清华金融学系列英文版教材

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公司理财学基础

财务管理逻辑和实践

第 4 版

(美) Arthur J. Keown, John D. Martin
J. William Petty, David F. Scott, Jr. 著

Foundations of Finance

The Logic and Practice of Financial Management

Fourth Edition

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EISBN: 0-13-047982-9

图书在版编目(CIP)数据

公司理财学基础：财务管理逻辑和实践 = Foundations of Finance: The Logic and Practice of Financial Management：第 4 版：英文 /（美）基翁(Keown, A. J.)等著. —影印本. —北京：清华大学出版社，2004.8
（清华金融学系列英文版教材）
ISBN 7-302-08996-5

Ⅰ. 公…　Ⅱ. 基…　Ⅲ. 公司—财务管理—高等学校—教材—英文　Ⅳ. F276.6

中国版本图书馆 CIP 数据核字（2004）第 066361 号

出 版 者：清华大学出版社
http://www.tup.com.cn
社总机：（010）6277 0175
地　　址：北京清华大学学研大厦
邮　　编：100084
客户服务：（010）6277 6969
责任编辑：江　娅
印 刷 者：北京四季青印刷厂
装 订 者：三河市兴旺装订有限公司
发 行 者：新华书店总店北京发行所
开　　本：203×260　**印张**：37.75
版　　次：2004 年 8 月第 1 版　2004 年 8 月第 1 次印刷
书　　号：ISBN 7-302-08996-5/F・841
印　　数：1~5000
定　　价：55.00 元

出 版 说 明

为了适应经济全球化的发展趋势，满足国内广大读者了解、学习和借鉴国外先进的管理经验和掌握经济理论的前沿动态，清华大学出版社与国外著名出版公司合作影印出版一系列英文版经济管理方面的图书。我们所选择的图书，基本上是已再版多次、在国外深受欢迎、并被广泛采用的优秀教材，绝大部分是该领域中较具权威性的经典之作。在选书的过程中，我们得到了很多专家、学者的支持、帮助和鼓励，在此表示谢意！清华金融学系列英文版教材由清华大学经济管理学院和北京大学经济学院朱武祥、刘群艺、宋逢明、杨炘等老师审阅，在此一并致谢！

由于原作者所处国家的政治、经济和文化背景等与我国不同，对书中所持观点，敬请广大读者在阅读过程中注意加以分析和鉴别。

我们期望这套影印书的出版对我国经济科学的发展能有所帮助，对我国经济管理专业的教学能有所促进。

欢迎广大读者给我们提出宝贵的意见和建议；同时也欢迎有关的专业人士向我们推荐您所接触到的国外优秀图书。

清华大学出版社经管事业部

2004.6

总序

世纪之交，中国与世界的发展呈现最显著的两大趋势——以网络为代表的信息技术的突飞猛进，以及经济全球化的激烈挑战。无论是无远弗界的因特网，还是日益密切的政治、经济、文化等方面的国际合作，都标示着21世纪的中国是一个更加开放的中国，也面临着一个更加开放的世界。

教育，特别是管理教育总是扮演着学习与合作的先行者的角色。改革开放以来，尤其是20世纪90年代之后，为了探寻中国国情与国际上一切优秀的管理教育思想、方法和手段的完美结合，为了更好地培养高层次的“面向国际市场竞争、具备国际经营头脑”的管理者，我国的教育机构与美国、欧洲、澳洲以及亚洲一些国家和地区的大量的著名管理学院和顶尖跨国企业建立了长期密切的合作关系。以清华大学经济管理学院为例，2000年，学院顾问委员会成立，并于10月举行了第一次会议，2001年4月又举行了第二次会议。这个顾问委员会包括了世界上最大的一些跨国公司和中国几家顶尖企业的最高领导人，其阵容之大、层次之高，超过了世界上任何一所商学院。在这样高层次、多样化、重实效的管理教育国际合作中，教师和学生与国外的交流机会大幅度增加，越来越深刻地融入到全球性的教育、文化和思想观念的时代变革中，我们的管理教育工作者和经济管理学习者，更加真切地体验到这个世界正发生着深刻的变化，也更主动地探寻和把握着世界经济发展和跨国企业运作的脉搏。

我国管理教育的发展，闭关锁国、闭门造车是绝对不行的，必须同国际接轨，按照国际一流的水准来要求自己。正如朱镕基总理在清华大学经济管理学院成立十周年时所发的贺信中指出的那样：“建设有中国特色的社会主义，需要一大批掌握市场经济的一般规律，熟悉其运行规则，而又了解中国企业实情的经济管理人才。清华大学经济管理学院就要敢于借鉴、引进世界上一切优秀的经济管理学院的教学内容、方法和手段，结合中国的国情，办成世界第一流的经管学院。”作为达到世界一流的一个重要基础，朱镕基总理多次建议清华的MBA教育要加强英语教学。我体会，这不仅因为英语是当今世界交往中重要的语言工具，是连接中国与世界的重要桥梁和媒介，而且更是中国经济管理人才参与国际竞争，加强国际合作，实现中国企业的国际战略的基石。推动和实行英文教学并不是目的，真正的目的在于培养学生——这些未来的企业家——能够具备同国际竞争对手、合作伙伴沟通和对抗的能力。按照这一要求，清华大学经济管理学院正在不断推动英语教学的步伐，使得英语不仅是一门需要学习的核心

课程，而且渗透到各门专业课程的学习当中。

课堂讲授之外，课前课后的大量英文原版著作、案例的阅读对于提高学生的英文水平也是非常关键的。这不仅是积累相当的专业词汇的重要手段，而且是对学习者思维方式的有效训练。

我们知道，就阅读而言，学习和借鉴国外先进的管理经验和掌握经济理论动态，或是阅读翻译作品，或是阅读原著。前者属于间接阅读，后者属于直接阅读。直接阅读取决于读者的外文阅读能力，有较高外语水平的读者当然喜欢直接阅读原著，这样不仅可以避免因译者的疏忽或水平所限而造成的纰漏，同时也可以尽享原作者思想的真实表达。而对于那些有一定外语基础，但又不能完全独立阅读国外原著的读者来说，外文的阅读能力是需要加强培养和训练的，尤其是专业外语的阅读能力更是如此。如果一个人永远不接触专业外版图书，他在获得国外学术信息方面就永远会比别人差半年甚至一年的时间，他就会在无形中减弱自己的竞争能力。因此，我们认为，有一定外语基础的读者，都应该尝试一下阅读外文原版，只要努力并坚持，就一定能过了这道关，到那时就能体验到直接阅读的妙处了。

在掌握大量术语的同时，我们更看重读者在阅读英文原版著作时对于西方管理者或研究者的思维方式的学习和体会。我认为，原汁原味的世界级大师富有特色的表达方式背后，反映了思维习惯，反映了思想精髓，反映了文化特征，也反映了战略偏好。知己知彼，对于跨文化的管理思想、方法的学习，一定要熟悉这些思想、方法所孕育、成长的文化土壤，这样，有朝一日才能真正“具备国际战略头脑”。

以往，普通读者购买和阅读英文原版还有一个书价的障碍。一本外版书少则几十美元，多则上百美元，一般读者只能望书兴叹。随着全球经济合作步伐的加快，目前在出版行业有了一种新的合作出版的方式，即外文影印版，其价格几乎与国内同类图书持平。这样一来，读者可以不必再为书价发愁。清华大学出版社这些年在这方面一直以独特的优势领先于同行。早在1997年，清华大学出版社敢为人先，在国内最早推出一批优秀商学英文版教材，规模宏大，在企业界和管理教育界引起不小的轰动，更使国内莘莘学子受益良多。

为了配合清华大学经济管理学院推动英文授课的急需，也为了向全国更多的MBA试点院校和更多的经济管理学院的教师和学生提供学习上的支持，清华大学出版社再次隆重推出与世界著名出版集团合作的英文原版影印商学教科书，也使广大工商界人士、经济管理类学生享用到最新最好质优价廉的国际教材。

祝愿我国的管理教育事业在社会各界的大力支持和关心下不断发展、日进日新；祝愿我国的经济建设在不断涌现的大批高层次的面向国际市场竞争、具备国际经营头脑的管理者的勉力经营下早日中兴。

赵纯均 教授

清华大学经济管理学院院长

全国工商管理硕士教育指导委员会副主任

To my parents, from whom I learned the most.

Arthur J. Keown

In loving memory of my mother, who was ever encouraging, and to my father, whose life I seek to emulate.

John D. Martin

To Donna, a great wife, a dedicated mother, and a fun grandmother called Nonna.

J. William Petty

To my family, friends, and financial and professional supporters who have been ever so encouraging, entertaining, and understanding about my career.

David F. Scott, Jr.

About the Authors

Arthur J. Keown is the R. B. Pamplin Professor of Finance at Virginia Polytechnic Institute and State University. He received his bachelor's degree from Ohio Wesleyan University, his M.B.A. from the University of Michigan, and his doctorate from Indiana University. An award-winning teacher, he is a member of the Academy of Teaching Excellence, has received five Certificates of Teaching Excellence at Virginia Tech, the W. E. Wine Award for Teaching Excellence, the Alumni Teaching Excellence Award, and in 1999 received the Outstanding Faculty Award from the State of Virginia. Professor Keown is widely published in academic journals. His work has appeared in *The Journal of Finance*, the *Journal of Financial Economics*, the *Journal of Financial and Quantitative Analysis, The Journal of Financial Research*, the *Journal of Banking and Finance, Financial Management*, the *Journal of Portfolio Management*, and many others. In addition to *Foundations of Finance*, two other of his books are widely used in college finance classes all over the country—*Basic Financial Management* and *Personal Finance: Turning Money into Wealth*. Professor Keown is a Fellow of the Decision Sciences Institute, a member of the Board of Directors of the Financial Management Association, and former head of the finance department. In addition, he recently served as the co-editor of *The Journal of Financial Research* for six and a half years and is presently the co-editor of the Financial Management Association's *Survey and Synthesis* series. He lives with his wife and two children in Blacksburg, Virginia, where he collects original art from *Mad Magazine*.

John D. Martin is Professor of Finance and the holder of the Carr P. Collins Chair of Finance at Baylor University. Dr. Martin came to Baylor University in 1998 from the University of Texas at Austin where he taught for nineteen years and was the Margaret and Eugene McDermott Centennial Professor of Finance. He teaches corporate finance and his research interests are in corporate governance, the evaluation of firm performance, and the design of incentive compensation plans. Dr. Martin has published widely in academic journals including the *Journal of Financial Economics, The Journal of Finance, Journal of Monetary Economics, Journal of Financial and Quantitative Analysis, Journal of Corporate Finance, Financial Management,* and *Management Science*. His work has also appeared in a number of professional publications including *Directors and Boards*, the *Financial Analysts' Journal*, the *Journal of Portfolio Management*, and the *Journal of Applied Corporate Finance*. In addition to this book Dr. Martin is co-author of nine books including *Financial Management* (*9th ed.*, Prentice Hall), *The Theory of Finance* (Dryden Press), *Financial Analysis* (*2nd ed.*, McGraw Hill), *Value Based Management* (Harvard Business School Press), and he is currently writing a book on interest rate modeling. He serves on the editorial boards of eight journals and has delivered executive education programs for a number of firms including Shell Chemical, Shell E&P, Texas Instruments, and The Associates.

J. William Petty is Professor of Finance and the W. W. Caruth Chairholder of Entrepreneurship at Baylor University. He holds a Ph.D. and M.B.A. from the

University of Texas at Austin, and a B.S. from Abilene Christian University. He has taught at Virginia Tech University, Texas Tech University, and served as the dean of the business school at Abilene Christian University. His research interests include the creation and financing of high-potential entrepreneurial firms and shareholder value based management. He is also the Director of the Entrepreneurship Program at Baylor University. He has served as the co-editor for the *Journal of Financial Research* and the editor of the *Journal of Entrepreneurial and Small Business Finance*. He has published in a number of finance journals and is the co-author of two leading corporate finance textbooks, *Basic Financial Management* and *Foundations of Finance*, and co-author of a widely used text, *Small Business Management*. Dr. Petty serves on the board of a publicly-traded oil and gas firm. He has also served as a subject matter expert on a best-practices study by the American Productivity and Quality Center on the topic of shareholder value-based management. He recently served on a research team for the Australian Department of Industry to study the feasibility of establishing a public equity market for small and medium-sized enterprises in Australia.

David F. Scott Jr. received his Ph.D. from the University of Florida, an M.B.A. from the University of Detroit, and a B.S.B.A. from the University of Akron. He holds the Phillips-Schenck Chair in American Private Enterprise, is Executive Director of the Dr. Phillips Institute for the Study of American Business Activity, and is Professor of Finance at the University of Central Florida. From 1977 to 1982 he was Area Coordinator, then Head, Department of Finance, Insurance, and Business Law at Virginia Polytechnic Institute and State University. During 1985–1986 he was President of the Financial Management Association, an international group with 9,000 members. He was a member of the Board of Trustees of FMA from 1986 to 1993.

Dr. Scott is a member of the Board of Directors of CompBenefits Corporation, headquartered in Atlanta, Georgia. He is a past member of the local Board of Directors of BankFIRST-Goldenrod (Florida), that specializes in commercial banking services for small businesses. He served on the Investment Policy Committee of the University of Central Florida Foundation for over 10 years. Dr. Scott is also past founding co-editor of the *Journal of Financial Research*, past associate editor for the *Akron Business and Economic Review*, and past associate editor for *Financial Management*. He is past president of the Southern Finance Association. In addition to *Foundations of Finance*, Dr. Scott is co-author of *Basic Financial Management, Cases in Finance,* and *Guide to Financial Analysis*. He is widely published in academic journals including *Financial Management, Engineering Economist, Journal of Financial and Quantitative Analysis, Business Economics,* and many others.

Dr. Scott's op-ed and research pieces have appeared in several leading outlets intended for consumer and practitioner audiences. These include *USA Today, The Miami Herald, The St. Petersburg Times, Florida Today, Orlando Sentinel,* and *Florida Trend.*

Preface

In finance, our goal is to create wealth. This is done by providing customers with the best product and service possible, and it is the market response that determines whether we reach our goal. We are very proud of the market reaction to *Foundations of Finance;* the market's response has been overwhelming. With its success comes an even greater responsibility to deliver the finest possible textbook and supplementary package possible. We have done this with a 2-pronged approach of refinement, based upon users' comments, and of remaining the innovative leaders in the field, focusing on value-added innovations.

Foundations of Finance has gained the reputation for being 'intuitive'—allowing the reader 'to see the forest through the trees'—and 'lively and easy to read.' In the fourth edition of *Foundations of Finance,* we have tried to build upon these strengths, introducing the latest concepts and developments in finance in a practical and intuitive manner.

Pedagogy That Works

This book provides students with a conceptual understanding of the financial decision-making process, rather than just an introduction to the tools and techniques of finance. For the student, it is all too easy to lose sight of the logic that drives finance and focus instead on memorizing formulas and procedures. As a result, students have a difficult time understanding the interrelationships among the topics covered. Moreover, later in life when the problems encountered do not match the textbook presentation, students may find themselves unprepared to abstract from what they learned. To overcome this problem, the opening chapter presents 10 underlying principles of finance, which serve as a springboard for the chapters and topics that follow. In essence, the student is presented with a cohesive, interrelated perspective from which future problems can be approached.

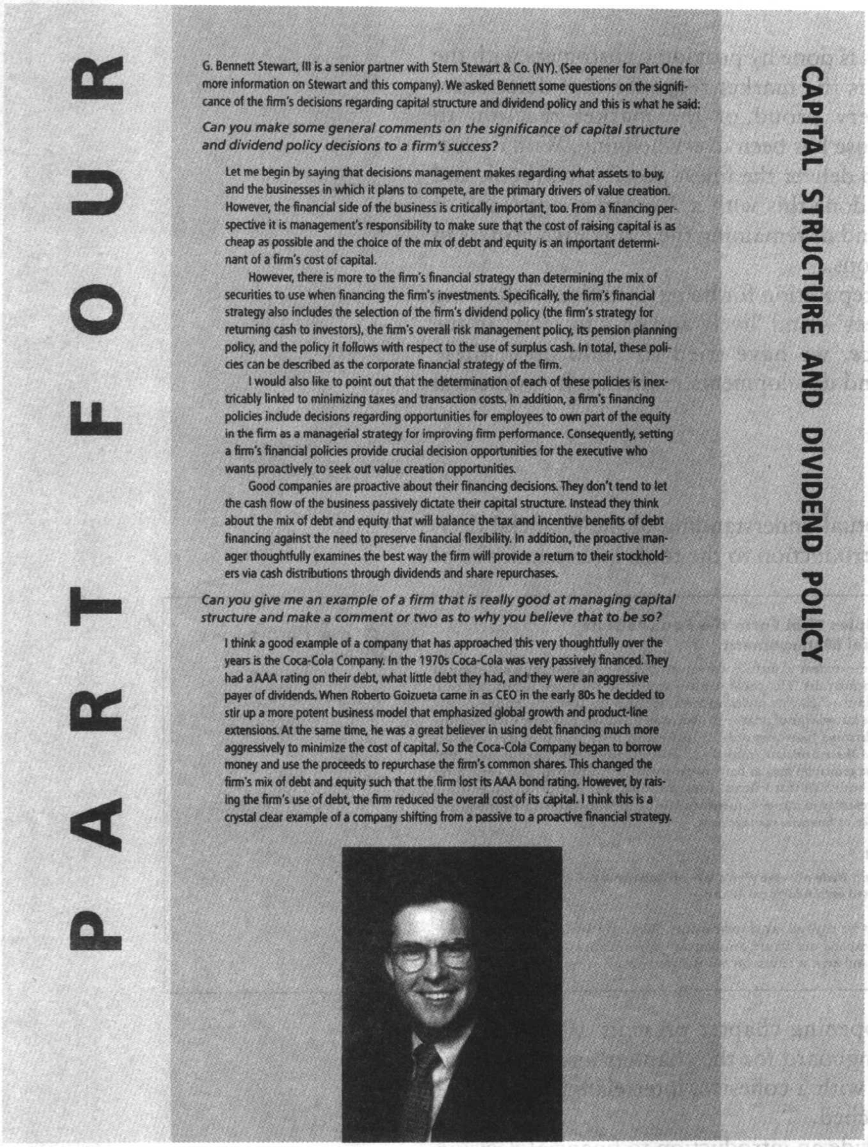
> **Ten Principles That Form the Foundations of Financial Management**
>
> 5 OBJECTIVE
>
> To the first-time student of finance, the subject matter may seem like a collection of unrelated decision rules. This could not be further from the truth. In fact, our decision rules, and the logic that underlies them, spring from 10 simple principles that do not require knowledge of finance to understand. *However, although it is not necessary to understand finance in order to understand these principles, it is necessary to understand these principles in order to understand finance.* Keep in mind that although these principles may at first appear simple or even trivial, they provide the driving force behind all that follows. These principles weave together concepts and techniques presented in this text, thereby allowing us to focus on the logic underlying the practice of financial management.
>
> **PRINCIPLE 1**
>
> **The Risk–Return Trade-off—We Won't Take on Additional Risk Unless We Expect to Be Compensated with Additional Return**
>
> At some point we have all saved some money. Why have we done this? The answer is simple: to expand our future consumption opportunities. We are able to invest those saving and earn a return on our dollars because some people would rather

With a focus on 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 is perhaps most apparent in the attention given 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 problems that face the financial manager. The goal of this text is not merely to teach the tools of a discipline or trade but also to enable students to abstract what is learned to new and yet unforeseen problems—in short, to educate the student in finance.

Innovations and Distinctive Features in the Fourth Edition

Part-opening Interviews with Business Professionals

These give students in-the-trenches insights into the application of theory to practice in the real world and provide perspective for *anyone* who is planning a career in business.



PART FOUR

CAPITAL STRUCTURE AND DIVIDEND POLICY

G. Bennett Stewart, III is a senior partner with Stern Stewart & Co. (NY). (See opener for Part One for more information on Stewart and this company). We asked Bennett some questions on the significance of the firm's decisions regarding capital structure and dividend policy and this is what he said:

Can you make some general comments on the significance of capital structure and dividend policy decisions to a firm's success?

Let me begin by saying that decisions management makes regarding what assets to buy, and the businesses in which it plans to compete, are the primary drivers of value creation. However, the financial side of the business is critically important, too. From a financing perspective it is management's responsibility to make sure that the cost of raising capital is as cheap as possible and the choice of the mix of debt and equity is an important determinant of a firm's cost of capital.

However, there is more to the firm's financial strategy than determining the mix of securities to use when financing the firm's investments. Specifically, the firm's financial strategy also includes the selection of the firm's dividend policy (the firm's strategy for returning cash to investors), the firm's overall risk management policy, its pension planning policy, and the policy it follows with respect to the use of surplus cash. In total, these policies can be described as the corporate financial strategy of the firm.

I would also like to point out that the determination of each of these policies is inextricably linked to minimizing taxes and transaction costs. In addition, a firm's financing policies include decisions regarding opportunities for employees to own part of the equity in the firm as a managerial strategy for improving firm performance. Consequently, setting a firm's financial policies provide crucial decision opportunities for the executive who wants proactively to seek out value creation opportunities.

Good companies are proactive about their financing decisions. They don't tend to let the cash flow of the business passively dictate their capital structure. Instead they think about the mix of debt and equity that will balance the tax and incentive benefits of debt financing against the need to preserve financial flexibility. In addition, the proactive manager thoughtfully examines the best way the firm will provide a return to their stockholders via cash distributions through dividends and share repurchases.

Can you give me an example of a firm that is really good at managing capital structure and make a comment or two as to why you believe that to be so?

I think a good example of a company that has approached this very thoughtfully over the years is the Coca-Cola Company. In the 1970s Coca-Cola was very passively financed. They had a AAA rating on their debt, what little debt they had, and they were an aggressive payer of dividends. When Roberto Goizueta came in as CEO in the early 80s he decided to stir up a more potent business model that emphasized global growth and product-line extensions. At the same time, he was a great believer in using debt financing much more aggressively to minimize the cost of capital. So the Coca-Cola Company began to borrow money and use the proceeds to repurchase the firm's common shares. This changed the firm's mix of debt and equity such that the firm lost its AAA bond rating. However, by raising the firm's use of debt, the firm reduced the overall cost of its capital. I think this is a crystal clear example of a company shifting from a passive to a proactive financial strategy.

Lessons Learned from the Downfall of Enron

Three new boxes have been introduced in Chapter 1, along with boxes in Chapters 3, 6, and 11, dealing with lessons learned from the downfall of Enron.

Excel Spreadsheets

Excel spreadsheets have been introduced to move money through time, deal with valuation of financial assets, and evaluate capital budgeting projects. These spreadsheet solutions are integrated throughout the text with spreadsheet problems now appearing at the end of various chapters, where appropriate.

Options in Capital Budgeting

A new section on options in capital budgeting has been added to Chapter 10.

Introduction of an Integrated Learning System

The text is organized around the learning objectives that appear at the beginning of each chapter to provide the instructor and student with an easy-to-use integrated learning system. Numbered icons identifying each objective appear next to the related material throughout the text and in the summary, allowing easy location of material related to each objective.

Real-World Opening Vignettes

Each chapter begins with a story about a current, real-world company faced with a financial decision related to the chapter material that follows. These vignettes have been carefully prepared to stimulate student interest in the topic to come and can be used as a lecture tool to provoke class discussion.

What's Ahead

In this chapter, we lay a foundation for the entire book by discussing what finance is and then explaining the key goal that guides financial decision making: maximization of shareholder wealth. We discuss the legal and tax environment of financial decisions and describe the golden thread that ties everything together: the 10 basic principles of finance. Finally, we briefly look at what has led to the rise in multinational corporations.

What's Ahead

These features allow students to preview what's coming up in the chapter. They include real-world examples to help students understand the relevance of the concepts to the financial world.

Pause and Reflect

In-text inserts appear throughout and focus the student's attention on 'the big picture.' These inserts help students identify the interrelationships and motivating factors behind core concepts.

Pause & Reflect

The first Chinese symbol shown here represents danger, the second stands for opportunity. The Chinese define risk as the combination of danger and opportunity. Greater risk, according to the Chinese, means we have greater opportunity to do well, but also greater danger of doing badly.

危機

EXAMPLE How much must we deposit in an 8 percent savings account at the end of each year to accumulate \$5,000 at the end of 10 years? Substituting the values FV_{10} = \$5,000, n = 10, and i = 8 percent into equation (5-8), we find

$$\$5{,}000 = PMT\left[\sum_{t=0}^{10-1}(1+.08)^t\right] = PMT(FVIFA_{8\%,\ 10\ \text{yr}})$$

$$\$5{,}000 = PMT(14.487)$$

$$\frac{\$5{,}000}{14.487} = PMT$$

$$\$345.14 = PMT$$

Thus, we must deposit \$345.14 per year for 10 years at 8 percent to accumulate \$5,000.

Integrated Examples

These provide students with real-world examples to help them apply the concepts presented in each chapter.

Extensive Coverage of Ethics

Ethics is covered as a core principle and *Ethics in Financial Management* boxes appear throughout. These show students that ethical behavior is doing the right thing and that ethical dilemmas are everywhere in finance.

Ethics in Financial Management

The Financial Downside to Poor Ethical Behavior

As we learned in **Principle 10: Ethical Behavior is Doing the Right Thing, and Ethical Dilemmas Are Everywhere in Finance**. Knowing the inevitable outcome—for truth does percolate—why do bright and experienced people ignore it? For even if the truth is known only within the confines of the company, it will out. Circumstances beyond even the best manager's control take over once the chance has passed to act on the moment of truth.

Johns Manville learned of the "crunching" lungs of asbestos workers in the 1930s, as reflected in the minutes of its board meetings. Instead of working on product development, warnings or even safety equipment, the company forged onward with a strategy of trying to keep the scientific community from disclosing its findings and of limiting the increasing numbers of plaintiffs by settlements for silence.

Dow Corning didn't deserve its bankruptcy or the multibillion-dollar settlements for its silicone implants because the science didn't support the alleged damages. However, there was a moment of truth when those implants, placed on a blotter, left a stain. The company could have disclosed the possible leakage, researched the risk, and warned doctors and patients. Given the congressional testimony on the implants, many women would have chosen them despite the risk. Instead, they sued because they were not warned.

Beech-Nut's crisis was a chemical concoction instead of apple juice in its baby food products. Executives there ignored an in-house chemist who tried to tell them they were selling adulterated products. Kidder-Peabody fell despite warnings from employees about a glitch in its accounting system that was reporting bond swaps as sales and income.

These cases all have several things in common. First, their moments of truth came and went while the companies took no action. Second, employees who raised the issue were ignored, or, in some cases, fired. Third, there were lawyers along for the ride, as they have been with Ford and Firestone.

Never rely on a lawyer in these moments of truth. Lawyers give controlling legal authority but are not particularly good at controlling damage. Lawyers shouldn't make business decisions; moments of truth require managers. More importantly, moments of truth require managers with strong ethics who will do more than the law requires and less than the law allows.

As a now infamous memo reveals, Ford and Firestone did not feel obligated to reveal to the U.S. Transportation Department that certain tires were being recalled in overseas markets. The companies should have realized that it was not a question of whether the recall would be reported, but by whom.

Do businesses ever face the moment of truth wisely? One great example is James Burke, CEO of Johnson & Johnson at the time of the 1982 Tylenol capsule scare. The minute Tylenol was linked to the cyanide poisonings, Johnson & Johnson recalled and destroyed 31 million bottles of the product, at a cost of \$100 million, and Mr. Burke bent over backward to deal openly and forthrightly with the media and public. The result was one of the best crisis-management performances in history; the company won back nearly all its customers.

Source *The Wall Street Journal*, "Manager's Journal: Ford-Firestone Lesson Heed the Moment of Truth," September 11, 2000, page A44. Copyright © 2000, Dow Jones & Company, Inc. Reproduced with permission of DOW JONES & CO INC in the format Textbook via Copyright Clearance Center

Concept Check

1. What features of common stock indicate ownership in the corporation versus preferred stock or bonds?
2. What are the two ways that a shareholder benefits from ownership?
3. How does internal growth versus the infusion of new capital affect the original shareholders?
4. If a corporation decides to retain its earnings, when will the value of the market price actually decrease?
5. What is the three-step process for common stock valuation?

Concept Checks

At the end of most major sections, concept checks highlight the key ideas just presented and allow students to test their understanding of the material.

Back to the Foundations

These in-text inserts appear throughout to allow the student to take time out and reflect upon the meaning of the material just presented. The use of these inserts, coupled with the use of the 10 principles, keeps the student focused on the interrelationships and motivating factors behind the concepts.

Back to the Foundations

Valuing common stock is no different from valuing preferred stock; only the pattern of the cash flows changes. Thus, the valuation of common stock relies on the same three principles developed in Chapter 1 that were used in valuing preferred stock.

Principle 1: **The Risk–Return Trade-off—We Won't Take on Additional Risk Unless We Expect to Be Compensated with Additional Return.**

Principle 2: **The Time Value of Money—A Dollar Received Today is Worth More Than a Dollar Received in the Future.**

Principle 3: **Cash—Not Profits—Is King.**

Determining the economic worth or value of an asset always relies on these three principles. Without them, we would have no basis for explaining value. With them, we can know that the amount and timing of cash, not earnings, drives value. Also, we must be rewarded for taking risk, otherwise, we will not invest.

Comprehensive Problem

It's been 2 months since you took a position as an assistant financial analyst at Caledonia Products. Although your boss has been pleased with your work, he is still a bit hesitant about unleashing you without supervision. Your next assignment involves both the calculation of the cash flows associated with a new investment under consideration and the evaluation of several mutually exclusive projects. Given your lack of tenure at Caledonia, you have been asked not only to provide a recommendation, but also to respond to a number of questions aimed at judging your understanding of the capital-budgeting process. The memorandum you received outlining your assignment follows:

TO: The Assistant Financial Analyst
FROM: Mr. V. Morrison, CEO, Caledonia Products
RE: Cash Flow Analysis and Capital Rationing

We are considering the introduction of a new product. Currently we are in the 34-percent marginal tax bracket with a 15-percent required rate of return or cost of capital. This project is expected to last 5 years and then, because this is somewhat of a fad project, to be terminated. The following information describes the new project:

Cost of new plant and equipment: $7,900,000
Shipping and installation costs: $ 100,000

Unit Sales	**Year**	**Units Sold**
	1	70,000
	2	120,000
	3	140,000
	4	80,000
	5	60,000

Sales price per unit: $300/unit in years 1 through 4, $260/unit in year 5

Variable cost per unit: $180/unit

Annual fixed costs: $200,000

Working-capital requirements: There will be an initial working-capital requirement of $100,000 just to get production started. For each year, the total investment in net working capital will be equal to 10 percent of the dollar value of sales for that year. Thus, the investment in working capital will increase during years 1 through 3, then decrease in year 4. Finally, all working capital is liquidated at the termination of the project at the end of year 5.

The depreciation method: Use the simplified straight-line method over 5 years. It is assumed that the plant and equipment will have no salvage value after 5 years

a. Should Caledonia focus on cash flows or accounting profits in making our capital-budgeting decisions? Should we be interested in incremental cash flows, incremental profits, total free cash flows, or total profits?
b. How does depreciation affect free cash flows?
c. How do sunk costs affect the determination of cash flows?

Comprehensive End-of-Chapter Problems

A comprehensive problem appears at the end of almost every chapter, covering all the major topics included in that chapter. This comprehensive problem can be used as a lecture or review tool by the professor. For the student, it provides an opportunity to apply all the concepts presented within the chapter in a realistic setting, thereby strengthening their understanding of the material.

Key Terms Identified in the Margins

Key terms are called out in the margin and highlighted in the text. They can also be found in the glossary in the back of the book with definitions, making it easier for the student to check their understanding of key terms. At the end of each chapter, key terms are listed along with page numbers as a study checklist for students.

Financial Calculators

The use of financial calculators has been integrated throughout this text, especially with respect to the presentation of the time value of money. Where appropriate, calculator solutions appear in the margin.

Content Updating

In response to both the continued development of financial thought and reviewer comments, changes have been made in the text. Some of these changes include:

Chapter 1 An Introduction to the Foundations of Financial Management—The Ties That Bind

This chapter was revised to reflect the impact in the carry-back, carry-forward change that resulted from the passage of the 2002 Economic Stimulus Plan. Chapter 1 also has three boxes that focus on the impact and lessons learned from the downfall of Enron. In addition, it has a new section that examines the impact of the tragedies of September 11th on corporate finance.

Chapter 2 The Financial Markets and Interest Rates

Several changes are spread throughout this chapter in response to suggestions from reviewers. The chapter opens with a review of the past five interest-rate cycles and puts this in the context of the immediate past recession that began in March 2001. It also examines how Federal Reserve monetary policy is related to the cost of capital through the *opportunity cost of funds* concept. The relationship between risk and return (Principle 1) is clarified with the incorporation of sharper and more complete graphics.

Interest rate levels and inflation rates over the 1981–2001 period are studied within the context of explaining interest rate determinants. Total returns on large-cap equities are reviewed over recent periods and are compared with returns on fixed-income securities. The significant difference between real and nominal interest rates is put into the context of a financial analyst's viewpoint on the subject. Building nominal interest rates through the technique of risk premiums is illustrated and reviewed through a comprehensive end-of-chapter problem. The difference between internal and external corporate financing patterns is reviewed via recent updated data.

Chapter 3 Understanding Financial Statements and Cash Flows

At the request of adopters, the presentation of free cash flows was significantly revised to break the computations into smaller bite sizes to help the student grasp this important but somewhat difficult concept. The result was a more intuitive presentation of the meaning and calculation of free cash flows.

Chapter 4 Evaluating a Firm's Financial Performance

In the discussion on how to measure a firm's liquidity and its efficient use of working capital, a section on understanding and computing a firm's cash conversion period was added.

Chapter 5 The Time Value of Money

The major changes in Chapter 5 revolve around the introduction of Excel spreadsheets to move money through time. Now, in addition to presenting solutions to time value of money problems with financial calculators and tabular solutions, the student is introduced to a spreadsheet approach to solving time value of money problems.

Chapter 6 The Meaning and Measurement of Risk and Return

To make it more relevant and interesting to students, we used a firm they would be familiar with—The Gap—to illustrate the concepts and computations regarding market risk.

Chapters 7 Valuation and Characteristics of Bonds and 8 Valuation and Characteristics of Stock

At the suggestion of practitioner reviewers, a new section on valuing a firm based on the present value of free cash flows has been added. This is an approach that is frequently used by investment bankers to value a company.

Chapter 9 Capital-Budgeting Techniques and Practice

The use of Excel spreadsheets to solve capital budgeting problems is introduced in Chapter 9. In addition, the trial and error approach to solving IRR problems with uneven free cash flows is deemphasized, and focus is now on the spreadsheet and financial calculator approaches. A new ethics box has been introduced, as well, that deals with the financial downside of poor ethical behavior, focusing on Johns Manville, Dow Corning, Beech-Nut, Ford, and Firestone.

Chapter 10 Cash Flows and Other Topics in Capital Budgeting

Chapter 10 underwent a major revision. At the request of adopters, the calculation of free cash flows now uses a more intuitive approach. The purpose of this change is to make it easier for both the student to understand and the professor to teach. In addition, a new section was added on options in capital budgeting.

Chapter 11 The Cost of Capital

The discussion of the cost of capital has been streamlined to increase student understanding and focus on the key issues that arise in evaluating a firm's hurdle rate for new investments. We provide additional emphasis on the growing importance of the cost of capital as an element in the calculation of periodic firm performance measures like Economic Value Added.

Chapter 12 Determining the Financing Mix

At the request of reviewers the chapter has been streamlined in several places, but still retains the proper emphasis on the relationship between financial leverage use and capital structure design. A quick but complete overview of capital structure theory is included that does not stress the student and at the same time appeals to practicing managers. Real-world discussions have been added that involve the Coca-Cola Company, Harley-Davidson, Georgia-Pacific, and The Walt Disney Company.

Chapter 13 Dividend Policy and Internal Financing

This chapter adds more actual company examples and discussions. These include Starbucks Corporation, whose dividend choices are related to the "residual theory of dividend policy"; Coca-Cola Company; a new example that focuses upon Harley-Davidson's dividend policy; Ford Motor Company; and The Walt Disney Company. Several examples of stock repurchases are put forth.

Chapter 14 Financial Forecasting, Planning, and Budgeting

This is a new chapter placement for the materials covering financial forecasting, planning, and budgeting. It is now the first of three chapters that discuss working-capital management issues.

Chapter 15 Introduction to Working-Capital Management

The working-capital management chapter has been shortened and focuses on the risk–return tradeoff and the analysis of current liabilities. The discussion of the cash conversion cycle was moved up in the book to the chapter on financial statement analysis.

Chapter 16 Liquid Asset Management

The current asset management chapter has been shortened through the streamlining of the discussion of cash management. This change makes the chapter much more accessible for beginner students and provides them with an appreciation of the treasury function.

Chapter 17 International Business Finance
This chapter has been thoroughly revised to reflect changes in the international setting, including changes in the European Union resulting from the introduction of the Euro.

The Support Package

For the Student:

Study Guide Provides the following: An orientation of each chapter, along with an outline of the important topics being addressed; sample problems for the student to complete, with worked-out solutions; self-test questions (true/false and multiple choice) with answers; a tutorial on understanding the internal rate of return; and an in-depth self-teaching supplement on capital-budgeting techniques.

Companion Web Site at **www.prenhall.com/keown**. The Web site includes: online quizzes for each chapter that enable students to test their skills and receive immediate scoring; current events articles to help students see the relevance of text topics to today's news; and downloadable resources including PowerPoint presentations and virtual financial calculators.

For the Instructor:

A Test Item File provides more than 1,400 multiple-choice, true/false, and short-answer questions with complete and detailed answers. It is designed for use with the Prentice Hall Custom Test, a computerized package that allows users to custom design, save, and generate classroom exams.

NEW! TestGen EQ Testing Software This user-friendly program allows instructors to custom design, save, and generate classroom tests. The software also permits instructors to edit, add, or delete questions from the test bank; edit and create graphics; analyze test results; and organize a database of tests and student results. This new software provides many options for organizing and displaying tests along with a search and sort feature. The software can prepare 25 versions of a single test.

Companion Web Site offers academic support for faculty adopting this text. From the Web site, at **www.prenhall.com/keown**, you can download supplements and lecture aids such as instructor's manuals, lecture notes, PowerPoint presentations, problem and case solutions, and chapter outlines. Call your Prentice Hall representative to get the necessary username and password to access these digital supplements.

An Instructor's Manual containing chapter orientations, prepared by the text authors, which provide a useful point of departure for lectures; chapter outlines; and solutions to all end-of-chapter questions.

PowerPoint Lecture Notes to accompany PowerPoint graphics. These provide individual lecture outlines to accompany *Foundations of Finance*. They are class tested and can be used as is or can be easily modified to reflect your specific presentation needs.

An Instructor's Resource CD-ROM. This resource contains print and media supplements including the Instructor's Manual, Test Item File, and PowerPoints. This enables faculty to customize supplements quickly and enjoy maximum portability and accessibility.

For any teacher wanting information about the supplements, please contact the Prentice Hall representative for your area. Also, feel free to call any of the authors with any questions you may have.

Acknowledgments

We gratefully acknowledge the assistance, support, and encouragement of those individuals who have contributed to *Foundations of Finance*. Specifically, we wish to recognize the very helpful insights provided by many of our colleagues. For their careful comments and helpful reviews of the text, we are indebted to:

Ibrahim J. Affeneh
Indiana University of Pennsylvania

Sung C. Bae
Bowling Green State University

Laurey Berk
University of Wisconsin, Green Bay

Ronald W. Best
University of South Alabama

Stephen Black
University of Central Oklahoma

Laurence E. Blose
University of North Carolina, Charlotte

Robert Boldin
Indiana University of Pennsylvania

Michael Bond
Cleveland State University

Waldo L. Born
Eastern Illinois University

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St. Norbert College

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Edwin Duett
Mississippi State University

John W. Ellis
Colorado State University

Suzanne Erickson
Seattle University

Slim Feriani
George Washington University

Greg Filbeck
Miami University

Jennifer Frazier
James Madison University

Bruce Fredrikson
Syracuse University

Karen Hallows
George Mason University

Ken Halsey
Wayne State College

James D. Harriss
University of North Carolina, Wilmington

Linda C. Hittle
San Diego State University

Robert Hull
Washburn University

Joel Jankowski
University of Tampa