

KEOWN
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FINANCIAL **M**ANAGEMENT

*PRINCIPLES
and
APPLICATIONS*

Ninth Edition

NINTH EDITION

FINANCIAL MANAGEMENT: PRINCIPLES AND APPLICATIONS

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FINANCIAL MANAGEMENT: PRINCIPLES AND APPLICATIONS

The ninth edition of *Financial Management: Principles and Applications* is dedicated to our families—the ones who love us the most.

Barb, Emily, and Artie

Arthur J. Keown

Sally, Dave and Mel, and Jess

John D. Martin

To the future of four wonderful grandchildren: Ashley, Cameron, John, and MacKenzie.

J. William Petty

To my dear late wife Peggy. Thank you for 36 marvelous, irreplaceable years.

David F. Scott, Jr.

PREFACE

In many ways, Harley-Davidson is the American experience. Its beginnings date back to 1903 and the Industrial Revolution in America, and it survived two world wars, the Great Depression, and competition from countless competitors from both home and abroad. Then, in 1985, Harley-Davidson came close to becoming a part of history as it teetered on the verge of bankruptcy. However, since then, Harley-Davidson reinvented itself, becoming one of the most successful companies in America and, as President Reagan once proclaimed, “an American success story.”

In many ways, the evolution of Harley-Davidson illustrates the enormous challenges faced by any company in today’s world—surviving and prospering in a business world involves a continuous series of challenges. In this text, we focus on how the firm can create wealth for its shareholders. How did Harley-Davidson do? Between 1986, when Harley-Davidson returned to public ownership with a successful stock offering, and 1999, Harley’s stock price rose approximately 100-fold. And how was all of this done? Through outstanding financial management. Harley-Davidson management made good decisions. That’s what we’re going to look at in this book. We’ll look at what it takes to turn Harley-Davidson or any other company around, and what it takes to keep a company like Harley-Davidson alive and well.

OUR APPROACH TO FINANCIAL MANAGEMENT

The first-time student of finance will find that corporate finance builds upon both accounting and economics. Economics provides much of the theory that underlies our techniques, whereas accounting provides the input or data on which decision making is based. Unfortunately, it is all too easy for students to lose sight of the logic that drives finance and to focus instead on memorizing formulas and procedures. As a result, students have a difficult time understanding the interrelationships between the topics covered. Moreover, later in life when the problems encountered do not fit neatly into the textbook presentation, the student may have problems abstracting from what was learned. To overcome this problem, the opening chapter presents 10 basic principles of finance that are woven throughout the book. What results is a text tightly bound around these guiding principles. In essence, the student is presented with a cohesive, interrelated subject from which future, as yet unknown, problems can be approached.

Teaching an introductory finance class while faced with an ever-expanding discipline puts additional pressures on the instructor. What to cover, what to omit, and how to do this while maintaining a cohesive presentation are inescapable questions. In dealing with these questions, we have attempted to present the chapters in a stand-alone fashion so that they could be easily rearranged to fit almost any desired course structure and course length. Because the principles are woven into every chapter, the presentation of the text remains tight regardless of whether or not the chapters are rearranged. Again, our goal is to provide an enduring understanding of the basic tools and fundamental principles upon which finance is based. This foundation will give a student beginning his or her studies in finance a strong base on which to build future studies and give the student who will take only one finance class a lasting understanding of the basics of finance.

Although historical circumstances continue to serve as the driving force behind the development and practice of finance, the underlying principles that guide our discipline

remain the same. These principles are presented in an intuitively appealing manner in Chapter 1 and thereafter are tied to all that follows. With a focus upon the big picture, we provide an introduction to financial decision making rooted in current financial theory and in the current state of world economic conditions. This focus can be seen in a number of ways, perhaps most obvious being the attention paid both to valuation and to the capital markets and their influence on corporate financial decisions. What results is an introductory treatment of a discipline rather than the treatment of a series of isolated finance problems. The goal of this text is to go beyond teaching the tools of a discipline or a trade, and help students gain a complete understanding of the subject. This will give them the ability to apply what he or she has learned to new and yet unforeseen problems—in short, to educate students in finance.

A TOTAL LEARNING PACKAGE

Financial Management is not simply another introductory finance text. It is a total learning package and reflects the vitality and ever-expanding nature of the discipline. Finance has grown too complex not to teach with an eye on the big picture, focusing on the interrelationships between the materials that are covered. Listed below are some of the distinctive pedagogical features that assist the student in understanding how concepts in finance link to the big picture of finance.

Learning Aids in the Text

TEN PRINCIPLES OF FINANCE The fundamental principles that drive the practice of corporate finance are presented in the form of 10 principles. These principles first appear in Chapter 1 and thereafter appear in in-text inserts called “Relate to the Big Picture.” These inserts serve to refocus the student’s attention on the underlying principles behind what is being done. In effect, they serve to keep the student from becoming so wrapped up in specific calculations that the interrelationships and overall scheme is lost.

INTEGRATIVE END-OF-CHAPTER PROBLEMS An Integrative Problem is provided at the end of each chapter and covers all the major topics included in that chapter. This comprehensive problem can be used as a lecture or review tool by the professor. To aid the instructor in presenting this material, the solution is provided to the instructor in Microsoft PowerPoint format. For students, the integrative end-of-chapter problems provide an opportunity to apply all the concepts presented within the chapter in a realistic setting, thereby strengthening their understanding of the material.

FINANCE MATTERS Strong emphasis is also placed upon practice, where practice is used to demonstrate both the relevance of the topics discussed and the implementation of theory. Moreover, to add life to the discussion, “Finance Matters” boxed inserts are provided throughout the text. These boxes are largely taken from the popular press with analysis and implications provided following each box. In this way, the subject matter comes to life with added relevance to the student.

HARLEY-DAVIDSON CHAPTER INTRODUCTIONS Each chapter opens with an introductory example that involves Harley-Davidson and sets the stage for what is to follow. In this way, the student can easily understand the relevance, use, and importance of the material to be presented. Moreover, by focusing on the challenges facing a single company, the stu-

dent can better understand the interrelationships between the different financial topics that are presented.

UNIQUE TREATMENT OF MANAGERIAL COMPENSATION AND MANAGING FOR SHAREHOLDER VALUE An important addition to the ninth edition of *Financial Management* is an entire chapter on managing for shareholder value. In the new Chapter 13, entitled Managing for Shareholder Value, we focus on the use of economic value added, or *EVA*[®], to measure firm and divisional performance. This measure of performance has been found to be an effective tool for managing for shareholder value by a large number of firms both in the United States and abroad. In fact, even the U.S. Postal Service has implemented a variant of the model to better control its internal operations.

Traditionally, the finance profession has had little to say about performance appraisal of the firm beyond a cursory discussion of financial ratios. In this new chapter we discuss value creation first in terms of how the market accords value to the firm in the context of market value added. Next we connect value creation to the individual contributions that the firm makes year-to-year in the form of *EVA*[®]. But measuring value creation is not enough. The proponents of shareholder value creation point out, quite appropriately, that to assure the continued focus of the firm's employees on value creation, the firm must reward them for doing the things that lead to value creation. Thus, the second half of this new chapter focuses on managerial compensation. This is the first corporate finance text to undertake a synthesis of both the measurement (*EVA*[®]) and reward (compensation) systems that are commonplace among the top value creators in corporate America.

INTERNATIONAL FINANCIAL MANAGEMENT In view of the continued globalization of world markets, we have integrated examples of international finance throughout the text. In addition, at the close of most chapters a new section has been added dealing with how the material in that chapter relates to the multinational firm. Finally, recognizing the fact that many of us approach the teaching of international finance in different ways, a separate chapter on international financial management is also provided.

CHAPTER LEARNING OBJECTIVES AND KEY TERMS Each chapter begins by setting out the learning objectives for that chapter, and setting in mind what that chapter will enable the student to do. In addition, at the end of each chapter, key terms and their locations in the text are identified, making for an easy review for the student.

FINANCIAL SPREADSHEETS AND CALCULATORS The use of financial spreadsheets and calculators has been integrated throughout this text. This provides the student with access to both methods of problem solving and introduces the advantages of each. In addition, we provide the student with hints and strategies for the use of financial spreadsheets directly in the text, while providing an appendix in the back of the book that guides them through the use of a financial calculator.

EXPANDED USE OF REAL-WORLD EXAMPLES OTHER THAN HARLEY-DAVIDSON In addition to the focus on Harley-Davidson, we have greatly expanded the illustrative use of examples of problems facing other real-world firms. This adds to student interest both by showing the relevance of the subjects covered and by providing an exciting framework within which to discuss financial concepts.

HOW FINANCIAL MANAGERS USE THIS MATERIAL Each chapter closes with a section entitled "How Financial Managers Use This Material." This section ties the material presented in

the chapter both to the student's future job setting and to real-world companies, thereby enhancing the student's interest and displaying the relevance of the material covered.

FUNCTIONAL INTEGRATION TO BUSINESS Where appropriate, we have pointed out the relevance of the material covered to those students who are not finance majors—information technology, accounting, marketing, and management majors. In this way, students who are not finance majors are brought into the subject matter.

NEW TO THIS EDITION

In addition to an updating and streamlining of the material, the following list includes the major additions that are new to *Financial Management*:

- The use of free cash flows has been integrated and emphasized throughout the text.
- A new Chapter 13, titled, "Managing for Shareholder Value," has been added. This chapter addresses issues of measurement and rewards designed to create shareholder value; that is, *EVA*.
- Chapter 1 has been revised with a new section that provides a flow of funds overview at end of chapter. In addition, the discussion of taxes has been moved to Chapter 2.
- The discussion of financial statements in Chapter 2 was tightened and shortened, while taxes were added. In addition, the discussion of an accounting cash-flow statement was replaced with measuring free cash flows.
- The discussion of the cash budget previously in Chapter 4 was moved to the working capital chapter. In addition, the chapter was refocused on forecasting firm/project free cash flow.
- Chapter 6 now includes an introduction to interest rates, including the Fisher model of determinants of risk-free rates, term structure effects, default risk premiums, and market risk premiums.
- Chapters 7 and 8 were updated to include more timely examples.
- Chapter 10 now focuses its discussion around project expansion decision and use of free cash-flow valuation as opposed to the replacement decision.
- Chapter 11 now includes a discussion of real options and their role in the capital-budgeting decision.
- Much of Chapter 14, "Raising Capital in the Financial Markets," actually came from Chapter 2 in the previous edition. In addition, this chapter now contains a discussion of private equity and debt markets.
- Chapter 17, "Dividend Policy and Internal Financing," now addresses the trend toward share repurchase as preferred method of cash distribution to stockholders.
- Chapter 18, "Working-Capital Management and Short-Term Financing," now contains the discussion of the cash budget, which previously appeared in the financial forecasting chapter. In addition, the discussion has been streamlined.
- In addition, Chapters 23 and 24 are now available on the Internet.

As a final, but important, comment to the teacher, we know how frustrating errors in a textbook or instructor's manual can be. Thus, we have worked diligently to provide you with as error-free a book as possible. Not only did we check and recheck the answers ourselves, but Prentice Hall hired faculty members at other universities to check the accuracy of the problem solutions. We therefore make the following offer to users of *Financial Management*.

Any professor or student identifying an error of substance (e.g., an incorrect number in an example or problem) in *Financial Management*, in the text, that has not been previously

reported to the authors, will receive a \$10 reward. If a series of related errors occurs resulting from an original error, the reward will be limited to a maximum of \$20 for the group of errors. Please report any errors to Art Keown at the following address:

Art Keown
Department of Finance
Virginia Tech
Blacksburg, VA 24061

LEARNING AIDS SUPPLEMENTAL TO THE TEXT

Financial Management integrates the most advanced technology available to assist the student and the instructor. Not only does it make their financial management come alive with the most current information, but also enhances a total understanding of all tools and concepts necessary in mastering the course.

The Support Package

STUDENT STUDY GUIDE Written by the authors, the Study Guide contains several innovative features to help the student of *Financial Management*. Each chapter begins with an overview of the key points, which can serve both as a preview and quick survey of the chapter content, and as a review. There are problems (with detailed solutions) and self-tests that can be used to aid in the preparation of outside assignments and to study for examinations. The problems are keyed to the end-of-chapter problems in the text in order to provide direct and meaningful student aid. Multiple-choice and true/false questions are also included to provide a self-test over the descriptive chapter material.

INSTRUCTOR'S MANUAL WITH SOLUTIONS The Instructor's Manual, prepared by the authors, contains these four key elements for each chapter:

1. A chapter orientation, which offers the instructor a simple statement of the authors' intent for the chapter, and a useful point of departure for in-class lecture;
2. A chapter outline for easy reference to key issues;
3. Answers to all end-of-chapter questions in the test;
4. A second set of alternative problems with answers.

TEST BANK The Test Bank, revised for this edition by Philip T. Thames of California State University, Long Beach, provides multiple-choice, true/false, and short-answer questions with complete and detailed answers.

PRENTICE HALL TEST MANAGER The Test Bank is designed for use with the Prentice Hall Test Manager, a computerized package that allows instructors to custom design, save, and generate classroom tests. The test program (in Windows format) permits instructors to edit, add, or delete questions from the test bank; edit existing graphics and create new graphics; analyze test results; and organize a database of tests and student results.

POWERPOINT PRESENTATION Lecture notes have been prepared by Professor Anthony Byrd of the University of Central Florida. These electronic slides exhibit full-color presentations of chapter overviews and examples coordinated with *Financial Management*, Ninth Edition. The PowerPoint slides are available from the Prentice Hall Web site www.prentice-hall.com/keown

SPREADSHEET TEMPLATES AND SOLUTIONS In addition to the solutions being provided in the Instructor's Manual, the authors have also developed Spreadsheet Solutions for virtually all of the end-of-chapter problems. These solutions have been prepared in Excel. The user can change the assumptions in the problem and thereby generate new solutions. Student templates consist of select end of chapter problems that are meant to be worked out off our website. (Available to download at www.prenhall.com/keown).

SPREADSHEET MODELING IN CORPORATE FINANCE EDITION TO ACCOMPANY FINANCIAL MANAGEMENT, NINTH EDITION Comes as a book and browser-accessed CD-ROM that teaches students how to build financial models in Excel. Created by Craig W. Holden, Indiana University.

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As a final word, we express our sincere thanks to those using *Financial Management* in the classroom. We thank you for making us a part of your team. Always feel free to give any of us a call or contact us through the Internet when you have questions or needs.

A.J.K.

J.D.M.

J. W. P.

D. F. S.



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