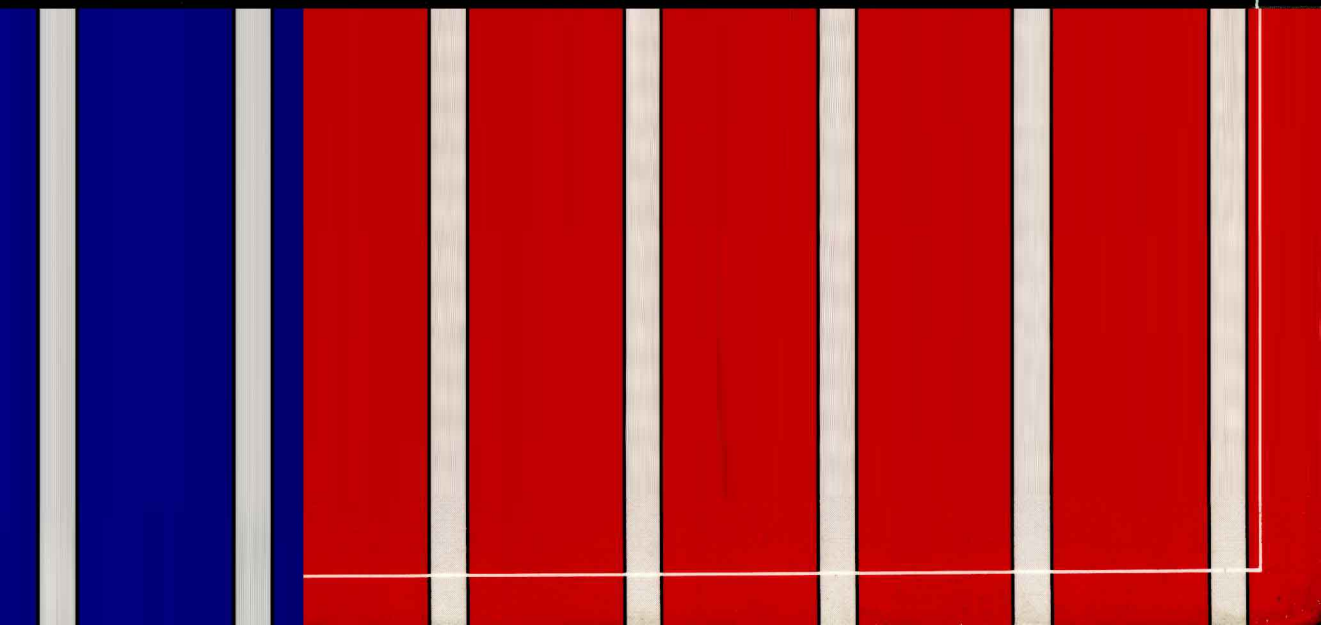


George E. Pinches

Essentials of Financial Management

Second Edition



ESSENTIALS OF FINANCIAL MANAGEMENT

Second Edition

George E. Pinches

The University of Kansas

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Preface

Management of the activities that bear on financial decisions today is a rapidly changing field. A growing body of theory and practice is helping us understand and respond effectively to evolving financial needs, institutions, and instruments. Increasingly, the essentials must be studied as they apply not only to large, profit-oriented firms, but also to small firms, governmental units, and international organizations. The distinguishing features of *Essentials of Financial Management* have therefore been maintained in this second edition:

1. A consistent framework is used throughout, based on the magnitude, timing, and riskiness of expected cash inflows and outflows—with less dependence on accounting data and conclusions.
2. The text links all financial decisions to the concepts of risk and expected return in order to emphasize the goal of maximizing the value of stockholder claims on the firm. All major financial decisions, even in such often neglected areas as working capital management and mergers, are studied in terms of value maximization and the net present value framework.
3. A balanced approach gives equal weight to both theory and practice and to both short- and long-term considerations.
4. Relevant international material is interspersed wherever it is appropriate—instead of being segregated at the end of the book, where students may never cover it. This way of introducing international finance has the advantage of meeting the requirements of the American Assembly of Collegiate Schools of Business (AACSB) without disturbing the logical sequence.
5. Step-by-step illustrations and examples have been provided so that students will see all relevant calculations used in the decision-making process.
6. An introductory text in the subject must be as up-to-date and contemporary as financial management itself. The world we live in is changing so rapidly that current trends in financial practice, along with recent developments in relevant theory, must be—and have been—incorporated.
7. Most financial management texts fail to show students how firms actually plan for the future. Chapter 20 of this text demonstrates how financial officers use the techniques presented previously to conduct financial planning.

Learning Aids in the Text

In addition, I have incorporated a number of special features to enhance the learning process. Each chapter begins with an overview that highlights the major issues and ends with a summary that may be used as a chapter review. Each chapter also includes an extensive problem set that was class tested during the preparation of the text. (Answers to selected problems are provided at the end of the book.) Key terms appear in italics in the text and are defined in a glossary at the end of the book. The treatment of cash flows as an integrating theme is reinforced by repeated use of time lines, and highly readable and relevant figures illustrate chapter materials.

Based on the comments of numerous students and professors, this approach has succeeded—and not only in the first course in finance. Students have found that *Essentials of Financial Management* can also be used in subsequent courses and in their passage from formal study into the business world.

Major Changes in the Second Edition

Organization

I have made significant changes in the second edition to streamline the book and improve the logic and flexibility of the chapter sequence:

1. **Financial analysis and forecasting** are now Part Two, following the introductory chapters. Chapter 3 (financial analysis) and Chapter 4 (cash flows, cash budgets, and financial forecasts) were reworked extensively. These two chapters may now be covered where they are placed, or after Part Three.
2. **Capital budgeting** was moved forward in the book, since most professors prefer to cover this important topic before considering working capital management, and its coverage was expanded from two to three chapters.
3. **Long-term financing** has a thoroughly revised and restructured treatment. Chapters 11 and 12 (external financing, common stock, and debt) now come immediately before the chapters on marginal cost of capital, capital structure, and dividend policy.
4. **Financial planning and special topics**, as before, conclude the text. In this edition, however, Part Seven includes the summary chapter on financial planning and strategy and a chapter on mergers and acquisitions. Part Eight then covers the special topics of leasing, convertibles, and bankruptcy (which all can easily be omitted). *The first six parts of the book—19 chapters—provide a comprehensive first text for schools on the quarter system.*

This restructuring results in a more natural sequence of material, one that at the same time provides greater flexibility for those instructors who prefer a different sequence. All of the major changes brought about by the Tax Reform Act of 1986—which is the most sweeping revision of the federal income tax system ever passed—are reflected in the second edition.

Coverage

I have eliminated extraneous material in several chapters of this edition so that the essential elements of finance are presented more clearly and concisely—yet instructors

will find that the scope of the text has been expanded in a number of areas. The most significant one is capital budgeting, which now occupies three chapters. The material on present values and discounting, risk, financial leverage, and the Modigliani-Miller position has also been improved and clarified. Financial planning and strategy considerations (Chapter 20) are discussed at greater length.

Other significant extensions of coverage include

- individual and corporate taxes (Appendix 1A)
- interest rates and the cost of capital (Chapter 2)
- the limitations of financial analysis (Chapter 3)
- forecasting financial needs (Chapter 4)
- naïve forecasting (Appendix 4A)
- time value applications (Chapter 5)
- why beta is important (Chapter 6)
- bond and stock valuation in financial management (Chapter 7)
- what leads to positive NPVs (Chapter 8)
- abandonment decisions (Chapter 9)
- strategic decisions and contingent projects (Chapter 10)
- zero-coupon bonds and liquidity management (Chapter 12)
- jumps in the MCC schedule (Chapter 13)
- why firms have working capital (Chapter 16)
- figuring the yield on Treasury bills (Chapter 17)
- credit scoring, and ABC and just-in-time inventory systems (Chapter 18)
- recent merger and acquisition developments (Chapter 21)
- setting lease rates and finding the percentage cost of leasing (Chapter 22)

These changes make the second edition more current and comprehensive.

Introductory Examples

As in the first edition, this text relies wherever possible on examples from the actual business world. In particular, J. C. Penney is used in Chapter 3 (financial analysis) and 13 (marginal cost of capital) and mentioned elsewhere in the text. In addition, the key elements of each chapter are now introduced with relevant examples in a special section at the beginning of each chapter.

New Self-Test Problems

Over 70 self-test problems have been added at the ends of chapters. Step-by-step solutions appear a few pages later. These new exercises foster the students' ability to set up problems so that proper financial decisions can be made. At the same time, the regular problem sets at the end of each chapter have been expanded by 35 percent from the first edition. *Essentials of Financial Management* now contains the best problem set, in terms of quality and range of difficulty, of any introductory text. The problems are all matched to the coverage and level of their chapters, and all the new problems have been class tested, just as those in the first edition were.

Figures and Tables

To enhance understanding, a number of figures have been added to show visually how various concepts and flows are related. Conversely, the number of tables has been significantly reduced.

References

Selected current references have been added at the end of each chapter.

Supplementary Materials

Essentials of Financial Management offers a complete set of supplements designed to maximize student understanding and mastery of financial management. Instructors are given solid support so that they can concentrate on enhancing learning.

Instructor's Manual

I have prepared a complete *Instructor's Manual*, consisting of four parts: (1) "Notes for Instructors," providing supplementary teaching ideas and expanding on key concepts; (2) answers to all chapter questions; (3) complete solutions to all problems in the text; and (4) handouts on supplemental ideas that can be reproduced and distributed to students. This manual also describes alternative sequences for presenting the text material.

Test Bank

A separate *Test Bank*, prepared by Kathryn M. Kelm (University of Kansas) and myself, consists of approximately 1,450 multiple-choice and true-false questions, as well as 120 additional problems. The multiple-choice and true-false questions will also be available on a new microcomputerized test-generation package.

Study Guide

An extensive *Study Guide*, prepared by David C. Ketcham (University of Tennessee) and myself, supplements, explains, and extends the material in the text. Its key elements include topical outlines stressing the main features of each chapter, summaries of key equations, "What to Look for" sections that discuss and elaborate on important or difficult concepts, completion questions that test understanding, and over 100 additional problems with step-by-step solutions especially designed to bring out the key analytical concepts of each chapter.

Pinches Problem Diskette

A thoroughly user-friendly diskette, available free to instructors, introduces the power of spreadsheet programs to the teaching of financial management. Compatible with Lotus 1-2-3, versions 1A and 2.0, as well as Lotus "clones," this diskette prompts students to perform sensitivity analysis on 23 in-text problems.

Transparency Masters

A set of transparency masters of key figures and tables is available to instructors who adopt the text.

Acknowledgments

Essentials of Financial Management has been class tested, and the comments, criticism, and encouragement given freely (and often vocally) by students contributed in no small way to the development of this text. I would also like to thank the professors whose detailed comments and suggestions improved this edition:

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Finally, I must acknowledge the continued love and support of my family. Without their understanding, this revision could not have been completed.

To the extent that I have succeeded in writing a clear introduction to finance, it is thanks in large part to the help and criticism I have received from others. I encourage users to continue to provide me with comments, suggestions, and criticism. All are most welcome.

George E. Pinches
Lawrence, Kansas
October 1986

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