



# ANALYSIS FOR FINANCIAL MANAGEMENT

Ninth Edition

Robert C. Higgins

# Analysis for Financial Management

*Ninth Edition*

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## ANALYSIS FOR FINANCIAL MANAGEMENT

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*In memory of my son*

STEVEN HIGGINS

1970–2007

# Preface

Like its predecessors, the ninth edition of *Analysis for Financial Management* is for nonfinancial executives and business students interested in the practice of financial management. It introduces standard techniques and recent advances in a practical, intuitive way. The book assumes no prior background beyond a rudimentary and perhaps rusty familiarity with financial statements—although a healthy curiosity about what makes business tick is also useful. Emphasis throughout is on the managerial implications of financial analysis.

*Analysis for Financial Management* should prove valuable to individuals interested in sharpening their managerial skills and to executive program participants. The book has also found a home in university classrooms as the sole text in Executive MBA and applied finance courses, as a companion text in case-oriented courses, and as a supplementary reading in more theoretical finance courses.

*Analysis for Financial Management* is my attempt to translate into another medium the enjoyment and stimulation I have received over the past three decades working with executives and college students. This experience has convinced me that financial techniques and concepts need not be abstract or obtuse; that recent advances in the field such as agency theory, market signaling, market efficiency, and capital asset pricing are important to practitioners; and that finance has much to say about the broader aspects of company management. I also believe that any activity in which so much money changes hands so quickly cannot fail to be interesting.

Part One looks at the management of existing resources, including the use of financial statements and ratio analysis to assess a company's financial health, its strengths, weaknesses, recent performance, and future prospects. Emphasis throughout is on the ties between a company's operating activities and its financial performance. A recurring theme is that a business must be viewed as an integrated whole and that effective financial management is possible only within the context of a company's broader operating characteristics and strategies.

The rest of the book deals with the acquisition and management of new resources. Part Two examines financial forecasting and planning with particular emphasis on managing growth and decline. Part Three considers the financing of company operations, including a review of the principal security types, the markets in which they trade, and the proper choice of



security type by the issuing company. The latter requires a close look at financial leverage and its effects on the firm and its shareholders.

Part Four addresses the use of discounted cash flow techniques, such as the net present value and the internal rate of return, to evaluate investment opportunities. It also deals with the difficult task of incorporating risk into investment appraisal. The book concludes with an examination of business valuation and company restructuring within the context of the ongoing debate over the proper roles of shareholders, boards of directors, and incumbent managers in governing America's public corporations.

An extensive glossary of financial terms and suggested answers to odd-numbered, end-of-chapter problems follow the last chapter.

## Changes in the Ninth Edition

Readers familiar with earlier editions of *Analysis for Financial Management* will note several changes and refinements in this edition, including

- Use of suburban lawn care maven Scotts Miracle-Gro Company as the extended example throughout the book with particular emphasis on analyzing their bold leveraged recapitalization in 2007.
- Examination of KKR's leveraged acquisition of First Data Corporation, including problems encountered in completing financing in the midst of the credit meltdown of 2007.
- Expanded treatment of activist investors including Carl Icahn's efforts to force Yahoo to reconsider Microsoft's buyout offer.
- Discussion of cannibalization in investment appraisal and of the "lemons problem" in issuing new securities.
- More on private placements and the rapid growth of shelf-registered equity issues.

As in earlier editions, you will continue to find annotated Web site references at the end of each chapter. Also available is an *Analysis for Financial Management* Web site containing the following:

- Spreadsheet problems and suggested answers.
- An instructor's page with suggested answers to even numbered problems.
- Standard & Poor's Market Insight problems and suggested answers.
- Supplementary end-of-chapter problems and suggested answers.
- URLs of all Web sites mentioned in the book.
- Complimentary software.

- An annotated list of suggested cases to accompany the book.
- PowerPoint versions of selected tables and figures.

The complimentary software consists of three easy-to-use Excel programs, which I have found helpful when analyzing financial statements, projecting financing needs, and evaluating investment opportunities. The URL for this cornucopia of treats is [www.mhhe.com/higgins9e](http://www.mhhe.com/higgins9e).

A word of caution: *Analysis for Financial Management* emphasizes the application and interpretation of analytic techniques in decision making. These techniques have proved useful for putting financial problems into perspective and for helping managers anticipate the consequences of their actions. But techniques can never substitute for thought. Even with the best technique, it is still necessary to define and prioritize issues, to modify analysis to fit specific circumstances, to strike the proper balance between quantitative analysis and more qualitative considerations, and to evaluate alternatives insightfully and creatively. Mastery of technique is only the necessary first step toward effective management.

I want to thank Nathan Walcott and Eric Wehrly for continuing help on end-of-chapter problems. Both will make fine finance teachers in coming years. I am indebted to Andy Halula of Standard & Poor's for providing timely updates to Research Insight. The ability to access the most recent Compustat data on compact disc was a great help in providing timely examples of current practice. I also owe a large thank you to the following people for their insightful reviews of the 8th edition and their constructive advice. They did an excellent job, and any remaining shortcomings are mine not theirs.

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I envy you learning this material for the first time. It's a fascinating intellectual adventure.

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# Brief Contents

Preface xi

## **PART ONE**

### **Assessing the Financial Health of the Firm 1**

- 1** Interpreting Financial Statements 3
- 2** Evaluating Financial Performance 37

## **PART TWO**

### **Planning Future Financial Performance 87**

- 3** Financial Forecasting 89
- 4** Managing Growth 123

## **PART THREE**

### **Financing Operations 151**

- 5** Financial Instruments and Markets 153
- 6** The Financing Decision 203

## **PART FOUR**

### **Evaluating Investment Opportunities 247**

- 7** Discounted Cash Flow Techniques 249
- 8** Risk Analysis in Investment Decisions 295
- 9** Business Valuation and Corporate Restructuring 347

**Appendix A** Present Value of \$1 395

**Appendix B** Present Value of an Annuity of \$1 397

## **GLOSSARY 399**

**SUGGESTED ANSWERS TO  
ODD-NUMBERED PROBLEMS 411**

**INDEX 439**

# Contents

## Preface xi

## PART ONE

### ASSESSING THE FINANCIAL HEALTH OF THE FIRM 1

#### Chapter 1

#### Interpreting Financial Statements 3

The Cash Flow Cycle 3

The Balance Sheet 6

*Current Assets and Liabilities 10*

*Shareholders' Equity 11*

The Income Statement 11

*Measuring Earnings 12*

Sources and Uses Statements 16

*The Two-Finger Approach 18*

The Cash Flow Statement 18

Financial Statements and the

Value Problem 22

*Market Value versus Book Value 23*

*Economic Income versus Accounting Income 26*

*Imputed Costs 27*

Summary 29

Additional Resources 30

Problems 31

#### Chapter 2

#### Evaluating Financial Performance 37

The Levers of Financial Performance 37

Return on Equity 38

*The Three Determinants of ROE 38*

*The Profit Margin 40*

*Asset Turnover 42*

*Financial Leverage 48*

Is ROE a Reliable Financial Yardstick? 54

*The Timing Problem 55*

*The Risk Problem 55*

*The Value Problem 57*

*ROE or Market Price? 58*

Ratio Analysis 59

*Using Ratios Effectively 62*

*Ratio Analysis of Scotts Miracle-Gro Company 63*

#### Appendix

#### International Differences in Financial Structure 72

*Comparisons among Foreign Companies Trading on U.S. Markets 72*

*Public Companies 74*

*The Move Toward International Accounting Standards 76*

Summary 79

Additional Resources 80

Problems 82

## PART TWO

### PLANNING FUTURE FINANCIAL PERFORMANCE 87

#### Chapter 3

#### Financial Forecasting 89

Pro Forma Statements 89

*Percent-of-Sales Forecasting 90*

*Interest Expense 96*

*Seasonality 97*

Pro Forma Statements

and Financial Planning 97

Computer-Based Forecasting 98

Coping with Uncertainty 103

*Sensitivity Analysis 103*

*Scenario Analysis 103*

*Simulation 104*

Cash Flow Forecasts 106

Cash Budgets 107

The Techniques Compared 110

Planning in Large Companies 111

Summary 113

Additional Resources 114

Problems 115

**Chapter 4****Managing Growth 123**

Sustainable Growth 124

*The Sustainable Growth Equation 124*

Too Much Growth 127

*Balanced Growth 127**Genentech's Sustainable Growth Rate 129**"What If" Questions 130*

What to Do When Actual Growth Exceeds

Sustainable Growth 131

*Sell New Equity 131**Increase Leverage 133**Reduce the Payout Ratio 133**Profitable Pruning 134**Outsourcing 135**Pricing 135**Is Merger the Answer? 136*

Too Little Growth 136

What to Do When Sustainable Growth

Exceeds Actual Growth 137

*Ignore the Problem 138**Return the Money to Shareholders 139**Buy Growth 139**Sustainable Growth and Inflation 140*

Sustainable Growth and Pro

Forma Forecasts 141

New Equity Financing 142

*Why Don't U.S. Corporations Issue**More Equity? 144*

Summary 146

Additional Resources 147

Problems 147

**PART THREE****FINANCING OPERATIONS 151****Chapter 5****Financial Instruments and Markets 153**

Financial Instruments 154

*Bonds 155**Common Stock 161**Preferred Stock 167*

Financial Markets 167

*Private Equity Financing 168**Initial Public Offerings 170**Seasoned Issues 172**Issue Costs 176*

Efficient Markets 178

*What Is an Efficient Market? 179**Implications of Efficiency 182***Appendix****Forward Contracts, Options, and the Management of Corporate Risks 183***Forward Markets 184**Hedging in Money and Capital Markets 188**Hedging with Options 189**Limitations of Financial Market**Hedging 191**Valuing Options 193*

Summary 196

Additional Resources 198

Problems 199

**Chapter 6****The Financing Decision 203**

Financial Leverage 205

Measuring the Effects of Leverage  
on a Business 209*Leverage and Risk 211**Leverage and Earnings 213*

How Much to Borrow 216

*Irrelevance 217**Tax Benefits 219**Distress Costs 219**Flexibility 224**Market Signaling 226**Management Incentives 230**The Financing Decision and  
Growth 230*

Selecting a Maturity Structure 234

*Inflation and Financing**Strategy 234***Appendix****The Irrelevance Proposition 235***No Taxes 235**Taxes 237*

Summary	239
Additional Resources	240
Problems	241

## **PART FOUR**

### **EVALUATING INVESTMENT OPPORTUNITIES 247**

#### **Chapter 7**

##### **Discounted Cash Flow Techniques 249**

Figures of Merit	250
<i>The Payback Period and the Accounting Rate of Return</i>	251
<i>The Time Value of Money</i>	252
<i>Equivalence</i>	256
<i>The Net Present Value</i>	257
<i>The Benefit-Cost Ratio</i>	259
<i>The Internal Rate of Return</i>	259
<i>A Few Applications and Extensions</i>	263
<i>Mutually Exclusive Alternatives and Capital Rationing</i>	266
<i>The IRR in Perspective</i>	267
Determining the Relevant Cash Flows	268
<i>Depreciation</i>	270
<i>Working Capital and Spontaneous Sources</i>	272
<i>Sunk Costs</i>	273
<i>Allocated Costs</i>	274
<i>Cannibalization</i>	275
<i>Excess Capacity</i>	276
<i>Financing Costs</i>	278

<b>Appendix</b>	
<b>Mutually Exclusive Alternatives and Capital Rationing</b>	<b>280</b>
<i>What Happened to the Other \$578,000?</i>	281
<i>Unequal Lives</i>	282
<i>Capital Rationing</i>	284
<i>The Problem of Future Opportunities</i>	286
<i>A Decision Tree</i>	286

Summary	287
Additional Resources	289
Problems	289

#### **Chapter 8**

##### **Risk Analysis in Investment Decisions 295**

Risk Defined	297
<i>Risk and Diversification</i>	299
Estimating Investment Risk	301
<i>Three Techniques for Estimating Investment Risk</i>	302
Including Risk in Investment Evaluation	303
<i>Risk-Adjusted Discount Rates</i>	303
The Cost of Capital	305
<i>The Cost of Capital Defined</i>	306
<i>Cost of Capital for Scotts</i>	
<i>Miracle-Gro Company</i>	308
<i>The Cost of Capital in Investment Appraisal</i>	317
<i>Multiple Hurdle Rates</i>	318
Four Pitfalls in the Use of Discounted Cash Flow Techniques	320
<i>The Enterprise Perspective versus the Equity Perspective</i>	321
<i>Inflation</i>	323
<i>Real Options</i>	324
<i>Excessive Risk Adjustment</i>	327
Economic Value Added	329
<i>EVA and Investment Analysis</i>	330
<i>EVA's Appeal</i>	330
A Cautionary Note	332
<b>Appendix</b>	
<b>Asset Beta and Adjusted Present Value</b>	<b>333</b>
<i>Beta and Financial Leverage</i>	334
<i>Using Asset Beta to Estimate Equity Beta</i>	335
<i>Asset Beta and Adjusted Present Value</i>	336
Summary	339
Additional Resources	340
Problems	341

#### **Chapter 9**

##### **Business Valuation and Corporate Restructuring 347**

Valuing a Business	349
<i>Assets or Equity?</i>	350
<i>Dead or Alive?</i>	350
<i>Minority Interest or Control?</i>	352

Discounted Cash Flow Valuation 353

*Free Cash Flow* 354

*The Terminal Value* 355

*A Numerical Example* 358

*Problems with Present Value Approaches  
to Valuation* 360

Valuation Based on Comparable

Trades 361

*Lack of Marketability* 365

The Market for Control 366

*The Premium for Control* 366

*Financial Reasons for Restructuring* 368

*The Empirical Evidence* 375

*The First Data Buyout* 378

**Appendix**

**The Venture Capital Method of  
Valuation 380**

*The Venture Capital Method—One  
Financing Round* 381

*The Venture Capital Method—Multiple*

*Financing Rounds* 384

*Why Do Venture Capitalists Demand*

*Such High Returns?* 386

Summary 387

Additional Resources 388

Problems 389

**Appendix A Present  
Value of \$1 395**

**Appendix B Present Value of  
an Annuity of \$1 397**

**Glossary 399**

**Suggested Answers to  
Odd-Numbered Problems 411**

**Index 439**

PART ONE

# Assessing the Financial Health of the Firm





# Interpreting Financial Statements

Financial statements are like fine perfume; to be sniffed but not swallowed.

*Abraham Brilloff*

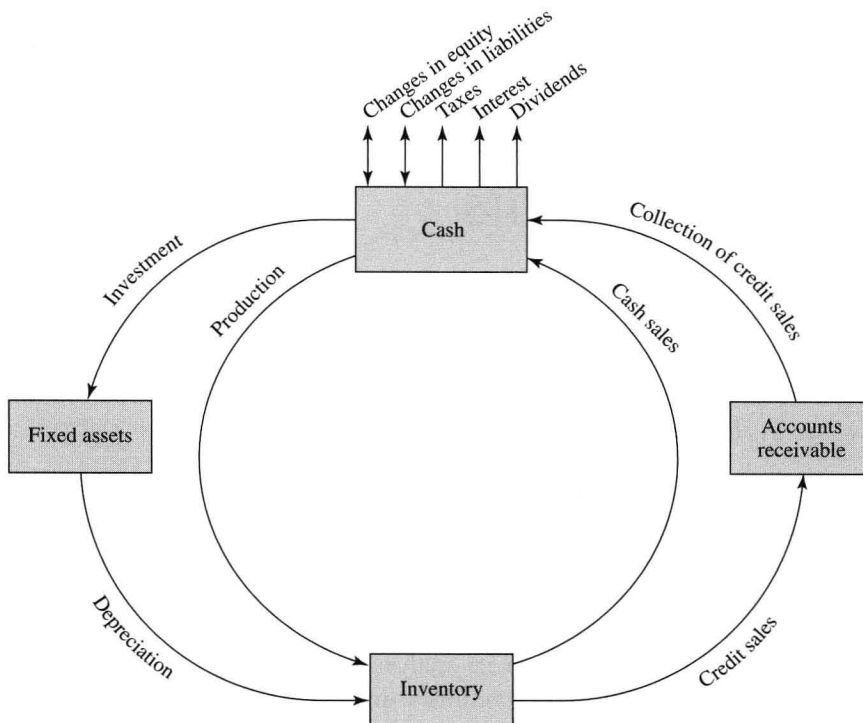
Accounting is the scorecard of business. It translates a company's diverse activities into a set of objective numbers that provide information about the firm's performance, problems, and prospects. Finance involves the interpretation of these accounting numbers for assessing performance and planning future actions.

The skills of financial analysis are important to a wide range of people, including investors, creditors, and regulators. But nowhere are they more important than within the company. Regardless of functional specialty or company size, managers who possess these skills are able to diagnose their firm's ills, prescribe useful remedies, and anticipate the financial consequences of their actions. Like a ballplayer who cannot keep score, an operating manager who does not fully understand accounting and finance works under an unnecessary handicap.

This and the following chapter look at the use of accounting information to assess financial health. We begin with an overview of the accounting principles governing financial statements and a discussion of one of the most abused and confusing notions in finance: cash flow. Two recurring themes will be that defining and measuring profits is more challenging than one might expect, and that profitability alone does not guarantee success, or even survival. In Chapter 2, we look at measures of financial performance and ratio analysis.

## The Cash Flow Cycle

Finance can seem arcane and complex to the uninitiated. However, a comparatively few basic principles should guide your thinking. One is that *a company's finances and operations are integrally connected*. A company's

**FIGURE 1.1** The Cash Flow-Production Cycle

activities, method of operation, and competitive strategy all fundamentally shape the firm's financial structure. The reverse is also true: Decisions that appear to be primarily financial in nature can significantly affect company operations. For example, the way a company finances its assets can affect the nature of the investments it is able to undertake in future years.

The cash flow production cycle in Figure 1.1 illustrates the close interplay between company operations and finances. For simplicity, suppose the company shown is a new one that has raised money from owners and creditors, has purchased productive assets, and is now ready to begin operations. To do so, the company uses cash to purchase raw materials and hire workers; with these inputs, it makes the product and stores it temporarily in inventory. Thus, what began as cash is now physical inventory. When the company sells an item, the physical inventory changes back into cash. If the sale is for cash, this occurs immediately; otherwise, cash is not realized until some later time when the account receivable is collected. This simple movement of cash to inventory, to accounts receivable, and back to cash is the firm's *operating*, or *working capital*, cycle.