George E. Pinches

Essentials of Financial Management

Fifth Edition

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George E. Pinches
University of Kansas

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Essentials of Financial Management

Preface

The world of business in the 1990s presents financial managers with tremendous challenges, as they attempt to deal with the major changes in the field of financial management begun in the 1980s. Numerous mergers, acquisitions—(friendly and hostile) bankruptcies, and recapitalizations have occurred, as firms have devised strategies for maximizing shareholder value and providing managerial independence for public firms that are being privatized. The market for options and other synthetic securities (derivatives) has matured and provided financial managers with new tools for managing risk. Global financial markets have become a fact of life, and computers have fundamentally changed how financial managers do their jobs. Access to technology through the Internet is changing the way that firms and individuals function. Given these changes, I felt that a fresh, new approach was needed to provide students a basis for understanding the financial management of corporations.

The instructor teaching a class in financial management accepts a daunting task. He or she faces a class of students intending to major in accounting, management, marketing, MIS, or finance. For many, this course may be their only exposure to finance. Accounting majors will appreciate exposure to the depreciation and taxation issues financial managers face; management students may want to delve into the ethical issues involved in insider trading; marketing majors may want to understand the basics of capital budgeting decisions that will affect new-product introductions; MIS majors will want to understand how financial concepts and decisions affect a firm's management information system. Finance majors will undoubtedly want to receive a sound grounding in the foundations of time value, risk and return, market theories, valuation, and the role of financial intermediation in finance. Given these divergent interests, I have tried to present a modern view of the key ideas and make them come to life through the use of contemporary examples. To this end, I have refocused and shortened the fifth edition of *Essentials of Financial Management*, streamlined and updated it, and built it around seven key ideas that affect financial decision making.

Distinguishing Features

Students who use this book should realize that there is more to know about finance than what appears between these covers. It is my hope that finance majors extract an understanding of the core ideas of finance that they can apply in future courses and throughout their careers, and that non-majors will leave with an understanding of the key ideas of finance and an appreciation of the role of finance in business. With this in mind, the fifth edition of *Essentials of Financial Management* contains a number of distinguishing features.

Fundamental Concepts

The text links financial decisions to seven key ideas:

1. *The goal of the firm is to maximize its value.* By market value, we mean the price that someone is willing to pay for the firm. For publicly traded firms this translates to the total market value of the firm's stock plus the total market value of its debt.
2. *Financial markets are efficient.* In efficient markets the current prices reflect all publicly available information. Students can understand financial management

and the implications of their decisions only if they understand the financial environment and markets, and how they operate.

3. *Individuals act in their own self-interest.* This concept focuses on what is referred to as "agency theory." As a follow-up to how financial market efficiency works, agency theory is examined extensively so that students can appreciate the human issues involved in finance.
4. *Firms focus on cash flows and their incremental effects.* By emphasizing the incremental inflow and outflow of cash we focus on the financial lifeblood of the firm. This would not be the case if we incorrectly focused our attention on the firm's accounting earnings.
5. *A dollar today is worth more than a dollar tomorrow.* The timing of the cash flows is important; in finance we employ time value of money concepts and net present value to deal with cash flows that occur at different points in time. This organizing principle underlies all of financial management, and it is stressed throughout the book so that students accept it as a paradigm, rather than an equation to be memorized and applied.
6. *Risk and return go hand-in-hand.* By focusing on risk and return we emphasize that in all financial decisions risk and return go hand-in-hand. In order for any firm or individual to increase its return, more risk must be incurred.
7. *Options are valuable.* An option provides the right, but not the necessity, of acting. Because options appear in many financial activities, the ideas behind them are introduced. Although the details are left to other courses, a basic understanding of options is important in financial management.

The emphasis on these key ideas has three major advantages. First, it provides a logical and consistent structure that ties together all of the firm's decisions. Second, it provides students a framework to which they can relate; put simply, it enables students to see the forest and not get lost in the trees. Finally, this approach is theoretically correct; therefore, without any special effort we develop an appreciation for the subject that can be applied to further study in finance.

A Balanced, Modular Approach

The book contains balanced coverage of all of the primary facets of financial management, including four chapters on short-term financial management, where coverage is sometimes skimpy. A modular approach allows greater flexibility in terms of sequencing of chapters.

This textbook has been designed to provide instructors with flexibility in course design, allowing them to include or exclude certain material. To facilitate flexibility an end-of-book Appendix D, "If the Last Is First," is provided for instructors who cover short-term financial management (Chapters 15–18) before covering Chapter 3, "Time Value of Money."

Additionally, a systematic effort has been made to shorten the fifth edition of *Essentials of Financial Management*, and to substantially reduce the number of appendices that contained higher-level topics. In that line, the number of appendices has been cut to four, down from thirteen in the previous edition.

Examples

Step-by-step examples illustrate the calculation so that students can understand the tools used in the decision-making process. Students should not be left guessing how the calculation was made.

International Topics

Because of its growing importance, international financial management is fully integrated into the appropriate chapters. In the past many texts left international finance to the last chapter, where it rarely got covered. By integrating it into selected chapters, we help students understand some of the international aspects of finance without taking attention away from topics at hand.

Up-to-Date Coverage

The text has been completely updated, to include the latest changes in the tax code, requirements in interest calculations, financial ethics, completely integrated coverage of agency issues, the presence of options in many of the financial activities that firms undertake, and coverage of derivatives and their impact on financial management.

Flexibility in the Classroom

Essentials of Financial Management, Fifth Edition, is designed to have a strong unifying theme, to be completely up-to-date, and to provide flexibility in sequencing course topics. Many instructors will cover the first five chapters in order, and then move to long-term investment decisions in Chapters 6 through 9. Some instructors have suggested two basic alternatives to this course sequence:

1. Instructors who want more coverage of stocks and bonds before or immediately after Chapter 4, "Valuation of Bonds and Stocks," will want to include Chapters 10 and/or 11 either before or after Chapter 4.
2. Chapter 6, "The Opportunity Cost of Capital," can be held until later, by moving directly from the first five chapters to Chapters 7 and 8. Chapter 6 can then be covered either immediately after Chapter 9, "Risk, Capital Budgeting, and Value Creation," or as part of the section on long-term financing decisions (Chapters 10 through 14).

Another course design favored by many instructors is to cover accounting statements, financial planning, and/or short-term financial management early in the course. In such a case, the fifth edition of *Essentials of Financial Management* provides a strong and consistent framework. There are a number of possible approaches when covering accounting statements, financial planning, and/or short-term financial management early in the course, including the following:

1. Cover Chapter 19, "Analyzing Accounting Statements," immediately after Chapter 2, "The Financial System, Interest Rates, and Foreign Exchange." Chapter 20, "Financial Planning and Forecasting," can then follow Chapter 19, if desired.
2. Short-term financial management, Chapters 15 through 18, can then be covered directly after Chapters 19 and/or 20, if desired. For instructors who want to cover Chapters 15–18 before Chapter 3, a unique, new end-of-book Appendix D, "If the Last Is First," provides the time value material needed for students to master Chapters 17–18 before covering Chapter 3.
3. A third alternative, one I have used increasingly in recent years, is to omit any lecture or testing on Chapter 19, "Analyzing Accounting Statements," but to require students to complete a major project that incorporates common-size statements, financial ratios, an analysis of the footnotes (or discussion) accompanying the firm's annual report, an analysis of the statement of cash flows, a major

expansion in financing for the firm, and pro forma accounting statements. This project is described in more detail in the *Instructor's Manual*. I have found that skipping Chapter 19, and including Chapter 20 between Chapters 15 and 16, provides a very solid and integrated treatment of accounting issues, short-term financial management, and financial planning and forecasting.

Many other chapter sequences have been successfully employed by instructors using previous editions of *Essentials of Financial Management*. The ability to sequence material in the desired manner has been further strengthened in the fifth edition.

Changes in the Fifth Edition

In many respects the fifth edition of *Essentials of Financial Management* is almost a completely new text. Major changes incorporated in this new edition are (1) the continual focus on seven key ideas that underlie finance; (2) the systematic approach taken to substantially shorten, update, and enliven the text based on the rapidly changing developments both in finance and the world in which we live; and (3) the substantial increase in pedagogical features.

The major changes in the fifth edition include:

1. *A shorter book*—now 20, rather than 23, chapters.
2. *Continuous coverage of international topics* as a main part of selected chapters where appropriate, so students gain an international perspective as they proceed through the course.
3. *Real-world executive interviews*, used as part openers and in-chapter interviews, which demonstrate how executives employ the ideas and concepts of finance in their daily corporate lives.
4. *Currency*—all material has been updated, and many chapters have been substantially rewritten, as detailed below. Special emphasis is given to financial ethics, agency issues, options and their occurrence in the day-to-day activities of firms, and derivatives.
5. Several *completely new features*, described in more detail later in the preface: learning objectives; marginal notes, which highlight the seven key ideas in financial management presented in Chapter 1 or provide additional explanatory material; concept review questions at the end of each section of text; and concept review problems at the end of each chapter, with solutions at the end of the book.

As was true in the first four editions of *Essentials of Financial Management*, there continues to be an emphasis on the role that cash inflows and outflows play in financial management. With the increased emphasis on seven key ideas in finance, this emphasis is reinforced throughout the text.

Chapter-by-Chapter Changes

The specific major chapter-by-chapter changes made in the fifth edition are as follows:

Chapter 1 expands from four to seven the key ideas in finance, which are then employed throughout the text; introduces net present value, in simple form; and includes a section on ethics and finance.

Chapter 2 includes a modified and streamlined discussion on interest rates, and uses data directly from *The Wall Street Journal* to construct a term structure of interest rates. Chapter 2 also discusses the returns from common stock demanded by investors, which parallels the discussion on the returns from bonds demanded by investors, and actual rates of inflation and yields on risk-free U.S. Treasury bills. This chapter contains an in-depth discussion of foreign exchange rates, since their impact must be understood before really dealing with international financial management issues.

Chapter 3 presents an extensively modified, rearranged, and streamlined discussion of present and future values. It introduces growing annuities and calculates their present value, and discusses how to make financial calculations. In the discussion of determining interest rates, the chapter explains that finding an interest rate is a specific application of the internal rate of return, and discusses internal rates of return. Finally, Chapter 3 provides an extensive, completely up-to-date discussion on effective interest rates, including why the annual percentage rate, *APR*, required under the Truth-in-Lending Act *is not* an effective annual rate, and why the annual percentage yield, *APY*, required under the Truth-in-Savings act *is* an affective annual interest rate.

Chapter 4 now has a completely new section on price/earnings ratios, the present value of growth opportunities, and how accepting positive net present value projects leads to increases in the value of the firm.

Chapter 5 has been streamlined, simplified, and shortened. It illustrates how information obtained from *Value Line Investment Survey* can be employed in determining information needed to estimate the expected return on the market portfolio. Also, Chapter 5 provides data and discussion on the use of, and pitfalls of using, historical data to estimate the expected return on the market portfolio.

Chapter 6 has been moved forward in the chapter sequence, to be the first in the long-term investment part. It now estimates the opportunity cost of capital for PepsiCo (as of the end of 1994) and shows the use of *Value Line Investment Survey* data in the analysis. Chapter 6 also includes a completely new section on using historical information to estimate the return on the market portfolio and risk premiums. Finally, this chapter covers new material on finding the cost of capital for multinational firms.

Chapters 7 and 8 have been rearranged to provide a clearer, more coherent presentation. For simplicity all of the calculations involving depreciation both in these chapters and throughout the text employ straight-line depreciation and ignore the half-year convention required by the Internal Revenue Service. A completely new section in Chapter 8, "Those Hard-to-Estimate Costs and Benefits," discusses how to proceed with difficult estimations, and also incorporates some ethical issues by reference to specific examples. Appendix 8A discusses the modified accelerated recovery, MACRS, system of depreciation.

Chapter 9 substantially changed and streamlined, contains new sections on factors to consider when estimating risk, what leads to positive *NPVs*, and the results of relying on market values. The revamped section on break-even analysis begins with a complete discussion of the accounting approach to break-even analysis. This thorough coverage of capital investment decision making ends with some guidelines for structuring and evaluating capital investment, including ten items required for effective capital investment decision-making systems.

Chapter 10 includes a new discussion and table on the sources of financing—external versus internal—for firms and an expanded discussion on the role played by investment banking firms in helping firms raise capital. Further, Chapter 10 addresses the topic of financial ethics in investment banking. This chapter also includes a new section on venture capital.

Chapter 11 discusses term loans and amortization schedules. It has an expanded coverage of junk (high-yield) bonds, and a new section on hybrids, asset-backed securities, and other innovations.

Chapter 12 has been substantially rewritten. It continues to focus on the Modigliani-Miller capital structure propositions, but in less detail. Chapter 12 contains an additional discussion of the many and varied approaches to capital structure theory that have led to the current thinking about the impact of capital structure on the value of the firm.

Chapter 13 rewritten and streamlined, contains a new section on the Modigliani-Miller dividend irrelevance argument, plus a section on why firms pay cash dividends.

Chapter 14 includes an abbreviated treatment on leasing, and discusses the underlying ideas about options and what influences their value. This chapter also discusses why stock is "just a call option," and covers new material on warrants and convertible securities.

Chapter 15 provides more discussion on the managerial implications of the cash conversion cycle. The chapter differentiates between aggressive (action oriented) and conservative (passive) asset or liability management policies and discusses financial slack, its tie to a firm's capital structure, and the role of liquidity. A new section on the changing nature of risk management highlights the tremendous changes occurring in how firms deal with short-term financial management issues and how they hedge some of their risk exposure.

Chapter 16 includes a new section on paper-based (e.g., check-driven) versus electronic payment systems. The chapter discusses the Expedited Funds Availability Act of 1987 and its rules on fund availability, as well as electronic funds transfer (EFT), electronic data interchange (EDI), and how firms are changing their ordering and payment systems.

Chapter 17 explains the use of an aging schedule for monitoring the collection of accounts receivable. The chapter now provides more material on collecting international receivables.

Chapter 18 provides extensive discussion of the role that nominal interest rates play in determining effective annual interest rates.

Chapter 19 provides a step-by-step analysis of the accounting statements of General Mills, and financial implications of the analysis. It also discusses the quality of earnings. Chapter 19 includes a short section on derivatives and the problems created by their lack of disclosure in the accounting process. This chapter also contains material on the financial effects of differing accounting standards in other countries.

Chapter 20 contains a new discussion of the statement of cash flows, using General Mills as an example. Discussion of forecasting sales has been streamlined in Chapter 20 as well.

Pedagogical Features

The fifth edition of *Essentials of Financial Management* has been designed with the student in mind. To that end, there are substantially more pedagogical features than in previous editions. The primary pedagogical features are:

1. Complete *step-by-step discussions and illustrations* of how to proceed in making decisions and conducting financial analysis. Instead of backing off and downplaying any discussion of the details, a hallmark of *Essentials of Financial Management* has always been that it provides complete step-by-step examples. This emphasis has been heightened in the fifth edition, and includes many more examples of where to obtain the necessary information, how to proceed with the analysis, and what the conclusions are from the analysis. This format focuses

student learning on how to use the concepts and techniques of financial management in real-world situations.

2. The use of *timelines* to represent cash inflows and outflows remains in the fifth edition of *Essentials of Financial Management*, to help students visualize the firm's cash flows.
3. Highly interesting and informative *Executive Interviews* have been added at the beginning of each of the six parts of the text, and in selected chapters. In these interviews, highly qualified executives have been encouraged to provide their thoughts, in their own words, to link the material in the text to its application in the business world.
4. *Learning objectives* have been added at the start of each chapter, and then repeated where the material is covered in the chapter, to help students organize their study progress and to provide an organizational *roadmap* for instructors.
5. A *marginal glossary*, with simplified definitions, provides a quick review of important vocabulary.
6. *Marginal notes* refer back to the seven key ideas in finance presented in Chapter 1. The continuous reinforcement of underlying themes provides students with a means of focusing on the concepts that are crucial throughout finance. Other marginal notes clarify or elaborate on various important points in the text, to provide additional reinforcement and learning.
7. *Concept review questions* at the end of each section in a chapter encourage students to focus on the key points to be obtained from each section before they move on to the next.
8. Boxed *Financial Management Today* items, in selected chapters, make real-world connections for students. These boxes provide additional illustrations of how finance operates at selected firms, or emphasize how to employ the concepts discussed in the text.
9. A discussion of *financial calculators* in Chapter 3, followed by detailed, "how-to" instructions in a booklet accompanying the textbook, shows how financial calculators can be used to solve the calculations needed to master financial management.
10. All *financial calculations* are shown in step-by-step fashion throughout the text. That is, there are no leaps of faith that cause students and instructors difficulty in determining how the author got from the data to the answer. Where financial calculation requires present or future value concepts, the answers are provided using a financial calculator solution and, in a footnote, the same calculation and answers are provided using a financial table. The same dual presentation using financial calculators and financial tables is carried throughout the Concept Review Problems and their solutions (provided in Appendix A), the Answers to Selected Problems (provided in Appendix C), and all problems in the *Instructor's Manual*. Therefore, students and instructors can have complete confidence that the appropriate answers are provided, whether a financial calculator or a financial table is employed.
11. A *bulleted summary* at the end of each chapter provides a focused synopsis of the key points to be learned in the chapter.
12. Completely new *Concept Review Problems* are included at the end of each chapter. These problems, with solutions provided in Appendix A, give students a valuable opportunity to apply chapter material before they undertake assigned problem material.
13. End of chapter *Problems* have been reworked and many new cues added, to make assignments more user-friendly. All problems and solutions are now

based on calculator answers, with financial table answers also provided where appropriate.

14. *A Mini Case* at the end of each chapter pulls together important strands of chapter coverage for comprehensive review.
15. *Selected references* are provided to topics covered in *Financial Management,* my upper level textbook, that are outside the desired introductory-level coverage of the fifth edition of *Essentials of Financial Management.*
16. The book's *endpapers* provide an annotated listing of all relevant equations employed in the text.

A Complete Teaching Support Package

Essentials of Financial Management, Fifth Edition, offers a complete support package designed to enhance the teaching of the text and maximize student understanding and mastery of financial management. The entire teaching support package has been extensively reviewed for accuracy. The following supplementary items are available:

Instructor's Manual. I have personally prepared the *Instructor's Manual* to accompany the book. It contains the answers to all of the chapter questions and complete step-by-step solutions to all of the problems in the text.

Test Bank. A separate *Test Bank,* prepared by Kathryn M. Kelm of Emporia State University and me, contains multiple-choice items as well as longer problem-type test items. The multiple-choice items are available in a computerized format as well as in a printed form.

Lecture Outlines and Transparencies (LOTS). An extensive set of lecture notes and transparencies, prepared by Kathryn M. Kelm, is available to adopters. Some of the transparencies are available in acetate form, and all of the transparencies are available as masters or on diskette for use with a projector pad and an IBM-compatible PC.

Study Guide. An extensive *Study Guide,* authored by Michael B. Madaris, University of Southern Mississippi, is available to provide students with explanations and extensions of the material in the text. The *Study Guide* contains an outline for each chapter, summaries of key equations, and over 200 problems with detailed worked-out solutions that illustrate the key concepts presented in each chapter.

Using Financial and Business Calculators

Shrinkwrapped free with every new copy of the text is a 36 page booklet on "Using Financial and Business Calculators." It includes extensive coverage of how students can most effectively use any of three popular financial calculators: HP10B, HP12C, and the TIBAII+. For all of the calculations in the book and in the *Instructor's Manual,* solutions using both financial tables and a financial calculator are provided. In addition, for the different types of homework problems that can be solved by a financial calculator, step-by-step calculations are shown for all three calculators.

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In addition, a number of other individuals made important contributions to the book. Alfie Davis, of Queen's University, my co-author for *Canadian Financial Management*, contributed to my thinking on numerous topics. Marlene Bellamy secured the Executive Interviews for each part and the selected in-chapter interviews. Jim Gentry, Mike McNamara, Tim Manuel, and Joe Messina contributed ideas for marginal notes. Mridu Vashist worked long and hard on the calculator booklet that accompanies the book; Gennady Zalko provided the original thoughts for learning objectives; Laurian C. Lytle, University of Wisconsin—Whitewater, provided helpful comments on ethics in finance; and David A. Volkman of the University of Nebraska—Omaha provided the new Concept Review Problems. Ann Torbert, the development editor for the fifth edition of *Essentials of Financial Management* did a truly outstanding job. Without Ann's talents, organizational skills, and constant good humor and enthusiasm, this project would have not been completed. I owe Ann a true vote of thanks. The staff at HarperCollins deserves a special thanks for their efforts on this book. They include Lisa Pinto, Arlene Bessenoff, Mary McGeary, and Ed Yarnell. Melonie Salvati pulled, pushed, and persuaded to get the material through the production process. Thanks, too, to Kate Steinbacher, marketing manager, whose enthusiasm and ideas help support this book both before and long after publication. Special thanks to Kirsten Sandberg and Joan Cannon, finance acquisitions editors, who labored long and hard to make the fifth edition of *Essentials of Financial Management* a reality and a success.

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To the extent I have written an up-to-date, clear statement of the fundamental concepts, theoretical developments, and practical aspects of financial management, I owe a large debt of thanks to the help and criticism I have received from others. I encourage all users to provide me with comments, suggestions, and criticism. All are most welcome in my attempt to provide an ever improving means of learning financial management.

George E. Pinches
School of Business
University of Kansas
Lawrence, KS 66045
(913) 864–7533

A Visual Guide To:

Essentials of Financial Management

George E. Pinches
University of Kansas

Fifth Edition
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Reflecting the dramatic changes and challenges of today's business world, the fifth edition of *Essentials of Financial Management* provides students with a modern view of the fundamental concepts in finance. Pinches builds the text around the seven key ideas that affect financial decision making: (1) the goal of the firm is to maximize its value; (2) financial markets are efficient; (3) individuals act in their own self-interest (agency theory); (4) firms focus on cash flows and their incremental effects; (5) a dollar today is worth more than a dollar tomorrow (time value and net present value); (6) risk and return go hand-in-hand (portfolio theory and capital asset pricing model); and (7) options are valuable. The text stresses applications by providing step-by-step illustrations for both long- and short-term financial management. Including the most recent international developments, tax codes, interest calculations, and ethical concerns, *Essentials* illustrates the role of finance in today's business world. Refocused and redesigned, this fifth edition also offers more real-world examples, interviews with practicing finance professionals, an enriched learning system, and cases to help students understand financial concepts.

PART 1

THE FINANCIAL MANAGEMENT ENVIRONMENT

EXECUTIVE INTERVIEW WITH DONALD M. MUIR

Treasurer
Stratus Computer, Inc.,
Marlborough,
Massachusetts

Stratus

Donald Muir received a B.B.A in accounting from the University of Massachusetts, Amherst, and a M.B.A. in finance from Boston University. From 1978 to 1987, he held various accounting, financial, and operations management positions at Wallace Murray Corporation and at Prime Computer, Inc. He joined Stratus Computer, Inc. in 1987, where he served as controller of two business units and director of finance and administration before being promoted to treasurer in 1993. We asked Mr. Muir to discuss the financial management environment.

As business students and as business professionals you will be continuously exposed to a wide variety of financial data and information. How well you understand, interpret, test, and use it will greatly influence your ability to make sound business decisions. Every aspect of business requires managers to analyze and report financial results. This is true for activities ranging from developing new-product sales projections to choosing insurance coverage or buying capital equipment. Both operations managers and financial managers must understand how the numbers are derived in order to explain their ideas and justify their proposals.

In the computer industry today financial management plays a key role in helping firms survive difficult economic and technological times. The proliferation of low-cost desktop computers and improved microprocessor technology have increased competition and eroded gross margins for hardware manufacturers.

Stratus Computer's ability to grow is largely the result of its financial strength. The company was formed in 1980 to provide continuously available computer systems that virtually eliminate the risk of computer downtime. Our systems are used by industries for whom continuous availability is critical, such as telecommunications companies, banks, stock exchanges and brokerage

EXECUTIVE INTERVIEW

At the beginning of each part of the book, *Executive Interviews* show students how what they learn in the classroom is applied in the real world by highlighting the key content issues used by a real-world practitioner.

SEVEN KEY IDEAS

Seven key ideas of finance, introduced and discussed in chapter 1 and then integrated throughout the text, reinforce how the firm's decisions are tied together while providing students with a view of the role of finance in today's business world.

FINANCIAL MARKETS Markets outside the firm in which financial transactions take place.

PROPRIETORSHIP An unincorporated business owned by one individual.

PARTNERSHIP A business owned by two or more individuals.

CORPORATION A legal entity with the power to act as an individual and with limited liability.

LIMITED LIABILITY By law, a restriction on the amount owners of a corporation can lose in the case of bankruptcy.

COMMON STOCK An ownership share of a corporation.

BONDS Long-term debt instruments (IOUs) issued by firms and governments.

vacuum. Performance is affected by a variety of external factors: the health of the economy, taxes, interest rates, international tensions, and the prevailing political and regulatory moods. In fact, the performance of the firm is ultimately judged by the external **financial markets,** where stocks and bonds are traded.

The ideas, tools, and techniques of financial management apply to all kinds of firms as well as to individuals. Our focus in this book will be on corporations, rather than on proprietorships or partnerships. A **proprietorship** is an unincorporated business owned by one individual. A **partnership** is a business owned by two or more individuals. Proprietorships or partnerships often are used in the early stages of a business, but most successful ones are eventually converted into corporations. A **corporation** is a legal entity given the power to act as an individual, and it has limited liability. **Limited liability** is a major advantage of a corporation; it means that if the firm goes bankrupt, the owners can lose no more than the money they have invested in the firm.

Corporations can raise funds by issuing and selling shares of their **common stock.** In return for investing in the firm the common stockholders become the owners of the firm. Corporations can also obtain funds by selling **bonds,** which are long-term debt instruments. Bonds are nothing more than IOUs that firms use to obtain financing. The bondholders have a fixed, but limited, claim on the firm. In addition, firms obtain needed funds, and incur financial obligations, through bank loans and credit extended to the firm.

CONCEPT REVIEW QUESTIONS

- What are the three main elements in the definition of financial management?
- Describe the three forms of business organization.

KEY IDEAS IN FINANCIAL MANAGEMENT

LEARNING GOAL 2

List and discuss the seven key ideas underlying financial management.

In this course, you'll learn to speak the language of finance. In the business world, a command of the finance "lingo" is critical.

Throughout this book you will encounter new terms, ideas, and relationships. Although they are all important in one way or another, certain key ideas underlie the theory and practice of financial management. Since these will come up over and over again, it makes sense to understand them from the start. The seven key ideas that guide our discussions are:

1. The goal of the firm is to maximize its market value.
2. Financial markets are efficient.
3. Individuals act in their own self-interest.
4. Firms focus on cash flows and their incremental effects.
5. A dollar today is worth more than a dollar tomorrow.
6. Risk and return go hand-in-hand.
7. Options are valuable.

Before we begin to use these ideas in making financial decisions, let's briefly explore them one by one.

sensitive to changes in domestic demand. In commenting on the Fed's 1994 efforts, one European banker noted: "Even if the one pair of brakes the Fed has hasn't seemed to be working that effectively, it's still the only pair of brakes they have. And they'll have to use them."

International Financial Markets

In addition to the domestic financial market, the financial marketplace is now worldwide. Large U.S. firms routinely issue bonds or secure short-term financing overseas. Some even list their stock on foreign stock exchanges. While many of the same forces are at work worldwide, there are two fundamental differences. First, the role of a single government, or governmental unit such as the Federal Reserve, is diminished since funds tend to flow fairly freely between many countries. Second, the value of a foreign currency relative to other currencies—called *exchange rates*—can and do change. As discussed later in this chapter, understanding exchange rates is important for financial managers who deal in almost any financial management transaction. The internationalization of the money and capital markets is a fundamental development affecting financial management.

Why Is the Financial System Important?

You may already see the need to know about financial institutions and markets. Here are some of the reasons:

Remember Key Idea 2—in developed countries, like the United States, financial markets are efficient.

1. The financial system provides an effective means of bringing together suppliers and demanders of funds. It enables firms that have excess funds, or firms that need funds, to make transactions quickly and cheaply.
2. The financial system includes the crucial secondary market. By facilitating the buying and selling of outstanding securities, an organized secondary market makes it easier for a firm to raise external debt or equity capital. This occurs because potential investors would be reluctant to buy securities if they thought they might be stuck with them forever. Only in industrialized countries with well-developed secondary markets are the financial markets efficient. Thus, only in countries where an extensive array of financial institutions and markets does the value of a firm's outstanding securities provide a good estimate of the value, or economic worth, of the firm.
3. The financial system changes rapidly, affording new opportunities. New institutions, securities, and markets appear every year. These allow astute firms to use new sources or securities for raising capital.
4. The value of the firm is determined in the financial markets. That value depends on the interaction of supply and demand in the financial marketplace—given the external business environment and management's strategies and policy decisions. The welfare of the firm and all of its stakeholders—its owners, creditors, employees, managers, and the community at large—rests directly on the value of the firm as determined in the financial markets.

CONCEPT REVIEW QUESTIONS

- How do financial institutions aid the transfer of funds between suppliers and demanders?
- How do primary and secondary markets differ?
- Why are financial markets important to financial managers?

CHAPTER-OPENING ANNOTATED OUTLINE AND LEARNING GOALS

Extensive pedagogical aids throughout each chapter provide students with tools to highlight, test, and remember key topics. A *Chapter Outline* previews the key topics in the chapter. *Learning Goals*, listed at the beginning of each chapter and introduced at the start of the relevant text material, focus students' attention on key concepts.

CHAPTER 2

The Financial System, Interest Rates, and Foreign Exchange

Sections in this chapter:

- **The Financial System**
  The major players in finance and where the action takes place.
- **Interest Rates and the Required Rate of Return**
  Two sides of the same coin—the cost to the borrower equals the return to the lender.
- **Returns and Risk**
  The steadiest couple in finance.
- **Foreign Exchange Rates**
  "I'll give you 2 pesos for 1 guilder."

In finance, the 1980s were the decade of junk bonds and high leverage. In the 1990s the emphasis has switched to globalization, the information superhighway, interest in health care reform, and attempts to shrink the role of the federal government. Freer trade, through NAFTA (the North American Free Trade Agreement), GATT (General Agreement on Tariffs and Trade), expansion of the European Community, and other bilateral or regional agreements, is becoming ...

... hand, in response to ...

... globalization, American Ex... joined a number of ... such as McDonald's, Philip Morris, 3M, and Walt Disney—in having its common stock listed on the Tokyo Stock Exchange. "We think," the company explained, "it broadens the market for American Express stock with investors around the world and will enhance our reputation in Japan because there will be a lot of publicity surrounding the listing." Likewise, multinational firms are increasingly raising capital in the United States, in the form of both debt and equity financing.

Learning Goals

After studying this chapter, you should be able to:

1. Explain the role of financial institutions and distinguish between the primary and secondary markets.
2. Determine the required returns for bonds and for stock, and explain how interest rates affect these returns.
3. Know how returns are measured, and understand the relationship between risk and return of financial assets.
4. Understand the relationship between current (as of today) and forward exchange rates of two currencies.

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CHAPTER 9

Risk, Capital Budgeting, Value Creation

Sections in this chapter:

- **Risk and Strategic Decisions**
  When and why more risk can be beneficial.
- **Opportunity Cost of Capital for Capital Budgeting Decisions**
  Which opportunity cost is important?
- **Information About the Riskiness of Projects**
  We can't ignore risk.
- **What Leads to Positive *NPVs*?**
  What to watch for in the capital budgeting process.
- **Other Capital Investment Decisions**
  We aren't finished yet!

Intel is the world's largest manufacturer of microprocessor chips—the silicon "brains" that make a computer work. The vast majority of personal computers sold contain Intel chips. Intel dominated the market with its 486 processor, and its successor, the Pentium. Yet, others are attempting to seize part of Intel's market share: Advanced Micro Devices (AMD) and Cyrix, both much smaller firms, make Intel-compatible chips. In addition, IBM and Apple Computer have joined up to develop an alternative microprocessor, the PowerPC. While the combination of IBM and Apple Computer seems formidable, the PowerPC is handicapped in a couple of ways. First, it will not run many of the current software packages, and software makers are reluctant to redesign their programs to run on the PowerPC. Second, Microsoft, the developer of the DOS and Windows operating software, says its new Windows version will not be compatible with the PowerPC.

To maintain its lead in supplying microprocessors to the computer industry, Intel must keep spending larger and larger sums to develop the next generation of chips. While the 486 is still here the Pentium chip is the dominate chip in personal computers. And the successor to the Pentium, the P6, is already far along in development at Intel. To keep ahead of the competition, Intel continues with a high level of capital expenditures every year.

Investment decisions can have unforeseen consequences, and it is not easy to conduct a capital budgeting analysis in the face of a continuing stream of future investment opportunities. As an executive of a major firm recently stated, "You simply can't put a dollar sign on a technological future that may have a tremendous payoff." He noted that quantitative analysis is complicated by uncertainty. Which opportunities

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CHAPTER-OPENING VIGNETTES

Chapter-opening vignettes pique students' interest by relating real-world business situations to the chapter topic.