

# **BASIC FINANCIAL MANAGEMENT**

■ Petty

■ Keown

■ Scott

■ Martin

**SIXTH EDITION**



---

6<sup>th</sup> Edition

---

# BASIC FINANCIAL MANAGEMENT

---

**J. William Petty**

Baylor University  
Professor of Finance  
and the W. W. Caruth Endowed Chair  
of Entrepreneurship

**Arthur J. Keown**

Virginia Polytechnic Institute  
and State University  
R. B. Pamplin Professor of Finance

**David F. Scott, Jr.**

University of Central Florida  
Holder, Phillips-Schenck Chair  
in American Private Enterprise

**John D. Martin**

University of Texas at Austin  
Margaret and Eugene McDermott  
Professor of Banking and Finance



PRENTICE HALL, Englewood Cliffs, NJ 07632

**Library of Congress Cataloging-in-Publication Data**

*Basic financial management*/J. William Petty . . . [et al.]—6th ed.  
976 pp. cm.  
Includes index.  
ISBN 0-13-059635-3  
1. Business enterprises—Finance. 2. Corporations—Finance.  
I. Petty, J. William.  
HG4026.B318 1993  
658.15—dc20

92-32701  
CIP

Acquisitions Editor: LEAH JEWELL  
Development Editor: TRISH NEALON  
Production Editor: ANNE GRAYDON  
Interior design: MAUREEN EIDE and MERYL POWESKI  
Page layout: MERYL POWESKI  
Cover design: RICHARD STALZER, RICHARD STALZER ASSOC., LTD.  
Prepress Buyer: TRUDY PISCOTTI  
Manufacturing Buyer: PATRICE FRACCIO  
Editorial/Production assistance: COLETTE CONBOY,  
EILEEN DEGUZMAN, RENEE PELLETIER, and ADAM VELTHAUS  
Publisher: GARRET WHITE  
Senior Managing Editor: JOYCE TURNER  
Managing Editor: FRANCES RUSSELLO  
Supplements Editor: DAVID SHEA  
Marketing Manager: PATTI ARNESON



© 1993 by Prentice-Hall, Inc.  
A Simon & Schuster Company  
Englewood Cliffs, New Jersey 07632

All rights reserved. No part of this book may be  
reproduced, in any form or by any means  
without permission in writing from the publisher.

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

ISBN 0-13-059635-3

Prentice-Hall International (UK) Limited, *London*  
Prentice-Hall of Australia Pty. Limited, *Sydney*  
Prentice-Hall Canada Inc., *Toronto*  
Prentice-Hall Hispanoamericana, S.A., *Mexico*  
Prentice-Hall of India Private Limited, *New Delhi*  
Prentice-Hall of Japan, Inc., *Tokyo*  
Simon & Schuster Asia Pte. Ltd., *Singapore*  
Editora Prentice-Hall do Brasil, Ltda., *Rio de Janeiro*

---

## PREFACE

---

Historical circumstances are a driving force underlying the development and practice of financial management. For example, in the 1970s volatile energy prices, interest rates, and exchange rates dominated both the financial press and the economic environment within which financial decisions were made. These factors led to the development of new commodity and financial futures markets in which firms could hedge their risk exposure and speculate on the directions of anticipated price movements. Similarly, in the 1980s corporate control contests have resulted in the restructuring of corporate America. This unprecedented wave of transactions has included corporate divestitures, leveraged buyouts, joint ventures, spinoffs, split-ups, employee stock option plans (ESOPs), partial public offerings, project financings, and a host of other types of truncations that have filled the financial press during the 1980s.

Some have characterized this latest wave of corporate control contests simply as evidence of the continual tug-of-war between the capital markets and corporate management for control over financial resources. If this be true, then it would appear that the 1980s have been a time of unparalleled victory for the capital markets. Many of the largest corporations have fallen victim to the “bust-up merger” as they have been bought up and their assets sold to the highest bidder. This, in turn, means that the investment and financing decisions of even the very largest firms are subjected to an unusual amount of scrutiny by the capital markets.

Some practicing financial managers have cried foul, saying that investors in the capital markets are too short-term oriented or myopic. This, they argue, has placed undue pressure on the corporate manager to produce short-term profits to the exclusion of making long-term commitments. The evidence from the academic community, however, has not supported this contention. Furthermore, as the pressures of international competition continue unabated, serious consideration must be given to the effect the capital markets have on the firm’s competitiveness in world markets through their influence on the firm’s investment and financing choices. Consequently, it is our belief that the events of the 1980s and early 1990s have *heightened* the importance of corporate finance in the overall formula for corporate competitiveness and success.

In the text, we provide an introduction to financial decision making that is rooted both in current financial theory and in the current state of world economic conditions. This focus is evident in a number of ways, perhaps the most obvious being the increased attention to the capital markets and their influence on corporate financial decisions. We have expanded our discussion of the concepts of risk and return and the related notion of opportunity costs. We believe the added emphasis on capital markets is consistent with their influence on corporate financial decisions.

### ***A Note to the Teacher***

*Basic Financial Management*, 6th edition, provides the reader with an overview of financial management as intended for an introductory course in the subject. Such a course might be taught in one semester or two quarters. The orientation continues to be managerial, with an emphasis on the identification and solution

of the financial problems confronting the business enterprise. Decision making within an *enterprise valuation framework* is stressed throughout the text and, thereby, provides a unifying theme across all discussions. In the preparation of the manuscript, three primary standards were used. First, we have made a strong effort to offer *completeness* in the treatment of each topic. Second, we have given *readability* a high priority; we have taken extra care to use a clear and concise writing style, especially in the treatment of concepts requiring the use of mathematics. Third, complete, *step-by-step* examples are used frequently to increase clarity and to crystallize the critical issues in the student's mind. In summary, the pedagogical approach taken, particularly for the more difficult topics, progresses from an intuitive presentation of the problem to the introduction and illustration of the appropriate decision-making framework.

A number of other changes have been made in the 6th edition. Besides the expanded emphasis on the role of the capital markets in corporate financial decision making, we have also made a number of significant changes throughout the text that might not be so obvious.

1. We continue to work at adding life to the presentations by increasing the number of *Basic Financial Management in Practice* boxes. Because these practical application inserts proved to be a very popular feature of previous editions, we have expanded them in this edition.
2. Given the constant need to address ethical issues in the workplace, we have made a concerted effort to identify some of the important ethical issues as they relate to financial decision making. We have added material throughout the text in the form of *Ethics in Financial Management* boxes and provided four ethics cases that afford a means for constructive dialogue.
3. In view of the continued globalization of world markets, we have integrated international finance throughout the text in the form of *International Financial Management* boxes.
4. One of the difficulties students frequently encounter comes in transferring knowledge into live situations. It is one thing to understand how to work an end-of-chapter problem, but quite another to apply that understanding to an actual company. We are therefore pleased that Prentice Hall has developed an agreement with Disclosure, Incorporated, for the users of *Basic Financial Management*, 6th edition, to have access to the academic edition of Compact D<sup>TM</sup>/SEC. This database, designed for the personal computer, contains financial and management information on 100 publicly traded firms. Company data is taken from annual and periodic reports filed with the Securities and Exchange Commission. The firms have been selected for their diversity and appropriateness for the classroom. Approximately one half of the chapters have suggested uses for the database relative to the material in the respective chapter. The use of the database truly takes the student to a higher level of learning.
5. The use of the financial calculator has been integrated throughout the text, especially with respect to the time value of money. A separate appendix has been added that demonstrates the use of the Hewlett-Packard HP 17BII, the latest addition to the HP product line. We have also designed an insert card to the text that shows how to find the compound value interest factors and present value interest factors without the use of the table values. Finally, in the student study guide, we provide a complete article on the use of all the popular financial calculators.
6. The end-of-chapter problems have been expanded, as has the test item file.

7. In prior editions, the transparency acetates have been limited to figures from the text. In the 6th edition, not only do we provide these acetates, but we have also designed acetates that present the main issues of the primary chapters, along with examples that may be used in class presentations.
8. We have added section openers to each of the major parts of the text. These section openers allow the student to see the “big picture” before delving into the details of the individual chapters.
9. To enhance the use of the selected ABC News video tapes, a written introduction to each video follows each section opener; and at the end of each section is a concluding discussion, questions, and suggested readings. These introductions and conclusions will greatly improve the effectiveness of the videos in the classroom.

We believe the foregoing will greatly enhance the student’s learning experience.

Besides the broader changes just mentioned, modifications have also been made in each chapter. The following list includes the major additions that are new to *Basic Financial Management* in the 6th edition:

1. In our introduction to the capital markets (Chapter 2), we have significantly expanded our presentation on the term structure of interest rates.
2. Chapter 3, entitled Mathematics of Finance, has been simplified. In addition, we have adopted the more conventional notations of PVIF and FVIF in the equations.
3. We have divided the former chapter on valuation and rates of return into two chapters, one entitled Risk and Rates of Return (Chapter 4) and the other entitled Bond and Stock Valuation (Chapter 5). The division is part of our effort to give more attention to the influence of capital markets on financial decisions.
4. We have developed a clearer presentation of the capital asset pricing model and beta (Chapter 4).
5. We have moved the discussion on the arbitrage pricing model to an appendix in Chapter 4 to give the teacher added flexibility.
6. In Chapter 6, Capital Budgeting, we have simplified the presentation on how to measure a project’s benefits and costs. Consequently, the student will find the concept of “relevant cash flows” easier to understand.
7. The former chapter entitled Capital Budgeting Under Uncertainty, Chapter 7 in this edition, is retitled Advanced Topics in Capital Budgeting. It now includes other important practical matters in capital budgeting analysis, such as “equivalent annual annuities,” a measurement often used in practice.
8. In Chapter 8, we have expanded the material on determining the weighted marginal cost of capital and increased significantly the number of problems dealing with measurement of the weighted cost of capital.
9. Chapter 10, Planning the Firm’s Financing Mix, contains new material on (a) how managers feel about capital structure theory; (b) business cycles and financing behavior; and (c) agency theory, free cash flows, and the control hypothesis for debt issuance.
10. Chapter 15, Cash and Marketable Securities Management, includes new material from the Federal Reserve Banks of Atlanta and Richmond that focuses on the Fed’s role in determining interest rates and the topic of monetary policy.
11. In Chapter 16, we have simplified the presentation on marginal or

incremental analysis of credit policy and moved the material from the appendix to the main body of the chapter.

12. Chapter 18 now contains material that demonstrates how financial managers were net buyers of common equity (rather than issuers) during the 1980s and how this trend reversed with the rise in stock prices that occurred into 1992. A case considering the ethics of insider trading is also included.
13. The former chapter on convertibles, warrants, options and futures has been separated into two chapters: Convertibles and Warrants, and The Use of Futures and Options to Reduce Risks. The material on futures and options is discussed in a financial management setting and has been expanded.
14. For teachers who make a copy of the problem solutions available to their class, you will be pleased to know that a selected group of problem solutions (from Problem Set B only) have been added to the *Study Guide*. These solutions in the *Study Guide*, along with check figures for many of the Set A problems provided at the back of the text itself, should meet your needs in this regard; so that copies may no longer be necessary.

The preceding list of changes is not comprehensive. However, it does highlight the kinds of changes we have committed ourselves to making in order that *Basic Financial Management* continue to reflect the very best thinking that financial scholars have to offer.

As a final, but important, comment to the teacher, we know how frustrating errors in a textbook or instructor's manual can be. Thus, we have worked diligently to make certain that any errors are virtually eliminated. Not only did we check and recheck the answers ourselves, but Prentice Hall hired faculty members at other universities to check the accuracy of the problem solutions. We therefore make the following offer to users of *Basic Financial Management*, 6th edition:

Any professor or student identifying an error of substance (e.g., an incorrect number in an example or problem) in *Basic Financial Management*, 6th edition, in either the text or the instructor's manual, that has not been previously reported to the authors will receive a \$10 reward. If a series of related errors occur resulting from an original error, the reward will be limited to a maximum of \$20 for the group of errors.

### ***A Note to the Student***

As the authors of *Basic Financial Management*, we realize that our success ought to be measured by the level of effectiveness in our presentation to you, the end-user. Although you may not be involved in the process of selecting which text will be used in your finance class, we still consider you to be our customer. For this reason, we have made every effort to make the material understandable and to be sensitive to your needs in learning finance. Also, we have taken seriously our efforts to develop the *Study Guide* that assists and complements your learning. Two examples deserve note:

1. In addition to providing some sample problems with solutions in the *Study Guide*, we have added worked-out solutions to some of the end-of-chapter problems from Problem Set B.
2. We have made a first effort to provide outside material that may be helpful: In this edition of the *Study Guide*, we have included a complete article from *Financial Practice and Education* on the use of financial calculators. We believe you will find it quite helpful.

As our end-user, we would like very much to hear from you: Did you encounter anything in our presentation that was not clear or was confusing? We sincerely want to know what you think. While we cannot pay for your services, we would be willing to include your name and institution in the list of acknowledgments for your assistance in making the next edition of *Basic Financial Management* a better text for the student. Let us hear from you.

## Acknowledgments

We gratefully acknowledge the assistance, support, and encouragement of those individuals who have contributed to the successful completion and revision of *Basic Financial Management*. Specifically, we wish to recognize the very helpful insights provided by many of our colleagues. For their careful review of the text, we are indebted to:

Kamal Abouzeid, *Lynchburg College*; V. T. Alaganan, *Hofstra University*; Michael T. Alderson, *University of Missouri at St. Louis*; Dwight C. Anderson, *Louisiana Tech University*; Nasser Arshadi, *University of Missouri*; Gary Benesh, *Florida State University*; Sam G. Berry, *Virginia Commonwealth University*; Randy Billingsley, *Virginia Polytechnic Institute and State University*; Russell P. Boisjoly, *Simmons College*; Virgil L. Brewer, *Eastern Kentucky University*; Jozelle Brister, *Abilene Christian University*; John Byrd, *Washington State University*; Don M. Chance, *Virginia Polytechnic Institute and State University*; Albert H. Clark, *Georgia State University*; David W. Cole, *Ohio State University*; Bernard C. Dill, *Bloomsburg University*; Mark Dorfman, *University of Arkansas—Little Rock*; Marjorie Evert, *Xavier University*; Sidney R. Finkel, *Canisius College*; Frederick G. Floss, *Buffalo State University*; Lyn Fraser, *Texas A & M University*; John Gilster, *University of Ohio*; Sharon S. Graham, *University of Central Florida*; Dennis A. Gribenas, *Data Systems International, Inc.*; Jack Griggs, *Abilene Christian University*; Samuel C. Hadaway, *Financo, Inc.*; Nancy Lee Halford, *Madison Area Technical College*; William R. Henry, *Georgia State University*; Keith Howe, *DePaul University*; Charles R. Idol, *Idaho State University*; Vahan Janjigian, *Northeastern University*; Nancy Jay, *Gannon University*; Jeff Jenkins, *Security National Corporation*; William Jens, *Stetson University*; Steve A. Johnson, *University of Texas at El Paso*; Djavad Kashefnejad, *California State Polytechnic University*; James D. Keys, *Florida International University*; David R. Klock, *University of Central Florida*; Howard C. Launstein, *Marquette University*; Leonard T. Long, *American International College*; Abbas Mamoozadeh, *Slippery Rock University*; Terry S. Maness, *Baylor University*; Surendra K. Mansinghka, *San Francisco University*; Barry Marks, *University of Houston at Clearlake*; K. Gary McClure, *University of Central Florida*; James E. McNulty, *Florida Atlantic University*; James A. Miller, *University of Arkansas*; Naval Modani, *University of Central Florida*; Eric J. Moon, *San Francisco University*; Shalini Perumpral, *Radford University*; John M. Pinkerton, *Virginia Polytechnic Institute and State University*; Jack H. Rubens, *Cleveland State University*; Todd Schank, *University of Portland*; Peter A. Sharp, *California State University at Sacramento*; Jackie Shu, *University of Central Florida*; Michael Solt, *San Jose State University*; Raymond F. Spudeck, *University of Central Florida*; Suresh Srivastava, *University of Maryland*; Donald L. Stevens, *University of Colorado—Denver*; L. E. Sweeney, *Ball State University*; Amir Tavakkol, *Kansas State University*; John G. Thatcher, *Marquette University*; Gary L. Trennepohl, *Texas A & M University*; Ronald Tsang, *University of Central Florida*; Kenneth L. Westby, *University of North Dakota*; Lawrence C. Wolken, *Texas A & M University*; Kevin Woods, *University of Central Florida*; Steve B. Wyatt, *University of Cincinnati*.

We also thank our friends at Prentice Hall. They are a great group of folks. We offer our personal expression of appreciation to Garret White, the editor



who originally signed the first edition of *Basic Financial Management*; to Leah Jewell, of whom there is no equal as an encourager and advisor; to Patti Arneson, for her marketing genius; to Anne Graydon, for her attention to quality and detail and for her patience and understanding during the production process; and to the Prentice-Hall field representatives for their input based on their interaction with teachers from across the nation. We also thank Trish Nealon for her work as the developmental editor and Janet Cryer at Hewlett-Packard Company for helping to integrate the use of the calculator into the text.

As a final word, we express our sincere thanks to the many teachers who use *Basic Financial Management* in the classroom, in both academic as well as professional settings. We thank you for letting us serve you. Always feel free to give any of us a call when you have questions or needs. We view ourselves as partners in this venture, and we will be sensitive to your wishes and desires whenever possible.

J.W.P  
A.J.K.  
D.F.S.  
J.D.M.

---

# CONTENTS

---

Preface *xi*

---

## PART 1

---

### SCOPE AND ENVIRONMENT OF FINANCIAL MANAGEMENT 2

*Video Case 1: CEO Compensation 3*

## 1 The Role of Financial Management 4

Development of Financial Thought 4    Goal of the Firm 5  
Financial Decisions and Risk-Return Relationships 9    Why Prices Reflect  
Value 9    Ethics and Ethical Behavior in Financial Management 11  
Overview of the Text 12

Appendix 1A:

The Language of Finance—Accounting Statements 18

Appendix 1B:

Glossary of Accounting Terms 25

## 2 Financial Markets, Business Organization, and the Tax Environment 28

An Introduction to Financial Markets 28    Legal Forms of Business  
Organization 36    Federal Income Taxation 44

Appendix 2A:

Methods of Depreciation 60

## 3 Mathematics of Finance 64

Compound Interest 64    Compound Interest with Nonannual  
Periods 71    Present Value 72    Annuities 75    Amortized  
Loans 80    Present Value of an Uneven Stream 81  
Perpetuities 83    Bond Valuation: An Illustration of the Time Value of  
Money 84

*Video Case 1—Conclusion 97*

---

## PART 2

---

### VALUATION AND MANAGEMENT OF LONG-TERM INVESTMENTS 98

*Video Case 2: Investing in Employee Productivity 99*

## 4 Risk and Rates of Return 100

Expected Return 101    Risk 102    The Investor's Required Rate of  
Return 112    Rates of Return: The Investor's Experience 116

### Appendix 4A:

Measuring a Stock's Return and Risk Using a  
Calculator—Average Return, Standard Deviation,  
Alpha, and Beta 126

### Appendix 4B:

Measuring the Required Rate of Return—The  
Arbitrage Pricing Model 131

## 5 Bond and Stock Valuation 135

Definitions of Value 136    Valuation: An Overview 137    Valuation:  
The Basic Process 138    Bond Valuation 139    Preferred Stock  
Valuation 143    Common Stock Valuation 145    Expected Rates of  
Return 149

### Appendix 5A:

More on Bond Valuation—Understanding Key  
Relationships 160

### Appendix 5B:

The Relationship Between Value and Earnings 168

## 6 Capital Budgeting 173

Guidelines for Capital Budgeting 174    Measuring a Project's Benefits  
and Costs 176    Competitive Markets and Profitable Projects—Where  
Do Profitable Projects Come From? 183    Nondiscounted Cash Flow  
Criteria for Capital Budgeting Decisions 186    Discounted Cash Flow  
Criteria for Capital-Budgeting Decisions 188    A Glance at Actual  
Capital-Budgeting Practices 201

## 7 Advanced Topics in Capital Budgeting 221

Capital Rationing 221 Inflation and Capital-Budgeting  
Decisions 227 Risk and the Investment Decision 228 Methods for  
Incorporating Risk into Capital Budgeting 232 Risk-Adjusted  
Discount Rate and Measurement of Project's Systematic  
Risk 238 Other Approaches to Evaluating Risk in Capital  
Budgeting 241 Other Sources and Measures of Risk 244

## 8 Cost of Capital 265

The Concept of the Cost of Capital 266 Factors Determining the  
Weighted Cost of Capital 268 Assumptions of the Weighted Cost of  
Capital Model 271 Computing the Weighted Cost of Capital 273  
Marginal Cost of Capital: A Comprehensive Example 286 Required  
Rate of Return for Individual Projects: An Alternative Approach 292  
A Firm's Cost of Capital: Some Recent Evidence 294

*Video Case 2—Conclusion 311*

---

## PART 3

## FINANCIAL STRUCTURE AND DIVIDEND POLICY 312

*Video Case 3: RJR Nabisco Bondholder Lawsuits 313*

## 9 Analysis and Impact of Leverage 314

Business and Financial Risk 315 Breakeven Analysis 317  
Operating Leverage 326 Financial Leverage 331 Combination of  
Operating and Financial Leverage 335

## 10 Planning the Firm's Financing Mix 354

A Glance at Capital Structure Theory 356 Basic Tools of Capital  
Structure Management 372 A Glance at Actual Capital Structure  
Management 381 International Perspective 389

## 11 Dividend Policy and Internal Financing 408

Key Terms 409 Does Dividend Policy Affect Stock Price? 409  
Dividend Decision in Practice 422 Dividend Payment  
Procedures 426 Stock Dividends and Stock Splits 428 Stock  
Repurchases 430

*Video Case 3—Conclusion 439*



---

## PART 4

---

### FINANCIAL ANALYSIS, PLANNING, AND CONTROL 440

*Video Case 4: Bond-Rating Agencies* 441

## 12 Evaluating Financial Performance 442

Basic Financial Statements 443    Financial Ratios 449    Integrated  
Form of Financial Analysis Based on Earning Power 465

## 13 Financial Forecasting, Planning, and Budgeting 491

Financial Forecasting 491    Financial Planning and Budgeting 496  
Computerized Financial Planning 506

Appendix 13A:  
Microcomputers and Spreadsheet Software in  
Financial Planning 522

*Video Case 4—Conclusion* 529

---

## PART 5

---

### WORKING-CAPITAL MANAGEMENT 530

*Video Case 5: The Campeau Bankruptcy* 531

## 14 Introduction to Working-Capital Management 532

Managing Current Assets 533    Managing Current Liabilities 534  
Appropriate Level of Working Capital 537

## 15 Cash and Marketable Securities Management 550

Why a Company Holds Cash 551    Variations in Liquid Asset  
Holdings 554    Cash Management Objectives and Decisions 555  
Collection and Disbursement Procedures 557    Electronic Funds  
Transfer 569    Evaluation of Costs of Cash-Management Services 570  
*Composition of Marketable Securities Portfolio* 571    A Glance at Actual  
Cash-Management Practices 589

Appendix 15A:  
Cash-Management Models—Split Between Cash and  
Near-Cash 609

## 16 Accounts Receivable and Inventory Management 619

Accounts Receivable Management 619      Inventory Management 627  
Just-in-Time Inventory Control 635

## 17 Short-Term Financing 646

Estimation of Cost of Short-Term Credit 647      Sources of Short-Term Credit 648

*Video Case 5—Conclusion* 669

---

## PART 6

## LONG-TERM FINANCING 670

*Video Case 6: The Fall of Drexel Burnham Lambert* 671

## 18 Raising Funds in the Capital Market 672

The Mix of Corporate Securities Sold in the Capital Market 674      Why Financial Markets Exist 675      Financing of Business: The Movement of Funds Through the Economy 679      Components of the U.S. Financial Market System 683      The Investment Banker 687      Private Placements 693      Flotation Costs 694      Regulation 696      More Recent Regulatory Developments 697

## 19 Term Loans and Leases 704

Term Loans 704      Leases 708

## 20 Long-Term Debt, Preferred Stock, and Common Stock 726

Bonds or Long-Term Debt 726      Preferred Stock 739      Common Stock 743

## 21 Convertible Securities and Warrants 754

Convertible Securities 754      Warrants 761

## 22 The Use of Futures and Options to Reduce Risk 771

Futures 771      Options 780      How Financial Managers Use Options and Futures 791

*Video Case 6—Conclusion* 793

---

## PART 7

---

### SPECIAL TOPICS IN FINANCIAL MANAGEMENT 794

*Video Case 7: The USX Proxy Contest* 795

### 23 Corporate Restructuring: Combinations and Divestitures 796

Mergers and Acquisitions: A Historical Perspective 797    Why Mergers  
Might Create Wealth 800    Determination of a Firm's Value 804  
Financing and Corporate Restructuring 814    Tender Offer 816  
*Resistance of the Merger* 816    Divestitures 817

### 24 Failure and Reorganization 825

What Failure Is 825    Who Fails? 826    Frequent Causes of  
Failure 828    Symptoms of Bankruptcy 829    Voluntary Remedies  
to Insolvency 831    Reorganization 832    Liquidation 836

### 25 International Business Finance 851

The Globalization of Product and Financial Markets 852    Exchange  
Rates 853    Interest Rate Parity Theory 862    Purchasing Power  
Parity 865    Exposure to Exchange Rate Risk 868    Multinational  
Working-Capital Management 872    International Financing and  
Capital Structure Decisions 874    Direct Foreign Investment 875

### 26 Financial Management: A Small-Firm Perspective 882

Small Versus Large: Is There a Difference? 883    Capital Budgeting in  
the Small Firm 886    Financing of the Small Firm 890

*Video Case 7—Conclusion* 894

### Selected References 895

### Appendixes 909

*Appendix A:* Using a Calculator 909    *Appendix B:* Compound Sum of  
\$1 918    *Appendix C:* Present Value of \$1 920    *Appendix D:* Sum  
of an Annuity of \$1 for  $n$  Periods 922    *Appendix E:* Present Value of  
an Annuity of \$1 for  $n$  Periods 924    *Appendix F:* Solutions for  
Selected End-of-Chapter Problems 926

### Glossary 931

### Index 943

# BASIC FINANCIAL MANAGEMENT



# SCOPE AND ENVIRONMENT OF FINANCIAL MANAGEMENT

---

Financial management is largely about making decisions. Decisions about what assets or products to invest in, how to manage cash, and how to raise funds for growth. Part 1 sets the stage for the remainder of the text by describing the basic concepts on which financial decisions are based, the *language* and *arithmetic* used to make these decisions, and the world in which financial managers operate and how it influences financial decision making. We begin by discussing the objective of the financial manager, as well as some important concepts that will appear many times later in the text: market efficiency, the relationship between risk and return, the importance of prices as indicators of value, and the potential conflicts of interest that arise in business firms (Chapter 1). The decisions facing financial managers often are affected by forces outside the firm, such as taxes and the current sentiment in financial markets, so it is important to have some understanding of the business environment (Chapter 2). Finance has its own language and arithmetic. Many financial decisions are based on data from a firm's accounting statements: the balance sheet and income statement. One task of the financial manager is to bring accounting numbers to life; sometimes this means figuring out the rationale behind the entries on the financial statements or predicting how next month's or next year's number will look under various scenarios. Distinctions between the information needs of financial managers and accrual accounting also are basic to our study (Appendix 1A). The arithmetic of finance is built on the concept of the time value of money or *present value*: The value of money varies depending on when it is received (Chapter 3). This crucial concept underlies many of the ideas presented in this text. An investment in understanding the mechanics of present value early in the course will pay dividends later.