STUDY GUIDE TO ACCOMPANY SCHALL / HALEY

INTRODUCTION TO FINANCIAL MANAGEMENT

THOMAS E. STITZEL

SIXTH EDITION

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To Gladys, in appreciation for her friendship

Study Guide to Accompany Schall/Haley
INTRODUCTION TO FINANCIAL MANAGEMENT

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ISBN 0-07-055119-7

This book was set in Times Roman by J. M. Post Graphics, Corp.
The editors were Judy Motto and Bob Greiner;
the production supervisor was Louise Karam.
The cover was designed by Joan Greenfield.
R. R. Donnelley & Sons Company was printer and binder.

TO THE STUDENT

This book has been written to support your efforts to learn finance principles and their applications. The pages that follow are a *guide* to your *study*—material to help you better understand *Introduction to Financial Management*, sixth edition. Each *Study Guide* chapter distills concepts and major points from the textbook and gives you another pass through the subject matter.

Most people make progress in their learning by reading from or by listening to more experienced sources. The process is similar to the situation one faces in acquiring some new skill, such as hitting a golf ball or playing tennis. Your mastery of these skills suddenly improves once you "see how" by having someone else demonstrate and explain. The *Study Guide* fills this role. It presents the material covered in the textbook in a different, more concise manner. The concepts and principles are explained in the most straightforward way possible. The purpose is to give you "someone in your corner."

Quintessence

Each chapter begins with the *Quintessence* (according to Webster, "the essence of a thing in its most pure and concentrated form"), a paragraph describing the theme and highlights of the material covered. Read these sentences several times—at the outset, after going through the other parts of the chapter, and again to refresh your memory before an exam.

Outline

The next section of each *Study Guide* chapter is an *Outline* of the text chapter. These brief sentences offer a summary of the text discussion and tie things together. The outlines begin with *what* the chapter is about, follow with *why* the topics are important, and end with *how* to understand and use the theory and techniques presented in the textbook. Major information is restated in an abbreviated form and elaborated upon where appropriate.

Keys

Key terms and concepts are printed in **boldface** type in the margins of the outlines. Skimming these words will be helpful as a last-chance review before exams.

Completion

The *Completion Questions* are part of each *Study Guide* chapter. They help test your recall and comprehension. Use this section by covering up the answers and writing in your own solutions. Another approach is to complete the questions while looking at the answers provided, and then carefully reread the entire statement. Many of these sentences are direct quotes of key points made in the text, and the additional impression will further cement the idea or concept in your mind.

Problems Much of finance can be best learned by problem solving. The last section of each chapter contains *Problems,* based on those given in the textbook, to help you learn by **doing.** The detailed solutions to the problems are an important learning aid. Each step is part of the thought process that has been carefully organized and developed to illustrate the principles outlined in the text. But remember, you must **do,** to learn. Try for your own answer before studying the solutions. This is why space has been left just after each question. If you become stuck, look at the beginning of the solution for a hint to get started.

To get the most from the following pages, first read and study Schall and Haley's book. This is essential. The *Guide* is a condensation of the text presentation; it is less than one-third the length of *Introduction to Financial Management.* After working with the text material:

Summary

1. Read the *Quintessence*. It should help affix the overall picture in your mind.
2. Ask yourself while going over the *Outline,* "How would I explain this point to a friend who knows nothing about finance?"
3. Try the *Fill-in Questions* for a quick review.
4. Work the *Problems* for mastery of the material, covering up the answers at first. When you come up against a tough one, review the solution carefully and watch for the **reasoning.**
5. For last-minute reviews before an exam, read the key terms and concepts found in the margins of the outlines.

Constructive criticisms from readers of earlier editions of the *Study Guide* have improved it. Their assistance is gratefully acknowledged, and yours is invited to further strengthen the material.

Finally, please remember that the objective of this book is to help you "get it all together." GOOD LUCK!

Thomas E. Stitzel

CONTENTS

CHAPTER ONE

FINANCIAL MANAGEMENT AND GOALS

QUINTESSENCE

The goal of most firms is to maximize the value of their shares while operating within laws and restrictions that protect the interests of society. Management, stockholders, and members of society may have different interests (i.e., salaries, profits, and pollution control). The resulting conflicts may be minimized by an understanding of the potential problems and by careful financial planning. The function of the financial manager is to raise and employ funds.

OUTLINE

I. What
- A. Purpose of the book:
  1. To identify and explore the factors that are relevant to financial decision making for both large and small businesses.
  2. To identify goals and policies and develop a framework using problem solving tools of effective financial management.
- B. Topics discussed in this chapter:
  1. Areas of mutual benefit or conflict between:
     - a. Owners (stockholders) and managers.
     - b. The firm and the rest of society.
  2. Ways to resolve the interests of conflicting groups.
  3. Finance as a discipline and the key role of the financial manager in raising money and putting it to work.

II. Why
- A. Money is the lifeblood of most activities. It is the scorecard for our financial endeavors. Principles of finance apply to most situations—individual, business, and governmental.
- B. *Financial decisions affect all segments of our society; it is important to* understand potential conflicts between groups and to offer suggestions for settling these problems.

III. How
- A. Set corporate objectives (goals):

Maximizing Wealth

  1. Maximize the owners' wealth.
  2. Establish policies (strategies) to achieve this.

Owners vs. Managers

B. Potential conflicts
   1. Owners and managers may have different interests; **agency theory** helps explain the interrelationships. Differences can be minimized by:
      a. Encouraging management through performance bonuses or having them become part owners through stock purchase plans.
      b. The increased legal accountability of the board of directors.
      c. The threat that an outside group may gain control. The potential for a **takeover** encourages management to strive to keep the owners happy.

Business vs. Society

   2. Corporations and society
      a. According to one view, an active government is needed to ensure that companies behave (Galbraith and Nader).
      b. Others feel free competition serves the best interests of everyone (Friedman and Kristol).

Ethical Considerations

   3. Ethical principles
      a. Consider the impacts of decisions on:
         i. Shareholders.
         ii. Employees.
         iii. Customers.
         iv. Other people.
      b. Theories or principles for ethical behavior
         i. Utilitarianism—greatest good for the greatest number.
         ii. Egalitarianism—strive for equal benefits for everyone.
         iii. Individual rights—individual people are the key.
         iv. Libertarianism—free choice; keep promises.
         v. When in Rome . . .—recognize cultural differences.

C. The solution for most firms is to maximize the value of their shares, operating within laws and economic considerations that protect the interests of society.
   1. This means maximizing earnings, part of which are reinvested in the business and part of which are used to pay dividends.
   2. The trade-offs between riskiness and the level of future earnings must be considered in setting policies.
   3. Maximizing share values is a long-run goal. Day-to-day price fluctuations are not of vital concern.

Role of Finance

D. Finance plays a key role in and for:
   1. Business, where there is a need to know:
      a. How best to obtain financing.
      b. How best to use money and control financial activities to ensure success (maximize wealth of the owners).
      c. How the financial vice president or manager is responsible for:
         i. Fund raising and usage (treasurer).
         ii. Accounting and control (controller).
   2. Individuals, who can maximize their well-being by making intelligent choices between consumption and investment:

a. Finance aids in the process of selecting investments.
b. It also helps to know how to raise money so that consumption and/or investment can be increased.

3. Financial markets and institutions, where a knowledge of opportunities, attitudes, and limitations helps one to play a more effective role in business, government, or personal life.

E. Outline for *Introduction to Financial Management*
1. Part 1 provides the background for the individual and corporate financial decision-making process. The financial environment is described. Fundamental concepts, including the time value of money and the effect of risk on asset values, are developed.
2. Part 2 deals with the basic techniques for investment, financing, and dividend decisions. Key issues include the cost of money, capital budgeting, internal and external sources of long-term funds, and how each of these issues is affected by uncertainty.
3. Part 3 presents tools to analyze past performances and to aid in planning for the future.
4. Short-term sources and uses of funds are emphasized in Part 4.
5. Part 5 covers the special topics of leasing, convertible securities, and mergers.

F. Check this blank ___ if you can recall the main points discussed under "To the Student." That material was written to explain the philosophy of the *Study Guide* and to offer suggestions for getting the most effective use from this book. You can maximize the value of the *Guide* by a careful reading of "To the Student"; therefore, if you didn't check the above space, please take a few minutes to go back and digest that section.

COMPLETION QUESTIONS

small, individuals, governmental

1. Principles of financial decision making apply to large firms as well as to __________ firms and to __________ and __________ units.

owners, managers, society, company

2. Potential conflicts of interest exist between __________ and __________ and between the rest of __________ and the __________.

Agency

3. __________ theory is used to help explain relationships between the owners and the managers of a firm.

maximizing
common stock

4. The objective of a corporation is usually stated in terms of __________ the value of the corporation's (*assets/common stock*).

strategies
goals

5. The policies of a company are the __________ it employs to achieve its __________.

board directors shareholders	6. The goals and policies of a firm are determined by the elected ________ of ____________, which is responsible for representing the (*creditors/shareholders*).
owners objectives	7. In most small businesses the ____________ are the same people as the managers, and so the ____________ of both groups will be identical.
owners *owners, stock option*	8. A method of minimizing potential conflicts between ____________ and managers involves creating opportunities for the managers to become part ____________ through ____________ ____________ plans.
owners *takeover, directors*	9. Increased interest of (*owners/managers*) in company affairs and the threat of a ____________ by outsiders or the election of new ____________ encourages managers to align their interests with those of the stockholders.
corporations *Galbraith, Nader*	10. A view that many large ____________ are unscrupulous and antisocial has been expressed by ____________ and ____________.
government	11. Their solution is to impose strict control by ____________.
Friedman, Kristol *free*	12. An opposing view offered by ____________ and ____________ places reliance on a ____________ marketplace.
society *corporations, interests*	13. Their position is that ____________ is best served when individuals and ____________ are allowed to serve their own ____________ within general rules of conduct.
unlikely	14. A return to a philosophy of "What's good for General Motors is good for the country" is (*likely/unlikely*).
Friedman	15. The action to deregulate the airlines would be applauded by (*Galbraith/Friedman*).
share *earnings, dividends* *reinvest*	16. The goal of maximizing (*share/asset*) value is translated to maximizing (*sales/earnings*), which are used to pay ____________________ and to ____________ in the company.
shareholders, *employees, customers*	17. Ethical considerations for the share value maximization objective include a review of the impacts a decision may have on ____________________, ____________, ____________, and other people.
utilitarianism, *egalitarianism* *rights, libertarianism*	18. When theories or principles of ethics are incorporated into decision making ____________ and ____________ are concerned with the results of decisions whereas individual ____________ and ____________ are concerned with the reasons or process for making the decisions.

profitable, risk	19. While stockholders prefer higher earnings, companies may pass up some potentially very ______ projects because the (*return/risk*) is too great.
long *daily*	20. Management is concerned with maximizing share values in the (*short/long*) run but is not vitally interested in (*daily/yearly*) stock price fluctuations.
raising *allocating*	21. The duties of the financial manager include ______ funds and ______ these moneys to their best use.
Money	22. ______ is often called the lifeblood of a company.
controller *planned*	23. The (*controller/treasurer*) of a firm is responsible for maintaining financial records and identifying deviations from ______ actual performance.
treasurer *planning*	24. The ______ of a firm is involved in overseeing the firm's cash and other liquid assets and in short- and long-range financial ______.
Finance *using, individuals* *businesses, governments*	25. ______ is the body of facts, principles, and theories dealing with the raising and ______ of money by ______, ______, and ______.
consumption, *investment*	26. Individual financial problems involve decisions of allocating resources between ______ and ______.
limitations *individuals, firms* *government*	27. A knowledge of financial markets and institutions is necessary to understand the opportunities, attitudes, and ______ that, in turn, influence financial decisions of ______, ______, and ______.

CHAPTER TWO

THE FINANCIAL SYSTEM: DOMESTIC AND INTERNATIONAL

QUINTESSENCE

The well-developed global financial system has played a major role in the achievement of a high standard of living. Transforming savings into investment is accomplished by the creation and transfer of financial assets. The key components in this process are (1) competing institutions (deposit types, insurance firms, and finance companies), (2) markets (primary, secondary, money, and capital), and (3) securities (federal funds; Treasury bills; banker's acceptances; commercial paper; certificates of deposit; corporate, federal, and municipal bonds; mortgage securities; and common stock). Prices of financial assets are determined by interest rates, which, in turn, are influenced by the supply of and demand for funds and the expected inflation rate. Understanding each piece and how and why it fits into the system is important to financial decision making. International financial markets serve savers and users of funds all around the globe. Spot and forward currency exchange rates are determined by the levels of interest rates and inflation in different countries and by governmental policies in each nation.

OUTLINE

I. What
  A. The American financial system consists of the institutions and markets that serve individuals and companies in financing the acquisition of goods and services, in investing capital, and in transferring the ownership of securities.
    1. Money, debt, and stock are the types of financial assets described in this chapter.
    2. The roles of financial institutions, including deposit-type institutions (banks, savings and loans, and credit unions), insurance operations, finance companies, pension funds, and mutual funds, are discussed.
    3. Primary and secondary markets are defined as well as money and capital markets (bond, mortgage, and stock markets).
  B. The level of interest rates is explained in terms of the supply of and demand for loanable funds and the expected rate of inflation.

II. Why
   A. A well-developed financial system is essential to a healthy economy.
   B. An understanding of the financial environment is of crucial importance to the study of the role and functions of a financial manager.

III. How (Study hint: Because of the large number of terms introduced in this chapter, it would be most helpful to make up a glossary [like that at the end of the text] for review purposes. Use this list to aid in recalling where each of the pieces [terms] fits into the system.)

Financial Assets

   A. The financial system provides services to transform savings into investments via the creation and transfer of **financial assets** (these are pieces of paper as opposed to tangible assets such as buildings, trees, and oil wells).
      1. Types of financial assets (claims against future income and assets)
         a. **Money** comprises:
            i. Currency and coin issued by the federal government. (Counterfeiters don't help the system, even though they may be creative.)
            ii. Checking accounts, demand deposits, **NOW** and **share draft accounts.**
         b. **Debt** is:
            i. IOUs, or promises to pay specific amounts in the future.
            ii. Issued by everyone—individuals, firms, and governments.
         c. **Stock:**
            i. Is a claim on future income *after* debtholders receive what is owed them.
            ii. Is issued only by business firms.
            iii. Includes **preferred stock,** which is like debt; it has limited claims on future income, but its claims must wait until debtholders have been paid.
            iv. Is mainly **common stock,** which represents ownership of the firm. Stockholders are last in the line for claims on the firm's earnings and assets, but they are entitled to everything that is left over.
      2. Creation and transfer of financial assets which are claims against future income and assets

Primary Markets

         a. The origination occurs in **primary markets.**
            i. The most direct method is for a "have-not" (borrower) to give a piece of paper (a financial asset such as a stock or a bond) to a "have" (investor) in exchange for money.
            ii. Funds more typically flow indirectly from savers to users through financial intermediaries.
            iii. The key function of the primary market involves the transfer of money from savers to users.

Secondary Markets

         b. The **secondary markets** are where the buying and selling of previously issued financial assets take place.

i. **Brokers** are go-betweens, bringing savers and users together, like real estate agents.
ii. **Dealers** buy from one party and sell to another, like car dealers.
iii. Primary and secondary markets offer investors a wide range of opportunities to buy and sell, just as the used-car market complements the new-car market. (This is a good analogy; think about it until you have a firm understanding of the separate and yet interdependent roles of the primary and secondary markets.)

Advantage of Financial Institutions

c. Financial intermediaries (**financial institutions**), e.g., banks, help transfer funds by:
   i. Collecting money from savers and investing it with users.
   ii. Providing *flexibility* by accumulating small amounts into large pools of funds.
   iii. Offering opportunities for investors to sell their securities for cash. This gives investors greater *liquidity* since they can sell their securities more easily.
   iv. Providing more safety by spreading investments out to many different places (*diversification*). Also, many of the institutions offer government insurance on deposits.
   v. Providing *convenience* by offering a variety of financial services—"one-stop shopping."
   vi. Offering investment *expertise*—skills and knowledge of full-time professionals—and economies of large-scale operations.

d. Other services of the financial system include insurance, consumer loans, and the monetary system for clearing consumer and business transactions.

B. Financial institutions are of crucial importance to the financial system because they help create the markets for funds.

Deposit Types

1. In the United States, **deposit-type** financial institutions accept deposits from, and lend to, individuals, businesses, and governmental units.

Commercial Banks

a. The 12,000 **commercial banks** are the largest and most diversified type of financial institution.

S and L's

b. **Savings and loan associations** are the second largest group. Most of their funds come from individual deposits. This money is lent back to individuals for real estate needs, i.e., loans for homes and apartments.

Savings Banks

c. **Savings banks** are similar to savings and loans, but they are located mainly in the Northeast. They and the S and L's have become more like banks in recent years.

Credit Unions

d. **Credit unions** outnumber banks, but as a group (18,000) they have the smallest aggregate amount of assets. They concentrate on providing services to individuals, receiving money from some and relending it for consumer credit.

Insurance Firms

2. **Life insurance firms** and **property and casualty companies** collect premiums, in advance, from a large number of people and firms to provide money to pay the smaller number who actually have losses.
   a. Insurance companies invest the premiums mainly in home mortgages and other debt forms.
   b. Most life insurance companies sell policies that have a savings element to build cash values. These plans make this type of company much larger and very similar to deposit-type financial institutions.

Pension Funds

3. **Pension funds** take in money to provide retirement and disability payments for persons in private and government employment. The major investment is in corporate stock, especially for the private pensions.

Mutual Funds

4. **Mutual funds** take in money from individuals and invest it in a diversified list of securities. They sell and buy back their own shares. This repurchase arrangement is unique to this group, so there is no secondary market in mutual fund shares. (Can you think why this is so?) Different funds choose their investments to emphasize current income, growth, tax-free returns, and various combinations and other special objectives. The dominant type of mutual fund was begun in 1974 and is called the **money market fund.** Money market funds invest in short-term, low-risk debt securities.

Finance Companies

5. **Finance companies** raise money by selling securities and borrowing from banks. They make short-term and intermediate-term loans to individuals and businesses.
   a. **Sales finance companies** concentrate on consumer installment loans, especially for cars.
   b. **Personal finance companies** make small loans to individuals.
   c. **Commercial finance companies** make large loans to business firms—particularly those who have high risks.

C. **Financial markets** and **securities** involve virtually every financial transaction. There are two general classes of markets in the United States.

Money Markets

1. **Money market** securities have little or no risk of loss. This means that they must be short-term, typically one year or less, and top-quality securities.
   a. The money market is the link that ties the local and regional money costs (interest rates) together in a national system.

Federal Funds

   b. **Federal funds** are reserves of depository institutions held at the Federal Reserve banks. These deposits can be loaned for very short periods. For example:
      i. Banks with excess reserves lend to banks having shortages.
      ii. These loans are at the federal funds rate, which is a very sensitive indicator of money market conditions.

Treasury Bills

c. **Treasury bills** are short-term (less than one year) debt of the U.S. government.
   i. They are sold at a discount and redeemed at par value; the difference amounts to interest.
   ii. Because of their safety (they are backed by the U.S. government and have short maturities), they are the most popular money market security.

Banker's Acceptances

d. **Banker's acceptances** are short-term notes, issued by firms and guaranteed by large banks.
   i. They typically arise out of foreign trade.
   ii. They are issued at a discount.

Commercial Paper

e. **Commercial paper** is soft and absorbent and comes in easy-to-tear rolls. Not really! It is short-term IOUs issued at a discount by firms or financial institutions. The equivalent interest rates are above the rates on Treasury bills.

CDs

f. **Negotiable certificates of deposit (CDs)** are large interest-bearing deposits having fixed maturities of typically less than one year.

g. Other money market securities include soon-to-mature bonds of governments and companies. No hard-and-fast time line separates the money market from the bond market; the distinction is between one and three years.

Capital Markets

2. The **capital markets** are comprised of intermediate- and long-term securities issued by individual firms and governmental units. These markets are subdivided into bonds, mortgages, and stock.

Issuing Securities

   a. The securities are "born" in the following ways:
      i. Most money is raised by the user going *directly* to the sources of funds and borrowing or selling stock.
      ii. In the **auction** approach, the securities are sold to the highest bidder. For example, the U.S. Treasury sells bills to investors who offer their money at the lowest competitive interest rates.

Investment Banking/ Underwriting

      iii. State governments, local governments, and some utilities (e.g., telephone and electric firms) rely heavily on **underwriting through competitive bids.** In this procedure, a group of financial institutions form a **syndicate** to bid on the issue. The winning group actually buys the securities and resells them to investors. Firms specializing in underwriting are called **investment bankers.**
      iv. Most companies raise funds by going to a particular investment banker for assistance in planning the terms of the offering. This method is called **negotiated underwriting.**

Bonds

   b. **Bonds:**
      i. Are debts of the federal government, state and local governments, and large firms.