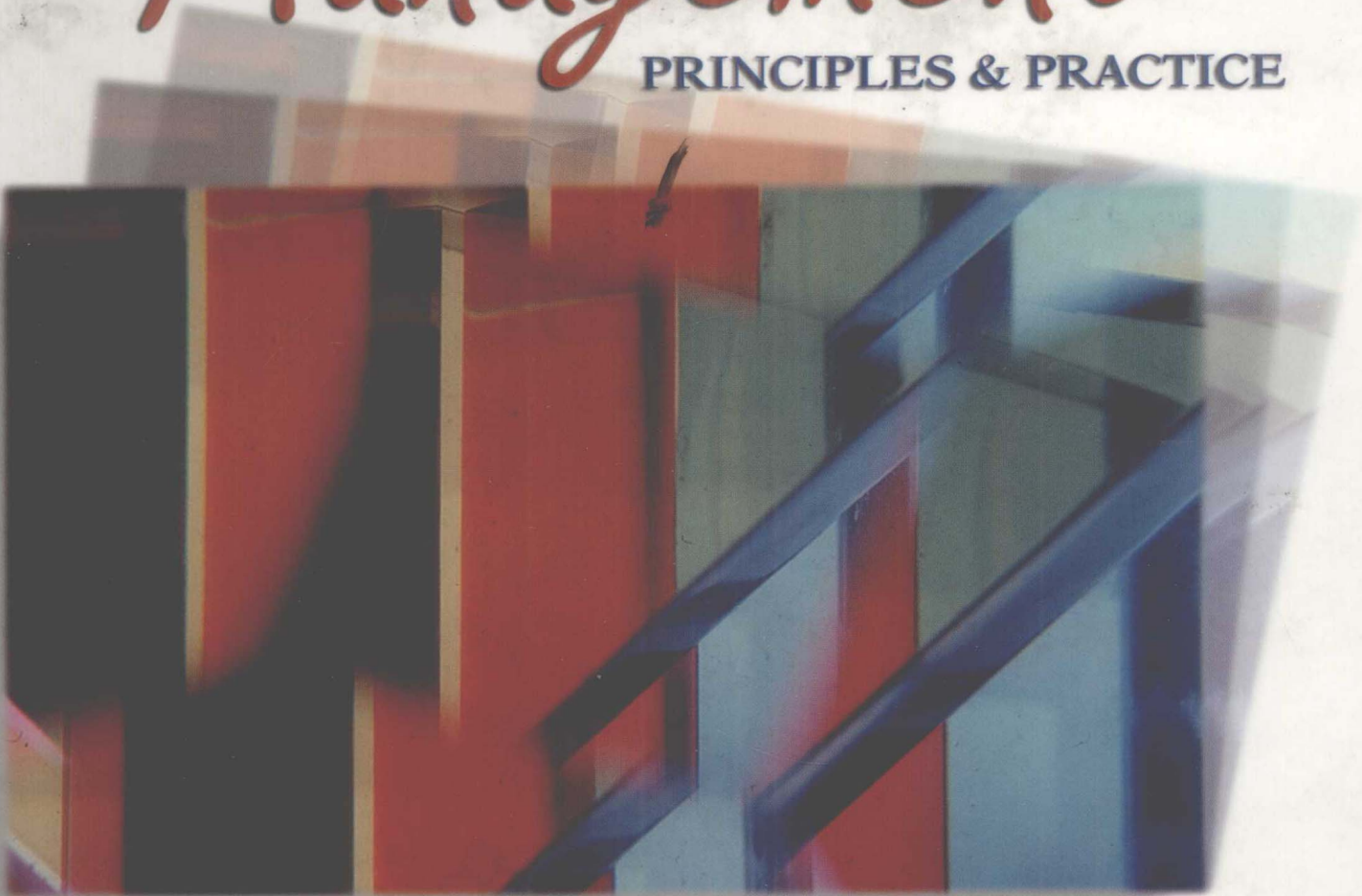


Third
Edition

FINANCIAL *Management* PRINCIPLES & PRACTICE



TIMOTHY J. GALLAGHER

JOSEPH D. ANDREW

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Financial Management

Principles and Practice

Third Edition

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Preface

THE CHALLENGE

Finance scares some students. There is a fear of numbers in some students and a mistaken belief that an introductory finance course requires high-level mathematics. Also, some students mistakenly believe finance is an area in which they will not need competency. Finance concepts often seem far removed from daily life. In spite of this, almost every major in a college of business and many majors in other colleges require a principles-of-finance course. As a result, many students who find themselves sitting in finance class on the first day of a semester do not want to be there.

We do not believe that this needs to be the case. Finance is important, dynamic, interesting, and fun. The challenge we take head-on in *Financial Management: Principles and Practice* is to convince students of this. In order to learn, students must want to learn. If they can see the usefulness of what is presented to them, they will work hard and they will learn.

Our many years of teaching experience have taught us that an introductory financial management course can be one that students enjoy and see as having added considerable value to their educational experiences. Finance is, after all, central to any business entity. More CEOs have come up through the finance ranks than any other discipline. Students need to know that the principles and practices of financial management apply to any business unit, from the very largest multinational corporation to the very smallest proprietorship, including the family. Financial ratios tell a story: They are not numbers to be calculated as ends unto themselves. Risk is important and can be managed. Time value of money has meaning and is understood as the central tool of valuation. Funds have a cost, and different sources of funds have different costs. Financial performance and condition can be assessed. Amortized loan payments, rates of return on investment, future value of investment programs, and present value of payments to be received from bonds and stocks can be calculated. The opportunities and special challenges of international operations can be understood.

OUR APPROACH

We believe that students should walk out of the room after taking the final exam for a finance course believing that they have learned something useful. They should see a direct benefit to themselves personally, rather than just the belief that some set of necessary job skills has been mastered, although the latter will be true if the material is mastered.

In *Financial Management: Principles and Practice*, we start with the student in mind and then package finance material so students (1) want to learn and (2) learn the necessary material. We do this because finance is not medicine, and it cannot be administered as such. Instead, we believe students must be engaged in such a way that they develop the desire to learn. There are those

who approach the task of teaching finance with the philosophy, “Here is the finance knowledge you need. Learn it!” These are not the people we had in mind when we wrote this book.

In the third edition, we have further integrated the text with the Internet and with multimedia material. We did this to facilitate the learning experience, not to have bells and whistles we could point to. There are Interactive Modules that directly tie material in the text to visually rich interactive material on the Web. These are not just links. The Mastering Finance CD-ROM that comes with the book has an abundance of multimedia material that relates the chapters to case studies, complete with videos and interactive quizzes.

Two key characteristics of *Financial Management: Principles and Practice* are currency and relevance. One of the authors of the text is an academic with more than 20 years of teaching experience, and the other is a full-time financial practitioner. This combination of backgrounds results in a text that presents the latest in financial theory while retaining a strong “real-world” connection. No other textbook on the market enjoys this balance of academic and practitioner perspectives.

There are a few cartoons in this book. Do not allow their presence to mislead you. This book is serious about learning and the cartoons serve a serious purpose. They tend to “lighten up” the presentation in order to capture students’ interest. Although our style is lighthearted, the writing itself is substantive, concise, clear, and easy to understand.

DISTINCTIVE FOCUS

Although there are many other introductory financial management books on the market, none contains the unique style and content of *Financial Management: Principles and Practice*, third edition. Many texts focus mostly on accounting, with little presentation of the economic theory that underlies the financial techniques presented. Others assume that students remember all that was learned in the accounting course that is usually a prerequisite for this course. Still others claim to take a “valuation approach” but present their topics in a straight accounting framework. In this book we are serious about focusing on what creates value. We are consistent throughout the book, addressing issues such as what creates value, what destroys it, how value is measured, and how value and risk are related. In so doing we maximize the value of the finance course to the student.

ORGANIZATION OF THE TEXT

The book is organized into six major parts as follows:

- Part I.** *The World of Finance* contains chapters on the structure and goals of firms, the role of financial managers, and an examination of the financial environment.
- Part II.** *Essential Concepts in Finance* presents chapters on accounting statements and their interpretation, forecasting, risk and return, and the time value of money.
- Part III.** *Capital Budgeting and Business Valuation* contains chapters on measuring a firm’s cost of capital, capital budgeting decision methods, incremental cash flow estimation, and business valuation.

- Part IV.** *Long-Term Financing Decisions* contains chapters on capital structure basics, corporate bonds, preferred stock, leasing, common stock, and dividend policy.
- Part V.** *Short-Term Financial Management Decisions* includes chapters on working capital policy, cash and marketable securities, accounts receivable and inventory, and short-term financing.
- Part VI.** *Finance in a Global Economy* is where international finance topics are covered, in addition to those international topics that are woven throughout the book.

SPECIAL FEATURES IN THE TEXT

Links to Web-Based Interactive Material

These Interactive Modules allow students to move seamlessly between the text and visually rich Web-based learning modules. Students move from the text to the online material and back to the text, enabling learning that is not possible from a printed page alone.



www.prenhall.com/gallagher

Mastering Finance CD-ROM

This feature allows students to participate in realistic financial decision-making situations through the use of video presentations and interactive quizzes. The videos focus on CanGo, a fictional Internet start-up that retails a variety of entertainment products online. Students watch as a team of young entrepreneurs work together to face challenging business decisions, both professional and personal, that center around key events in the life of an e-business.



Real-World Examples

Each chapter in *Financial Management: Principles and Practice* begins with a real-world example that illustrates the concept to be addressed in that chapter. This gives the student a reason to learn this material and to show its practical application.

Special Boxes

Three different types of special boxes are integrated into the chapters. *Ethical Issues* boxes identify many financial decisions that have ethical dimensions to them. We don't give answers, but we don't pull punches either. Cop-outs, such as "being ethical is good business," are avoided. This may be true, up to a point, but sometimes doing the right thing costs you. We don't avoid that. *Financial Management and You* boxes take financial management concepts intended for use within a firm and show how these same concepts can be used by individuals for personal financial decision making. This makes these topics less distant. *Finance at Work* boxes are designed to demonstrate how finance relies on, contributes to, and interacts with other functional areas of the firm. Not every student taking this course is a finance major, and understanding the role of finance within the firm is important.

Calculator Solutions

Financial calculator solutions to all general time value of money and specific security valuation problems are included. This material is presented in such a way that professors' differing preferences about the use of financial calculators can be accommodated.

Summaries

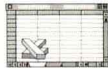
The summary for each chapter specifically describes how the learning objectives have been achieved, and it also provides a bridge to the next chapter.

Key Terms

Each chapter has key terms in **bold** that are defined in the chapter and in the glossary. There are self-test questions and problems at the end of chapters, along with their solutions, so students can check their grasp of the material presented.

Practice Questions and Problems

Review questions and an abundant number of end-of-chapter problems are included in the appropriate chapters.



Computer Spreadsheet–Supported Problems

A number of end-of-chapter problems are marked with the special computer-problem logo shown here. This indicates that a downloadable Excel spreadsheet template for the problem is available at the Companion Website at www.prenhall.com/gallagher.

Communication Skills

Suggested assignments to build students' written and oral communication skills are included in each chapter.

Cartoons

Cartoons are added for fun—and occasionally to make a financial point.

Color

Color is used for pedagogic effect, not just for looks.

CHANGES IN THE THIRD EDITION

- ▶ Interactive Web-linked modules have been integrated into the text. These modules lead students from the text to the book's Companion Website, where additional material is presented in a way that is often not possible on a printed page. At the Website, students interact with graphs, view video material, and listen to audio material before returning to the text. Students can make changes to key input variables and see the resulting changes to the visually rich graphs.

- ▶ Video cases on the Mastering Finance bundled CD-ROM are fully integrated into the text. Using this feature, students can see and hear how employees and executives of a company deal with issues directly related to the material in the text.
- ▶ Coverage of forms of business is expanded in Chapter 1. Descriptions of forms of business beyond the traditional sole proprietorship, partnership, and corporation have been included. Specifically, the rapidly growing uses of limited liability companies (LLCs) and limited liability partnerships (LLPs) are described.
- ▶ Coverage of electronic trading of stocks on the NYSE and the Nasdaq has been added to Chapter 2. The increasing role of electronic communications networks (ECNs) is also described.
- ▶ The discussion of market value added (MVA) was expanded in Chapter 5. Numerical examples have been added to the text. Homework problems about economic value added (EVA) and MVA have been added to the end-of-chapter material.
- ▶ Online sources of company information have been included in Chapter 5.
- ▶ The discussion of Real Options is expanded in Chapters 10 and 11. Numerical examples have been added to the text relating to abandonment and expansion options. Decision trees are described. Homework problems relating to real options have been added to the end-of-chapter material.
- ▶ The Cost of Capital chapter, which was Chapter 12 in the second edition, has been moved up to Chapter 9 in the third edition. Covering the cost of capital early in this fashion better prepares students for the discounting procedures that are introduced in the capital budgeting decision methods, cash flow estimation, and valuation chapters that follow.
- ▶ The Stock and Bond Valuation chapter, which was Chapter 9 in the second edition, has been moved to Chapter 12 in the third edition and titled “Business Valuation” to reflect the rapidly advancing field of business appraisal. Techniques for valuing complete businesses and individual assets have been added to the existing stock and bond valuation discussions. A numerical example of a real-world business is included, as well as a discussion of the value of control.
- ▶ The capital structure material in Chapter 13 has been rearranged to provide a more easily understood presentation of the subject.
- ▶ In Chapter 14, the bond refunding material previously covered in an appendix is now integrated into the basic chapter, and bond-refunding homework problems have been added. A numerical example of a lease–buy decision has also been included.
- ▶ There is updated coverage of international business developments in Chapter 21, particularly the latest events relating to the use of the euro currency.
- ▶ Coverage of Internet companies has been expanded throughout. Chapter vignettes have been revised to include Internet as well as conventional “brick and mortar” companies. Almost all second-edition chapter openers have been replaced with newer, real-world vignettes or interviews designed to make students want to read the content of that chapter.

- ▶ New homework problems have been added to each chapter, representing an increase in the homework problem bank of more than 50 percent. Many of the homework problems are supported with downloadable spreadsheets from the Companion Website at www.prenhall.com/gallagher.
- ▶ The book has been given a newer, more modern look. Artistic photographs related to the topic matter introduce each chapter, and color has been integrated to assist the pedagogy and to make the book easy to read.
- ▶ Suggestions from reviewers, faculty users, and students have been incorporated where practical.
- ▶ References and examples have been updated throughout.
- ▶ The Power Point slides accompanying the text are enhanced and updated.
- ▶ A multilevel quality control program has been implemented for the text and supplements. The program is designed to eliminate any and all errors.

FEATURES RETAINED FROM THE SECOND EDITION

- ▶ The book still is written in the student-friendly style that was extremely popular in the first and second editions. The concise, easy to understand presentation loved by student users is maintained.
- ▶ The book provides the level of rigor professors demand. When professors get past the friendly style, they find all the rigor and all the mainstream topics they expect in a book of this type. For example, if you are not already a Gallagher/Andrew user, does your book:
 - Cover real options with numeric examples?
 - Cover EVA, MVA, and EBITDA?
 - Use a value added (NPV) approach to the inventory and accounts receivable investment coverage rather than the outmoded return on investment ratio approach?
 - Have supplements that were not “farmed out” to subcontractors but that instead have the authors’ hands-on participation?
- ▶ Attempts to expand the book, and to make it longer, have been resisted. The topics that professors actually teach are here. Those that are most likely to be taught in the second course in financial management are left out. Students don’t have to buy more than what they need.

THE LEARNING PACKAGE

Financial Management: Principles and Practice is one component of a complete learning package carefully put together by the Prentice Hall team. This package includes the Mastering Finance CD-ROM that contains video cases, a dedicated and comprehensive Companion Website, print and computerized test banks, a study guide/workbook, an instructor’s manual, Power Point slides, and Excel spreadsheets. FinCoach version 2.0 CD-ROM is optional math practice software for the student.

For the Student

- **Companion Website**—The Companion Website can be accessed at www.prenhall.com/gallagher. Selected topics in the text are expanded upon at the Website. Visually rich and interactive material is included to facilitate learning in a way not possible on the printed page alone. There are also online current-event resources, Excel spreadsheet files containing templates that facilitate solving designated end-of-chapter problems, finance career information, Internet exercises, a study guide with online quizzes, and study skills help.
- **Mastering Finance CD-ROM**—The Mastering Finance CD-ROM contains multimedia material that presents realistic financial decision-making cases. Interactive quizzes allow you to check your learning. The videos focus on CanGo, a fictional Internet startup company. The student observes a team of young professionals working together while facing challenging business decisions, both professional and personal. Students get to put themselves into the shoes of these professionals as they apply the knowledge acquired in the principles of finance course.
- **Lecture Notes**—Power Point files may be downloaded from the Website and used as lecture notes so that students can focus on what their professor is saying without having to simultaneously take copious notes. These have been carefully updated and enhanced.
- **Student Workbook and Study Guide**—This is an item that may be purchased separately or that may be bundled with the book. Chapters are outlined, key points and terms are explained, and additional problems are presented for practice.
- **FinCoach Version 2.0**—This is a computer program similar to an enhanced study guide. Students can choose from 5 million problems to practice quantitative skills. Problems may be chosen according to the level of difficulty desired. Problems may be e-mailed, saved, and printed.

For the Professor

- **Instructor's Manual**—This provides the professor with chapter outlines and suggestions for alternative ways to present the material. Key points are identified and a variety of types of assistance for class preparation are presented.
- **Solutions Manual**—Detailed solutions, not just final answers, are presented for each end-of-chapter question and problem. These have all been personally checked by the authors, in addition to two other levels of checking, for accuracy.
- **Test Item File**—Available in both hard copy and computerized versions, multiple-choice, short-answer, and essay questions are available for each chapter. The computerized version allows for complete customization of an exam according to chapters covered, type of problem, and level of difficulty.
- **Power Point Slides**—Animated slides covering all main topics in the text are available to assist the professor during class. These have been expanded and triple-checked for accuracy. Special features have been added since the previous-edition Power Point slides were prepared.

- ▶ **Faculty Area of the Companion Website**—There is an area of the Companion Website that is password controlled and available only to faculty. Excel spreadsheets with full solutions to end-of-chapter problems may be downloaded. Also available are Solutions Manual files. There is a faculty chat room, a lecture material archive, and an area with computer usage advice.
- ▶ **Author Access**—Both authors are accessible to respond to individual questions from adopting professors that may come up. Tim Gallagher may be reached at tim@gallagher.com and Joe Andrew at josephandem@aol.com.

IN CONCLUSION

We believe that students will understand the very important finance concepts and master necessary problem-solving skills when they complete the course in which this text is used. “Students first” is our philosophy, and this belief shows up throughout the text. Professors who have more-enthusiastic students and who grasp the important content, both conceptual and problem solving, will find their classroom experiences more rewarding too. If we have helped to make this happen, we have succeeded in achieving our vision for *Financial Management: Principles and Practice*, third edition.

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The Prentice Hall team is the best there is. Special thanks go to Mickey Cox, Executive Editor, who brought to the third edition some great new ideas. We couldn’t have moved forward in these very positive ways in this third edition without her. PJ Boardman, Editor-In-Chief, has been hands-on from the beginning, and she knows what goes into a great book. Victoria Anderson, Media Project Manager, is the best at creating state-of-the-art media learning tools. Kathleen McLellan, Marketing Manager, knows how to communicate the message. Carol Samet, Production Editor, kept everything on schedule, including us. Melanie Olsen, Editorial Assistant, put out many fires. Kevin Hancock, Editorial Assistant, is always on top of the important details. Elena Picinic, Marketing Coordinator, played an important role in executing our marketing plan. Beth Romph, Assistant Editor, carried the load with the supplements. Previous editors Maureen Riopelle, Paul Donnelly, and Jill Lectka have made their marks on this book in lasting ways.

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About the Authors

Timothy J. Gallagher (Tim) is professor of finance and chair of the Department of Finance & Real Estate at Colorado State University. Tim received his Ph.D. in finance in 1978 from the University of Illinois at Urbana–Champaign.

Tim has taught undergraduate and graduate finance courses for 24 years, including courses in financial management, markets and institutions, and investments. He has taught traditional and nontraditional students at all levels, including executive MBAs, and in all types of classroom settings—large lecture, small seminar, and distance learning.

Tim has published in journals such as *The Journal of Money, Credit, and Banking*, *The Journal of Portfolio Management*, *Financial Management*, and *The Financial Review*, among others.

Joseph D. Andrew Jr. (Joe) is a financial analyst with BIA Financial Network, Inc., a financial consulting firm specializing in the analysis and appraisal of broadcasting, cable, and telecommunications companies and in preparation of bank presentations for communications clients. As a senior telecom analyst with BIA, Joe performs asset and stock appraisals, business plan analyses, industry studies, and litigation support functions for communications companies, primarily in the local, long distance, wireless, specialized mobile radio, and Internet industries. He also participates in specialized strategic research projects and impact studies covering various aspects of the communications industry. Joe is a member of the American Society of Appraisers and has been with BIA since April 1997.

Prior to joining BIA, Joe served as chief financial officer for X-Change Software, Inc., a start-up software development firm in Oakton, Virginia. As CFO, he was responsible for corporate investment analysis, cash flow planning, forecasting and analysis, receivables and payables management, and supervision of bookkeeping and accounting functions.

In addition to managing corporate finances, Joe teaches graduate courses for Webster University of St. Louis, Missouri, dividing his time between the university's Washington, D.C., campus and its international campus in Hamilton, Bermuda. His published works include this book and *Effective Writing: A Handbook for Finance People*, with Dr. Claire May of the Art Institute of Atlanta and Dr. Gordon May of the University of Georgia.

Joe's past experience includes teaching assignments for National-Louis University in McLean Virginia, the University of Southern Colorado in Colorado Springs, and McMurry College in Abilene, Texas. He also served 23 years as a missile maintenance specialist in the U.S. Air Force, retiring at the rank of chief master sergeant in 1982.

Tim and Joe's partnership in this book's creation represents a unique opportunity for readers to experience the best of both worlds—Tim's development of the theory and logic of financial principles and Joe's real-world financial orientation. Their combined experience with students ensures that readers will learn theory and practice in an innovative, up-to-date, accurate manner.

PART I

THE WORLD OF FINANCE

We begin our study of financial management with a look at what the field of finance is all about and the environment in which financial managers operate. Chapter 1 introduces you to finance, explains what financial managers do, states the objective of financial management, and describes the three basic forms of business commonly encountered

in the United States. Chapter 2 introduces you to the financial environment in which the firm operates. The financial system is explained, along with the various financial markets and the securities that are bought and sold there. The importance of financial markets to the firm is emphasized. Chapter 2 finishes with a discussion of interest rates, which represent the price of credit in the financial markets. Chapter 3 continues with descriptions of the various financial institutions through which buyers, sellers, borrowers, and lenders gain access to the financial markets. These three chapters set the stage for your study of the principles and practice of managing an individual company's finances.



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