helping managers anticipate the consequences of their actions. But techniques can never substitute for thought. Even with the best technique, it is still necessary to define and prioritize issues, to modify analysis to fit specific circumstances, to strike the proper balance between quantitative analysis and more qualitative considerations, and to evaluate alternatives insightfully and creatively. Mastery of technique is only the necessary first step toward effective management.

I am indebted to Neil Cohen, Hugh Hunter, Chandra Mishra, and Chris Muscarella for their valuable reviews of the fifth edition and their constructive recommendations for improvements. I also want to thank Bill Alberts, David Beim, Dave Dubofsky, Bob Keeley, Jack McDonald, George Parker, Megan Partch, Alan Shapiro, and Nik Varaiya for insightful help and comments on this and prior editions. The sixth edition has been a real family effort. My daughter, Sara Higgins, did a great job on the software accompanying the book, and my son, Steve, did the lion's share of the work on tracking down and verifying the recommended websites. My wife contributed her usual support and enthusiasm as well as an uncharacteristic degree of patience. I thank them all. Finally, I want to express my appreciation to students and colleagues at the University of Washington, Stanford University, The Koblenz Graduate School of Management, Boeing, and Microsoft, among others, for stimulating my continuing interest in the practice and teaching of financial management.

I envy you learning this material for the first time. It's a stimulating intellectual adventure.

Robert C. Higgins University of Washington rhiggins@u.washington.edu us.badm.washington.edu/higgins/

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PART I

ASSESSING THE FINANCIAL HEALTH OF THE FIRM

			1

INTERPRETING FINANCIAL STATEMENTS

Financial statements are like fine perfume; to be sniffed but not swallowed.

Abraham Brilloff

Accounting is the scorecard of business. It translates a company's diverse activities into a set of objective numbers that provide information about the firm's performance, problems, and prospects. Finance involves the interpretation of these accounting numbers for assessing performance and planning future actions.

The skills of financial analysis are important to a wide range of people, including investors, creditors, and regulators. But nowhere are they more important than within the company. Regardless of functional specialty or company size, managers who possess these skills are able to diagnose their firm's ills, prescribe useful remedies, and anticipate the financial consequences of their actions. Like a ballplayer who cannot keep score, an operating manager who does not fully understand accounting and finance works under an unnecessary handicap.

This and the following chapter look at the use of accounting information to assess financial health. We begin with an overview of the accounting principles governing financial statements and a discussion of one of the most abused and confusing notions in finance: cash flow. In Chapter 2, we look at measures of financial performance and ratio analysis.

The Cash Flow Cycle

Finance can seem arcane and complex to the uninitiated. However, a comparatively few basic principles should guide your thinking. One is that a company's finances and operations are integrally connected. A