



# **ESSENTIALS OF FINANCE**

**AN INTEGRATED APPROACH**

**GEORGE W. GALLINGER**

**JERRY B. POE**

**ANNOTATED INSTRUCTOR'S EDITION**

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# *Essentials of Finance: An Integrated Approach*

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# Preface

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Why did we write this book? There are many good textbooks available for the introductory finance class, but we believe that these books are missing an important point. Consider the fact that most business students take only one finance class in their curriculum—the required course. Instructors usually teach the class from a managerial, or corporate, finance perspective because that is the focus of the major books. Indeed, the title of many of these textbooks includes the word *managerial* or *corporate*. However, as a discipline the subject of finance is much broader. Finance encompasses financial markets and institutions, and investments, in addition to managerial finance.

We agree that managerial finance should be the emphasis of the introductory course. However, we also believe that by exposing students to broader coverage of financial markets and investments, they will have a better understanding of the role of managerial finance in the financial environment. Nonfinance specialists need to have more knowledge of financial institutions and financial decision making than is traditionally covered in most texts. The reengineering of corporate America is resulting in people from different specialties forming teams to solve problems. A broader exposure to finance provides the marketing, management, or production team player with improved insight about how to create shareholder value and the impact of changing financial markets on this value.

## THE MODEL MOST AUTHORS FOLLOW

Our textbook offers a fresh approach. But to provide some perspective, let's look at the pattern, or close derivative, that most comprehensive books follow. In the first few chapters there is a brief discussion of basic accounting and financial markets. Next, there is an examination of risk and time value of money concepts, which they use to value financial securities. However, rather than building on these valuation principles, the authors often interrupt the flow by changing the discussion to financial statement analy-



sis and forecasting. After this digression, they return to the valuation issue by examining capital budgeting topics. However, in the transition back to valuation they fail to discuss the value of the firm and how to create shareholder value. The discussion then proceeds to examine decisions related to investment banking, long-term debt, preferred stock, mergers, divestitures, holding companies and leveraged buyouts. (Some authors place many of these topics at the end of the book as special topics.) Following these topics, the texts often discuss cost of capital, leverage, and dividend policy. Issues examined in the last chapters usually relate to working capital management without any connection to investment decisions discussed earlier. In summary, there is an overall lack of a logical, consistent flow from one topic to another. There is little in the way of building blocks.



## OUR APPROACH

Our text differs from the traditional managerial finance textbook. We lay a broad foundation based on macrofinance topics and proceed in a logical order to microfinance topics. In this way, we explain the environment in which managers operate as they attempt to create value for shareholders. We present the topics as a cohesive body of knowledge, rather than as a series of seemingly unrelated pieces of information. As a result, students obtain a more thorough survey of the subject matter.

We divide our nineteen chapters into six parts. Part I provides for a quick review of prerequisite concepts studied in accounting and economics, two courses that are important for understanding finance. In Part II, we lay the foundation for understanding valuation through discussion of time value of money and risk-return concepts. Part III shows the value of financial securities and examines the important concept of efficient markets. In Part IV, we extend the valuation of securities to the valuation of the corporation and discuss how to create shareholder value. Part V examines specific techniques for evaluating both long-term and short-term investment opportunities for enhancing shareholder value. Part VI concludes our systematic progression by examining financial statement analysis and forecasting. Financial statement analysis shows the impact of management's investment, financing, and operating decisions on the financial position of the firm. With an understanding of what has happened, stakeholders can forecast the future financial position of the firm for enhancing shareholder value. The following annotated table of contents provides a more detailed overview.

## ANNOTATED TABLE OF CONTENTS

### PART I – INTRODUCTION

#### **1. *Introduction to Finance***

The introductory chapter lays out the principles that are important to finance, and introduces many key concepts studied in later chapters. We relate the finance function to the other functional areas of business management.

#### **2. *Review of Financial Statements***

This chapter provides an accounting review from a different perspective than found in most texts. We discuss the difference between accounting and economic profits and explain the importance of understanding cash flows. Much of the chapter revolves around discussing the annual report of Kellogg Company.

### **3. *An Overview of the Financial System***

The emphasis here is on why financial markets exist and the importance of interest rates and risk in the valuation of assets. An understanding of this chapter enhances students' understanding of time value of money in Chapter 4.

## **PART II – DETERMINANTS OF VALUE**

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### **4. *The Time Value of Money***

The focus of this chapter is on the fundamental principle of finance: Money has a time value represented by the interest cost. We solve extensive examples using formulas, tables, and calculators.

### **5. *Risk, Return, and the CAPM***

This chapter provides an understandable explanation of modern portfolio theory with several practical examples to keep students interested. The discussion includes problems associated with beta.

## **PART III – SECURITIES: MARKETS AND VALUATION**

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### **6. *Financial Markets***

The institutional framework for the issuance and trading of financing securities is the topic of this chapter.

### **7. *Fixed-Income Securities***

This chapter is full of real world examples from *The Wall Street Journal*. We discuss who issues and buys fixed-income securities and why. We also explain the tax treatment of debt interest versus the multiple taxation of dividends.

### **8. *Valuation of Fixed-Income Securities***

The basic concepts for understanding bond valuation are the focus in this chapter. Our discussion of duration is simple, but effective in showing students how it measures the sensitivity of bonds to interest rate changes.

### **9. *Common Stock and Its Valuation***

The strength of this chapter is that it successfully introduces common stock valuation concepts without becoming unnecessarily technical. We examine the debate about dividend relevancy in this chapter.

### **10. *Efficient Financial Markets***

Current theoretical and practical issues about market efficiency are the focus in this chapter. The discussion is straightforward so that students can understand the arguments for and against efficient markets.

## **PART IV – VALUE OF THE FIRM**

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### **11. *Creating Shareholder Value***

Here we extend the discussion of security valuation to the valuation of the firm. The underlying theme revolves around the creation of shareholder value in a principal-agent paradigm.

### **12. *The Cost of Capital***

This chapter builds on the concepts of Chapter 11 by integrating value creation, cost of capital, and capital structure management in a simple but effective fashion. Illustrations show that the cost of capital is a derivative of the firm's value, and not vice versa.

### **13. Capital Structure Management**

This chapter views the management of capital structure from a practical perspective. We examine capital structure changes in both healthy and distressed firms.

## **PART V – INVESTMENT DECISIONS**

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### **14. Capital Budgeting: Decision Process and Models**

Models for aiding the value-creating decision process are the theme of this chapter. We stress the advantage of net present value analysis over other approaches.

### **15. Capital Budgeting: Identifying Relevant Cash Flows**

This chapter allows students to understand the relevant cash flows in a variety of capital budgeting situations. It is a chapter of applications.

### **16. Short-Term Business Investment**

The focus of this chapter is twofold. First, we present value-enhancing decision models for determining investment in cash, accounts receivable, and inventory. Second, we examine techniques for monitoring the investment in these accounts.

### **17. Short-Term Financing**

This chapter discusses the use of operating, seasonal, and bridge loans to support the firm's short-term investments. There is extensive discussion of the use of financial ratios to measure liquidity risk of the firm.

## **PART VI – FINANCIAL ANALYSIS AND FORECASTING**

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### **18. Financial Statement Analysis**

The discussion of financial statement analysis in this chapter helps tie together many concepts discussed earlier in the text. By waiting until the last part of the text to study financial statement analysis, students have a better appreciation of the underlying concepts and interpretation of the statements and ratios.

### **19. Financial Planning**

This concluding chapter utilizes many of the financial ratios and techniques discussed earlier in the text to show how to forecast the firm's financial performance and position over the near future. The discussion reminds students of the importance of the economic and financial environments, and the guideposts to use in directing management decisions in the shareholder value-enhancing process.



## **IMPORTANT FEATURES**

Now that you have a better understanding of our approach to the introductory finance class, let us point out some important features you will find in the book.

- Each chapter begins with learning objectives and concludes with a detailed summary for students to review chapter contents quickly.
- There are only 19 chapters, thereby eliminating topics most instructors seldom cover in the introductory course (for example, mergers and acquisitions, and derivative securities).

- The vocabulary is readable and understandable to the average student. We bold-face key terms when we first use them, and also define them in the margin.
- *Comprehension Checks* at the end of each major section in a chapter allow students to check their understanding of the material.
- There is extensive use of graphs, tables, and illustrations to help demonstrate concepts and minimize the use of complex formulas. We explain all formulas by means of illustrations.
- Each chapter has at least one *Financial Reality* reading that allows students to see the importance of finance through articles published in leading business journals and newspapers.
- All but two chapters have an *Executive Commentary* that outlines a practicing executive's view of some aspect of finance discussed in the chapter.
- The use of a valuation approach, rather than a balance sheet approach, allows us to link concepts to the shareholder wealth-maximization principle. For example, we show that cost of capital is a derivative of firm value and not vice versa as implied in many texts.
- We introduce financial ratios as needed, as opposed to discussing all of them early in the text without showing their relationship to important financial concepts.
- International finance topics appear throughout the text, rather than isolated in appendices or boxes, and are highlighted by global icons.
- Each chapter has an average of 35 problems, including library assignments and *Disclosure* database assignments. Each chapter (except the first) has a comprehensive problem that integrates concepts and issues examined in the chapter.

## SUPPLEMENTAL MATERIALS



There is the usual complement of supplemental materials accompanying this book. In addition, there are two new features: electronic transparencies for instructors who are computerizing their classroom delivery, and a computerized study guide for students who want access to a multitude of practice problems. A brief description of the supplemental materials follows.

***Instructor's Manual*** The instructor's manual provides a lecture outline, teaching tips, quizzes designed to easily test students' comprehension of content, and detailed problem solutions which have been independently checked for accuracy.

***Text Bank*** Prentice Hall Test Manager provides individual tailoring of midterm and final examinations from a database of over 2000 questions and problems. This computerized test bank allows you to add and edit test questions, and assemble and save tests. Test scrambling options provide an almost infinite number of test versions.

***Transparencies*** Over 100 transparencies are available to facilitate instruction and learning by making it easy for instructors to present key concepts from the text.

***Electronic Transparencies*** Designed by Darrell Crutchley, Auburn University. Each chapter's *Comprehensive Problem* is on electronic transparencies. An instructor can teach the major concepts of the chapter using the comprehensive problem set. Many of the transparencies overlay to show the buildup of important concepts and answers.

***Study Guide*** Written by Stanley Jacobs, Central Washington University. The study guide is consistent in question content and structure with the text. Each chapter con-



tains suggestions for chapter study, a summary of key concepts, illustrative examples, multiple-choice and true-false questions keyed to chapter objectives in the text, problems keyed to objectives, and fully worked solutions to study guide problems.

**Finance A+** This electronic study guide operates in the Microsoft Windows® environment. Students can test their understanding of concepts and problems through true-false, multiple choice, numerical, and graphical questions. The software provides hints for correcting wrong answers. It also automatically grades performance and lists topics needing further study.

**ABC/Prentice Hall Video Library Cases** Written by John Byrd, Fort Lewis College. All but two chapters have video cases specifically written for the chapter. Each case's discussion questions relate the video to concepts and issues discussed in the textbook.



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Enjoy the book.

George W. Gallinger  
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