FOUNDATIONS OF CORPORATE FINANCE

SECOND EDITION

HICKMAN • HUNTER • BYRD

edition 2

FOUNDATIONS OF CORPORATE FINANCE

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About the Authors

Professors Hickman, Hunter, and Byrd have over 45 years experience teaching finance. Their research appears in more than 15 journals including the *Journal of Financial Economics, Financial Management*, the *Journal of Applied Corporate Finance, Financial Practice and Education*, the *Financial Review, Accounting Horizons*, the *Journal of Economic Behavior and Organization*, the *Journal of Portfolio Management, Financial Analysts Journal*, and the *Journal of the Royal Statistical Society*.

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Preface

A Message to Students

This is a book that we wanted to write. Probably all teachers at one time have said, "If I could write a book, this is how it would be." This is how we approached this book. Collectively, we have been teaching finance for over 40 years. That is not very remarkable, but it is long enough to form some opinions on how finance should be taught. This book represents a melding of our opinions.

In writing this book, we tried hard to avoid the "baby food syndrome". Some years ago, it was revealed that baby food manufacturers were putting salt and MSG into baby food so that the taste would appeal to the mother, who was, after all, making the purchasing decision. This is an example of an agency problem, one that we will deal with in the book. In this case, the mother was acting as a purchasing agent for the baby. Similarly, textbooks are meant to be read by students, but professors make the purchasing decision. It is not unreasonable, then, for textbooks to be "flavored" to appeal to professors.

We have tried our best to appeal to students. We have kept the book as short and free from clutter as possible. We have sought to explain the central ideas of finance in plain language. At the same time, we hope to pique your interest in this important, exciting, and challenging field.

You will find the book laced with illustrations and examples. They are there to help you understand and retain the most important ideas. Some are interesting, some are preposterous and some are just funny. They remind us that humor is present even in a science that deals with that most somber of commodities—money.

Most importantly, we have tried to provide a faithful representation of the field of finance. We have stripped away most of the accounting and statistics, and have replaced it with the important ideas of modern finance, most of which are younger than many of your professors. The following excerpt is from the last chapter, and sums up our commitment to this book.

> *In the first edition, we set out to write the perfect text. Then we scaled back our goal to merely writing the best finance text. Then, near the end with deadlines near, we settled for just a good text. Now, we have been given a second chance to produce something better than good. We sincerely hope that we have provided you with a solid foundation in finance. For many, this will be your only finance course. We would like to hear from you in about two years, to find out how many of these basic ideas you still retain. If you still remember the most important ones, we will have succeeded. If you don't, we will have to do better.*

You don't have to wait two years to contact us. We welcome all corrections, comments, praise and criticism. You may send an email via our web site, or you may write or phone:

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A Message to Instructors

Our aim was to write this book for the students. We assume that they come to finance with at least a vague knowledge of accounting, economics, and elementary statistics. We also assume that they have little innate desire to study finance. Therefore, rather than taking an encyclopedic approach, we develop and reinforce the essential ideas of finance. By providing a coherent and logical approach to the subject, we hope to sustain student interest in finance, build on their background, and appeal to their common sense. The financial balance sheet is a reference point for the discussion of these ideas, and each of the important ideas is explained in terms of its contribution to firm value.

Not every idea in finance is intuitive, but many are. Therefore, where possible, we appeal to students' common sense to understand the logic underlying the idea. We also lace the text with examples, some fictional and some real. We stress throughout that finance is not an abstraction, but an agglomeration of ideas that have value in the conduct of everyday business and everyday life. We hope that this approach will not only make it easier for your students to learn finance, but also easier for you to teach it. Imagine an introductory finance class in which the students learn the essential ideas with relative ease and approach the class with enthusiasm. Such a class may be as mythical as a company that maximizes wealth, but we hope that this book at least moves the teaching of finance in that direction, while at the same time maintaining the integrity of the subject matter. We entered this project with the assumption that it was possible to write a book that was both appealing and rigorous. As you guide your students through the book, you will doubtless have ideas that we could share with other instructors and that we can include in subsequent editions. Before these ideas escape, send us a note or an e-mail. We promise to respond, although that is the only extrinsic reward we can offer.

Distinguishing Features of This Text

1 *The theme of value creation is continued and reaffirmed throughout:* In the first chapter, we develop the theme of value creation and continue that throughout the text. The ideas developed in each chapter are linked to the firm's central mission of creating value for its shareholders.

2 *The Financial Balance Sheet:* A central construct, the Financial Balance Sheet is incorporated throughout the text to provide continuity between the current topic and value creation. The Financial Balance Sheet has several appealing attributes:

- It is analogous to, and contrasts with, the accounting balance sheet, an already-familiar concept to beginning finance students. This allows the instructor to directly confront one major source of confusion for students: accounting versus financial data and analysis.
- It is visual and intuitive.
- It can be used to visually characterize most financial decisions.

3 *Conceptual and intuitive:* Since our first edition promised to be intuitive in the mid-1990s, we note that many books have staked their own claims in this regard. You might try, as we have, to read excerpts from these books to see if you agree. In our opinion, far too many books are a compendium of recipes or formulas into which students plug numbers (or at least students view them as such, and the pervasiveness of hand-held financial calculators has reinforced this view). Missing from this approach is an understanding of how profits are earned, prices are set, and investment and financing decisions are made. We believe that students who understand the underlying concepts will not only be better able to apply the tools, but will also know when the tools are not appropriate.

Examples of this approach include a thorough discussion of where positive net present value projects might be found. Typically, NPV is presented as the output of a black-box formula. We believe that students should think about entry barriers or competitive advantages that will generate positive NPVs. Moreover, students should realize that profitable cash flows are unlikely to continue indefinitely. Entry barriers, firms exploiting competitive advantages, and the transitory nature of project cash flows are included in the coverage of capital budgeting, Chapter 7.

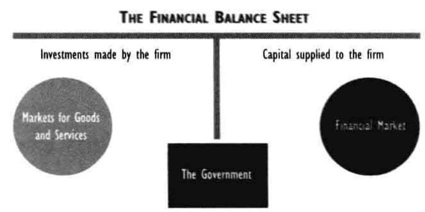
A second example is the treatment of time value. In our view, it is not enough to present students with formulas and keystrokes. In Chapter 4, we develop the formulas logically. We hope that by doing this we are giving them a few basic tools that they can adapt to solve any time value problem.

To foster the development of this intuitive understanding of financial decision making, we incorporate the following features:

- The coherent structure of the text enables the development of topics in a logical fashion and provides linkages between these topics.
- Most chapters begin with a financial balance sheet graphically highlighting the topic covered in the chapter.
- Each chapter contains an introduction that links the chapter to those preceding and following. These reinforce the structure of the text and impart to students a feel for where they're going and why they're making the journey.

CHAPTER 2 IN FOCUS

THE FINANCIAL BALANCE SHEET



In Chapter 2, the economic and regulatory environment within which the firm operates is linked to the value creation goal of the corporation.

4 *Finance in the Firm:* Our clients—businesses and students—are doing their best to get us to reduce our compartmentalized approach to teaching. They want us to explain how the various "disciplines" fit together into the coherent whole of business. It is difficult to not agree with this more eclectic approach; however most of us struggle to break out of our compartments. We have attacked this problem in two ways.

FINANCE IN THE FIRM

ACCOUNTING STATEMENTS AND THE FINANCIAL BALANCE SHEET

Profitability and show how ratios can measure a company's profitability. Explain solvency and show how ratios can measure a company's solvency. Describe leverage and show how it changes returns to stockholders. Explain some limitations of ratio analysis. Profitability and show how ratios can measure a company's profitability. Explain solvency and show how ratios can measure a company's solvency. Describe leverage and show how it changes returns to stockholders. Explain some limitations of ratio analysis. Profitability and show how ratios can measure a company's profitability. Explain solvency and show how ratios can measure a company's solvency. Describe leverage and show how it changes returns to stockholders. Explain some limitations of ratio analysis. Profitability and show how ratios can measure a company's profitability. Explain solvency and show how ratios can measure a company's solvency. Describe leverage and show how it changes returns to stockholders. Explain some limitations of ratio analysis. Profitability and show how ratios can measure a company's profitability. Explain solvency and show how ratios can measure a company's solvency. Describe leverage and show how it changes returns to stockholders. Explain some limitations of ratio analysis.

First, we have our *Finance In the Firm* boxes. Secondly, we have created Chapter 15 that shows how financial models and paradigms are applied to a wide variety of business activities.

5 *Selecting and packaging material for a single term course:* The text covers all the important topics of corporate finance, but some just briefly. We have found that many chapters of lengthy texts are not covered in a one-term introductory course. For example, chapters on bankruptcy, international finance, and small business management are often ignored. Class time devoted to topics such as cash management, inventory management, and financial ratios is usually much less than text coverage. We have designed a text that comes closer to matching the material we actually teach in our courses. For example, we summarize the important ideas of working capital management in a single chapter (Chapter 12). We feel that this approach makes it more likely that working capital will be included in the introductory course.

6 *International finance:* There is no chapter on international finance. Instead, we have integrated this topic into the text, indicated by an icon. For example, international capital markets are included in Chapter 6, and international corporate investing is included in Chapter 9. In addition, there are numerous references to international finance throughout. Covering international finance in this manner produces two benefits. First, it ensures that this important topic is covered, at least minimally. Secondly, it sends a signal to students that international finance is not separate from finance itself.

It is our belief that one cannot be informed about capital markets without understanding a little of the global markets; and that corporate investing must include consideration of foreign product markets and investment opportunities.

7 *Early emphasis on market value and cash flows:* Dealing with these topics in the early chapters establishes a link between accounting and finance and clarifies these important distinctions. Market versus book value is covered in Chapter 1. Cash flows versus earnings are covered in Chapter 3.

8 *Real options:* Real options are introduced in the text because options contracts are valuable and integral to many investment decisions. We introduce options in Chapter 2 and real options in Chapter 7.

9 *Capital markets coverage:* In keeping with the limitations of a single term course, we have a single chapter on capital markets. In it, we introduce the important ideas of portfolios, risk, and return. We try to impress upon the students that the essence of these ideas is not difficult to grasp and that they really are important. Understanding the basic nature and function of capital markets prepares finance students for more thorough coverage in later courses; and, we hope, we leave non-majors with a few useful ideas that they may apply in their personal, if not their professional, lives.

10 *A different approach to financial analysis:* In addition to ratio analysis, Chapter 13 covers the broader issues of evaluating corporate performance, including the need to search for important performance clues and to temper analysis with judgment.

11 *Capstone chapters:* This may be the only text with three capstone chapters. Corporate restructuring (Chapter 14) applies financial principles from other chapters to this important and interesting topic. Finance through the firm (Chapter 15) shows how finance is broadly applied throughout the firm. And the epilogue (Chapter 16) includes a solved case that illustrates financial decision making in a business setting.

12 *Ethical issues:* Ethical issues, indicated by an icon and integrated throughout, present some of the ethical dilemmas facing financial managers and raise sensitivities to these issues. This treatment of ethics is consistent with the AACSB's recommendation for coverage of these issues.

13 *Pedagogical aids:* In addition to those already mentioned, there are numerous other features of the text that are designed to assist the process of learning. They are:

- key terms highlighted in each chapter and listed at the end of the chapters
- calculator solutions to time value problems presented in Chapter 5
- Internet addresses and descriptions in the margins, directing students to Web sites that expand on the material being presented

www.finance.com

- Margin notes offer helpful tips and summaries of key points in the chapter
- extensive end-of-chapter questions and problems, including solved demonstration problems and Excel™ problems

Excel™

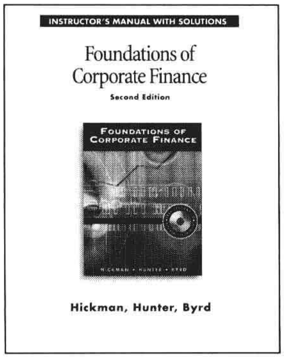
- end-of-chapter Internet exercises for further research
- a glossary of key terms, with definitions, at the end of the text
- solutions to selected end-of-chapter problems in a text appendix

Changes to the Second Edition

The first edition of this text was, in several important ways, different from most existing introductory texts. It was brief, conceptual, appealed to students' intuition and pulled together the disparate parts of finance via the financial balance sheet. We have maintained those key features in this new edition. Users of the first edition will note that we have combined Chapters 2 and 3 into a single chapter that includes an introduction to valuation and the effect of markets and government on the firm. We have also collapsed Chapters 7 and 8 on capital markets to a single Chapter 6. And, of course, we have added a new Chapter 15 on finance and the firm. To emphasize the financial balance sheet as a tool that ties together the various parts of finance, we placed at the beginning of each chapter a financial balance sheet that graphically highlights the topic covered in that chapter.

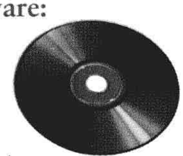
In addition to these changes, as mentioned in the "pedagogical aids" list above, we have added margin URLs and Internet exercises. Calculator keystrokes can now be found in the time value of money chapter, and ethical and global issues have been identified with icons. New "Finance In the Firm" boxes highlight the text's interdisciplinary perspective. A student CD has also been created to help students master the course.

Ancillary Materials



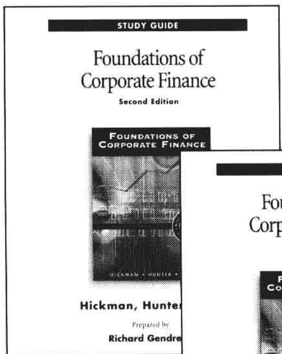
Instructor's Manual with Solutions: This includes a chapter summary, learning objectives and detailed chapter outlines with teaching tips. Solutions are provided for all end-of-chapter questions and problems.

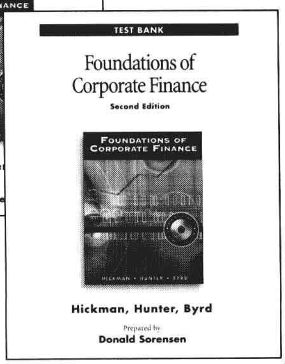
Instructor's Resource CD-ROM with ExamView Testing Software: The Instructor's CD is available to instructors and contains all supplements in electronic format plus the ExamView Testing Software. ExamView is a computerized testing program that contains all of the questions in the printed test bank and is an easy-to-use test creation software compatible with Microsoft Windows. Instructors can add or edit questions, instructions, and answers; and select questions by previewing them on the screen, selecting them randomly, or selecting them by number. Instructors can also create and administer quizzes online, whether over the Internet, a local area network, or a wide area network.



PowerPoint™: A PowerPoint Slide Presentation package, prepared by Ted Fu of Stanford University, is offered to enhance lecture materials and presents the key topics in each chapter in an electronic format.

Student CD-ROM: A Student CD-ROM comes free with every new copy of the text. It is designed to help students master the Corporate Finance course. The following are included on the CD: General Calculator Keystrokes, Financial Tables, Quizzes, Glossary, PowerPoint Lecture Slides, Spreadsheet Templates, and The Problem Bank: Practice Problems for Financial Management. The Problem Bank contains over 400 finance problems with solutions, divided into seven major categories such as Time Value of Money, Capital Budgeting, Risk and Return, etc. Solving these problems requires the use of a financial calculator and is intended to supplement the text's end-of-chapter problems, thereby providing additional practice for students in their preparation of homework assignments and for exams.





Study Guide: Written by Richard Gendreau of Bemidji State University, the Study Guide includes an outline and a variety of practice questions. Alongside the usual multiple choice, true-false and fill-in questions, there are also essays, problems, and an Internet exercise, to match virtually any testing method.

Test Bank: Donald Sorensen of the University of Wisconsin-Whitewater, prepared this ancillary. The Test Bank has been expanded for this edition to include short answer and essay questions along with true-false, multiple choice, and problems.

Web Site: **http://hickman.swcollege.com** is the address of the Web site that supports *Foundations of Corporate Finance*. The site provides teaching resources, learning resources, and an Interactive Study Center with key concepts, key terms, online quizzes, Internet applications, current updates, links to relevant finance sites, and many more features.

Excel™ Templates: These templates are customized to the end-of-chapter problem sets. They are easy to use, yet are relatively simple in design. Students are encouraged to use these as models for enhancing their own spreadsheet programming skills. Accompanying the spreadsheets is a small data set containing returns on the stocks of the 20 companies featured in Chapter 6. Students may use this data to solve capital market problems.

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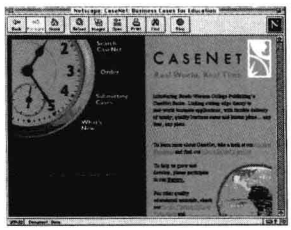
Additional Ancillary Materials

Principles of Finance: An Interactive Approach CD-ROM by Steve Wyatt, puts the user in total control of this innovative learning tool that comes complete with multimedia tutorials, interactive quizzes, simulations, a sophisticated financial calculator, links to online finance resources, and more. For more information, contact your Thomson Learning/South-Western sales representative, or visit **http://wyatt.swcollege.com**



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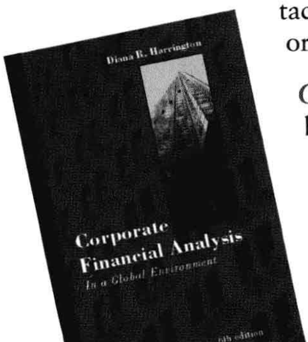

Corporate Financial Analysis in a Global Environment, by Diana Harrington. This paperback text emphasizes the financial concepts and tools essential for understanding fundamental business decisions. Harrington uses current examples of actual business situations to demonstrate how financial tools, concepts, and theories can be used by managers to create value through improved financial decision making.

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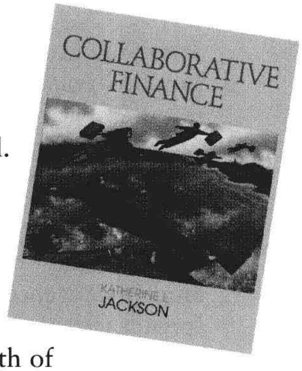
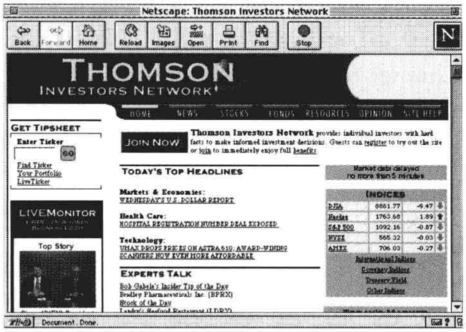
Collaborative Finance, by Katherine Jackson. Enhance the learning experience with this workbook, which introduces the team approach into finance education and offers a better understanding of why and when it is appropriate and beneficial. This book provides the resources necessary to effectively implement a variety of team projects covering the major topics of introductory finance classes.





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Acknowledgments

Reviewers are especially crucial for a book that takes a different approach to teaching finance. Our reviewers had, first, to sanction our approach, and then force us to deliver on our promises. When we went astray, they let us know. Most of all, they were a wonderfully supportive group, providing us with countless suggestions, exposing our lapses, and telling us when we got it right.

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In the preface to the first edition, we reported that the three of us survived this seemingly interminable project with friendships and marriages intact. Now, both have survived a second edition, due, in no small measure, to our wives—Gini, Maureen and Shere. To them, we again dedicate this book.

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