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AN INTRODUCTION TO FINANCIAL MANAGEMENT

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PREFACE

It is customary for a textbook's preface to indicate that the order of the material can be rearranged to suit users' preferences. All experienced instructors already know that. This book is especially amenable to such rearrangements in that each chapter is a tightly organized discussion of one set of closely related topics.

However, the book's order was chosen for reasons both practical and pedagogical. Surveys of business employers suggest that they expect finance courses to prepare students in two specific areas: financial analysis (Part I) and capital budgeting (Part II). Those are our first two topics. Most, if not all, finance courses require accounting as a prerequisite. Experience has convinced us that a quick review of financial statements is justified. Chapter 2, therefore, discusses accounting statements before explaining financial analysis in detail.

We consider the Appendix, Federal Income Taxes, as part of the introductory material. Taxes can be covered immediately following Chapter 2 if the instructor wants to include the topic. The tax appendix was put at the back where we can incorporate the very latest tax information and forms without reordering the rest of the book.

After the introduction, accounting reviews, and taxes, Part II discusses the time value of money, valuation, cost of capital, and capital budgeting. Financial literature indicates that U.S. capital markets are largely efficient. This implies that businesses make their money on their capital investment decisions not on their financial decisions. Further, theory is better developed in capital budgeting than it is in financing (e.g., capital structure, dividend policy). We see a first course in financial management as a place to teach usable techniques that have evolved from the application of financial theory. We have left discussion of current theoretical explorations for the more advanced courses that finance majors take.

The sequence in capital budgeting is self defining. Understanding the time value of money is necessary for valuation. Understanding valuation is necessary to comprehend the cost of capital—its derivation and its meaning. A discount rate is necessary to perform discounted cash flow analyses—that is, capital budgeting. Capital budgeting under risk is covered last.

The first six chapters (Parts I and II, plus the Appendix if wanted) make a natural block of test material. Admittedly, this "front loads" the course. By covering financial analysis, cost of capital and capital budgeting early, students are allowed to quickly assess their readiness, aptitude, and willingness to do the work necessary to learn finance. The size of this material block is also convenient for exam scheduling. Such an exam would typically be scheduled a week or so before midterm, allowing time for grading before any required midterm progress (or grade) reports are due.

If a firm produces goods and/or services, it needs more than just capital assets. Firms must have and manage working capital. Part III covers working capital management, again starting with a review of the necessary accounting tools—budgets and *pro forma* statements. The four-chapter working capital section can be used for a second exam. Such a schedule can be especially convenient in the spring when working around spring break can create problems for both instructors and students.

Part IV covers financing. This coverage has a decidedly practical perspective. That does not mean it is watered down. All of the necessary analytical material on lease-or-borrow, leverage, financial break-even, refunding, and analysis of long-term financing decisions is covered in depth, with example calculations. What *is* missing are the theoretical considerations concerning optimal capital structure and dividend policy decisions. It is not that we consider this material unimportant. Quite the opposite. However, theory in these areas is still being refined. Our experience has been that rather than being enlightened by exposure to such theory, beginning students are merely confused. We minimized coverage of these "frontier" areas. Instead we describe, in detail, the attributes of the available financing choices, the factors to be considered in a practical, point-in-time decision, and explain the mechanics of the investment banking and underwriting process.

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The placement of descriptive material at the end of the course has a number of benefits. After being heavily involved in analysis for two-thirds of the course, the descriptive material is a change of pace. It can also be covered quickly to make up for any ground lost earlier. Further, invariably such material can be enlivened with real-world examples.

Having a heavy dose of description at the end of the course also has some advantages for testing. If circumstances (small classes) afford the luxury, the material is suitable for an essay final. On the other hand, if the more typical circumstances prevail (oversize classes and short grade deadlines), the material lends itself to testing by objective, machine-graded exams. Instructors will find the availability of the Addison-Wesley TESTGEN services to be a real time-saver.

Section V covers topics that should be included in a beginning textbook although most classes never cover them. However, each chapter in the section is current and technically correct. None of these topics can be adequately covered in a chapter. Each could legitimately be a course in itself. However, the student can derive a basic understanding of the material from our chapters. One or more of these can be included as a logical extension of the existing chapter sequence. International finance as discussed in Chapter 16 should prove especially convenient for programs striving to include some topical international coverage in each of their core courses.

Our textbook organization was largely dictated by the logic of the discipline and what we assess as its trends. The organization and presentation of the material within each chapter was dictated by pedagogical objectives. We wanted a book to study from—not a book to read and reread. The secret to an easy-to-study book is organization. We used every trick we could find. Some examples include

1. Every chapter was completely outlined before we started to write. To help the student grasp that structure each chapter starts with a topical outline.
2. Every chapter begins with the statement of well-defined learning objectives.
3. Illustrations and examples are numerous and detailed. Where students are expected to learn to do a particular type of problem, the solution technique is explained with a detailed numerical example.
4. All new terms are italicized when first mentioned and bold faced when defined. In addition, an extensive glossary is provided.
5. All important formulas are summarized and highlighted.
6. All chapter questions and problems were written *by the authors* at the time the chapter was written to assure they were internally consistent. Answers to selected problems are provided at the end of the book. Again, these were worked out by the authors not by graduate assistants.

One other thing is critical to an effective text—readability. We decided early to use active voice to reduce unnecessary words that accompany passive voice.

After that we had lots of help. The entire text was copyedited and revised before going out for professional review. We had five thorough, dedicated reviewers. Each made numerous suggestions about content and presentation that undoubtedly improved the book. After revisions were incorporated, the entire manuscript was reedited. Again the overriding considerations were style and pace. We wanted the material to be understandable and to get to the points quickly.

Ancillary materials include a useful student study guide and comprehensive instructor's resource guide.

The *Student Study Guide*, coauthored by Glenn Henderson and Sharon Garrison, reviews the textbook chapters, answers the questions posed at the beginning of each chapter, defines terms, lists important formulas, provides sample problems and solutions like those in the text, and gives the student self-test questions that assist in preparing for exams. We are confident the student will benefit from its use.

The *Instructor's Resource Guide* that we prepared offers the instructor chapter outlines, solutions to all chapter questions, transparency masters of key text exhibits and illustrations, and an extensive test bank made up of true/false, multiple-choice, and short problem solving questions. Instructors will find the supplement an invaluable aid.

No one pretends finance is easy. We simply want to make it understandable and palatable. Further, we want to highlight what is important, not bury it in details and alternative methods or theories. If our approach is successful we'll soon know. Markets are efficient—generally.

Acknowledgements

We were blessed with unbelievably good support. Regina DeRose (Tempe), Phillis Leiby (Columbia), Mary Wilson (Tucson), and Barbara Burmeister (Tucson) typed drafts and rewrites of the various chapters. They tolerated our poor handwriting, corrected our spelling, and generally turned out better work than we turned in. In addition to helping on the manuscript, Rita Nenaber typed the entire *Instructor's Resource Guide* to be camera ready, coordinating corrections and rewrites, while two of the authors were moving around the country. In addition to being a dependable tireless worker, she is a dear friend.

The help of several graduate students and associates is appreciated. Although we did the *Instructor's Resource Guide* ourselves, we are not foolish enough to believe ourselves infallible. Different parts of the manual were proofed (and reproofed) by anyone we could enlist. Of particular note are Dave Campbell, an MBA student at Arizona State University, and Nora Welsh, a teaching associate in economics at University of Arizona. Each took to the task with a dedication we still find hard to comprehend. (They found some mistakes.)

Special thanks are due to some of our colleagues. Stephen E. Skomp of Louisiana Tech University was coauthor of the paper (and recently accepted article) that is the basis for Appendix 6A. James Rauschkolb, Senior Vice President of Valley

National Bank in Phoenix, and Maurice Sandfort, President of Centerre Bank in Cape Girardeau, Missouri, provided valuable input on the working-capital-management chapters. John T. Emery, University of Arizona, and Allen A. Abrahamson, University of Denver, reviewed early versions of Chapters 7, 15, 17, and 18 and offered numerous suggestions that were incorporated in the final manuscript. Fred Zamon, Vice President of Centerre Bank of St. Louis (International Division), reviewed and made several constructive suggestions for Chapter 16. Alan P. Stein, librarian and lawyer at California State University at Los Angeles, reviewed Chapter 18 to assure its technical accuracy. Rich Panich, an Arizona State University doctoral student in tax, wrote the first draft of the tax appendix.

Patricia B. Peat did a super job of homogenizing our writing styles. To the extent that it appears that the three authors write in a similar style she deserves much credit. She cannot be held responsible for any remnants of our own poor grammar or syntax.

Our professional reviewers were just that—professional. They did not pull any punches and the book is better because of it. Our thanks to Russel P. Boisjoly of Simmons College, Severin C. Carlson of University of Rhode Island, Randolph A. Pohlman of Kansas State University, Joseph D. Vinso of University of Southern California, and (especially) Joseph E. Finnerty of University of Massachusetts.

It is supposedly poor form to thank the publisher's staff. That's too bad. We want to single out some people. We appreciate the efforts of Vanessa Piñeiro for coming up with what we think is an unusually attractive design. Bill Hamilton, our sponsoring editor, never cut a corner on us; in every instance the criterion was the same—do it the right way. Last, because she was always there to the bitter end—Marilee Sorotskin, our production editor: She is the most thoroughly dedicated professional we have ever worked with.

Finance is a demanding but exciting field. We hope that this text will convey some of this excitement to the student. More important, we hope it contributes to a better understanding of financial management. As we say in the first chapter, in the U.S. everyone must be a financial manager regardless of training. Good financial management is critical to our system's continued existence and growth.

Denton, Texas
Columbia, Missouri
Tucson, Arizona

G. V. H., Jr.
G. L. T.
J. E. W.
February 1984

CONTENTS

PART I INTRODUCTION 1

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