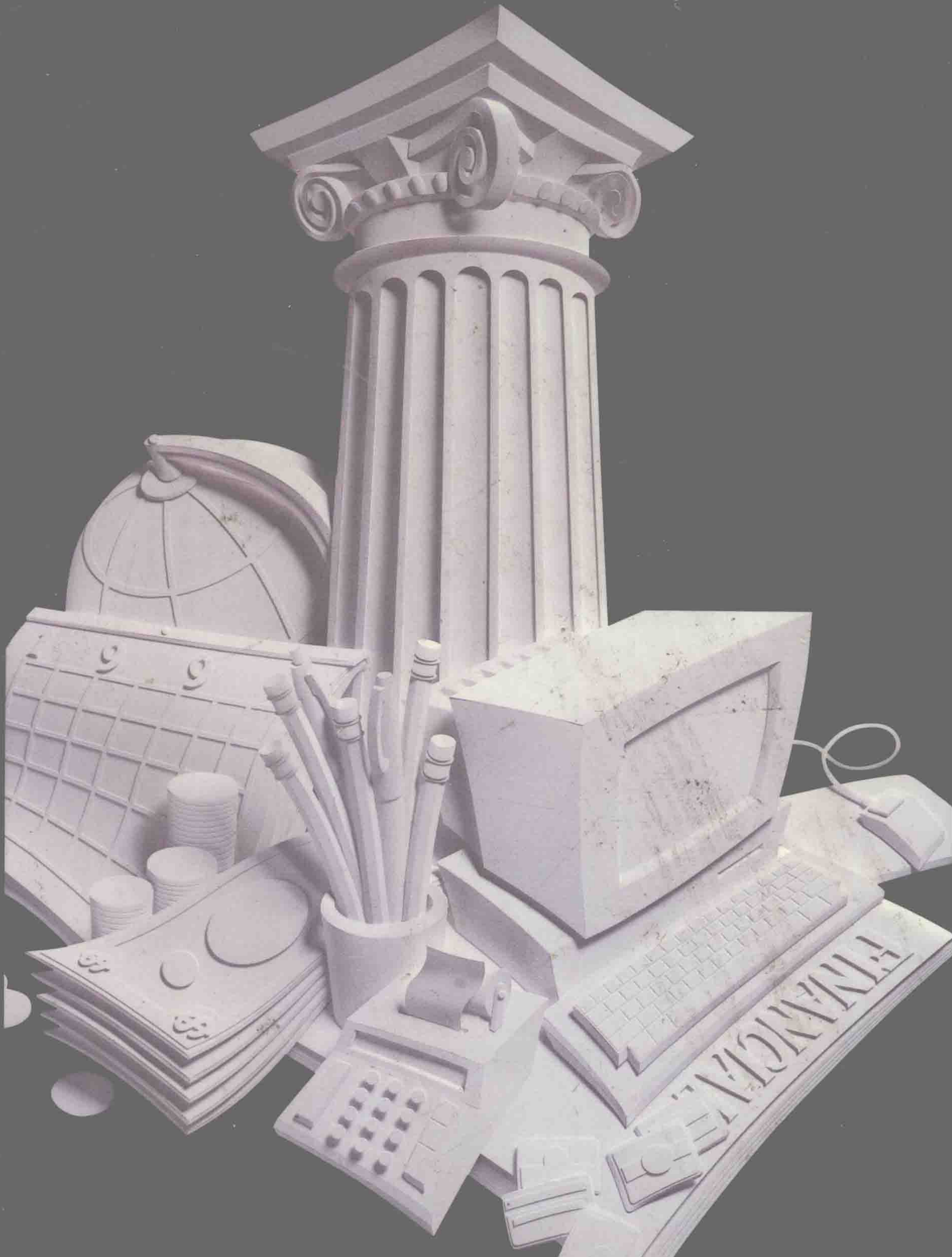
BASIC FINANCIAL MANAGEMENT



SEVENTH EDITION

KEOWN • SCOTT • MARTIN • PETTY

BASIC FINANCIAL MANAGEMENT

SEVENTH EDITION

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

J. WILLIAM PETTY

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

Prentice Hall, Upper Saddle River, NJ 07458

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The seventh edition of
Basic Financial Management
is dedicated to our families—the ones who love us the most.

Barb, Emily, and Artie
Peggy
Sally, David and Melonie, and Jess
Donna, Krista and Greg, and Katie and Carter

PREFACE

Over the past thirty years the teaching of finance has evolved from a descriptive presentation of ill-defined decision rules taught through the use of case examples to a science where the logic and decision rules spring from basic economic principles. Today, finance continues to change and develop at an ever increasing pace. Sparked by the changing business environment and developments in the academic world, new financing and risk management techniques seem to appear on almost a daily basis.

How do you prepare for a field as dynamic as finance? The answer is to go beyond the answers and understand the logic that drives those answers. It is for this reason that the presentation in this text has been crafted around ten basic axioms. Using these axioms, 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. Our objective is to provide the student with a relevant understanding of financial decision making that is based on theory.

OUR APPROACH TO BASIC FINANCIAL MANAGEMENT

The first-time student of finance will find that corporate finance builds upon both accounting and economics. Economics provides much of the theory that underlies our techniques while accounting provides the input or data on which decision making is based. Unfortunately, it is all too easy for students to lose sight of the logic that drives finance and focus instead on memorizing formulas and procedures. As a result, students have a difficult time understanding the interrelationships between the topics covered. Moreover, later in life when the problems encountered do not fit neatly into the textbook presentation, the student may have problems abstracting from what was learned. To overcome this problem, the opening chapter presents ten basic principles or axioms of finance that are woven throughout the book. What results is a text that is tightly bound around these guiding principles. In essence, the student is presented with a cohesive, interrelated subject from which future, as yet unknown, problems can be approached.

Teaching an introductory finance class while faced with an ever-expanding discipline puts additional pressures on the instructor. What to cover, what to omit, and how to do this while maintaining a cohesive presentation are inescapable questions. In dealing with these questions we have attempted to present the chapters in a stand-alone fashion so that they could easily be rearranged to fit almost any desired course structure and course length. Because the axioms are woven into every chapter, the presentation of the text remains tight regardless of whether or not the chapters are rearranged. Again, our goal is to provide an enduring understanding of the basic tools and fundamental principles upon which finance is based. This foundation will give a student beginning his or her studies in finance a strong base on which to build future studies and give the student who will take only one finance class a lasting understanding of the basics of finance.

While historical circumstances continue to serve as the driving force behind the development and practice of finance, the underlying principles that guide our discipline remain the same. These principles are presented in an intuitively appealing manner in Chapter 1 and thereafter are tied to all that follows. With a focus upon the big picture, we provide an introduction to financial decision making rooted in current financial theory and in the current state of world economic conditions. This focus can be seen in a number of ways, perhaps most obvious being the attention paid both to valuation and to the capital markets and their influence on corporate financial decisions. What results is an introductory treatment of a discipline rather than the treatment of a series of isolated finance problems. The goal of this text is to go beyond teaching the tools of a discipline or of a trade, and to help the student gain a complete understanding of the subject. This will give him or her the ability to apply what is learned to new and yet unforeseen problems—in short, to educate the student in finance.

DISTINCTIVE FEATURES AND INNOVATIONS

Basic Financial Management is not simply another introductory finance text. Its structure reflects the vitality and ever-expanding nature of the discipline. Finance has grown too complex not to teach with an eye on the big picture, focusing on the interrelationships between the materials that are covered. Listed below are some of the distinctive pedagogical features presented in this book.

Ten Axioms of Finance

The fundamental principles that drive the practice of corporate finance are presented in the form of ten axioms. These axioms first appear in Chapter 1 and thereafter appear in in-text inserts called "Back to the Basics." These inserts serve to refocus the students' attention upon the underlying principles behind what is being done. In effect, they serve to keep the student from becoming so wrapped up in specific calculations that the interrelationships and overall scheme are lost.

Chapter Reorganization and Consolidation

In response to both the continued development of financial thought and reviewers' comments, the text has been dramatically reorganized, including the consolidation and elimination of old chapters and the creation of new ones. In addition to the introduction of the ten axioms, the main features of this reorganization and consolidation include the introduction of a third chapter dealing with capital budgeting, two chapters on valuation (one dealing with bonds and one with stocks), expanded coverage of financial markets and interest rates in chapter two, and the movement of ratio and financial statement analysis to the front of the text.

Integrative End-of-Chapter Problems on Microsoft PowerPoint

An integrative problem is provided at the end of almost every chapter covering all the major topics included in that chapter. This comprehensive problem can be used as a lecture or review tool by the professor. To aid the instructor in presenting this material, the solution is provided to the instructor in Microsoft PowerPoint format. For the student, the integrative end-of-chapter problems provide an opportunity to apply all the concepts presented within the chapter in a realistic setting, thereby strengthening their understanding of the material.

Stop and Think

In-text inserts titled Stop and Think appear throughout the text, serving to direct the student's attention to the "big picture." The use of these Stop and Think inserts coupled with the use of the ten axioms keeps the student from losing sight of the interrelationships and motivating factors behind what is being done.

Basic Financial Management in Practice

Strong emphasis is also placed upon practice, where practice is used to demonstrate both the relevance of the topics discussed and the implementation of theory. Moreover, to add life to the discussion "Basic Financial Management in Practice" boxed inserts are provided throughout the text. These boxes are largely taken from the popular press with analysis and implications provided following each box. In this way the subject matter comes to life with added relevance to the student.

Introductory Examples

Each chapter opens with an introductory example, setting the stage for what is to follow with the related experiences of an actual company. In this way the relevance, use, and importance of the material to be presented can easily be understood by the student.

International Financial Management

In view of the continued globalization of world markets, we have integrated examples of international finance throughout the text. In addition, recognizing the fact that many of us approach the teaching of international finance in different ways, a separate chapter on international financial management is also provided.

Chapter Learning Objectives

Each chapter begins by stating the learning objectives for that chapter, and highlighting what that chapter will enable the student to do.

Suggested Applications for DISCLOSURE®

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 situation. We are therefore pleased that Prentice Hall has developed an agreement with Disclosure, Incorporated, for the users of *Basic Financial Management* to have access to the academic edition of Compact D™ /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.

ABC News/PH Video Library for Finance

Video cases selected from ABC News are available to all adopters. These videos examine current topics covered in the text and provide the instructor with an added way of making the material both relevant and interesting.

Financial Calculators

The use of financial calculators has been integrated throughout this text, especially with respect to the presentation of the time value of money. Where appropriate, calculator solutions appear in the margin.

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 7th edition:

- New, relatively simple, problems have been added to almost every chapter to give the Professor more choice in homework assignments.
- Coverage of organizational form and taxes has been moved to chapter 1. In this way the tax environment is presented early, with coverage of taxes limited to tax questions that will affect financial decision making.
- Chapter 2 has been substantially revised and streamlined with regard to both organization and content in order to provide a more useful and teachable introduction to the financial markets. This chapter is now titled "The Role of Financial Markets and Interest Rates in Financial Management." It encompasses several key topics including (a) why financial markets exist, (b) the role of the investment banker, (c) historical rates of return in financial markets, (d) an overview of interest rate determination, and (e) the term structure of interest rates.
- The movement of "Evaluating Financial Performance" from Chapter 12 in the previous edition to Chapter 3 reflects the fundamental importance of basic accounting concepts to the study of all facets of the study of corporate finance. In addition to changing this chapter's location in the text we have completely rewritten it in an effort to simplify and open up the presentation. We recognize that the purpose of much of this material is to refresh the concepts in the minds of the student and set forth basic concepts that will be used throughout the text.
- Chapter 4, "Financial Forecasting, Planning, and Budgeting," has been moved forward from Chapter 13 in the previous edition. Again we have reordered this material to appear much earlier in the text based upon its symbiotic relationship to Chapter 3 and the importance placed on this material by financial practitioners. Within the chapter we have simplified the presentation of financial forecasting and incorporated consideration for the Sustainable Rate of Growth concept.
- Coverage of the Annual Percentage Yield (APY) or effective annual rate and annuities due is now provided in chapter 5.
- In the sixth edition of *Basic Financial Management,* we had a chapter on "risk and rates of return" and another explaining the concepts of bond and stock valuation. Given the increasing attention during the late 1980s and in the 1990s on enhancing firm value, we thought it important to expand our treatment of these two chapters. Thus, in this edition we have made several significant changes in this area:
  - Chapter 6, Risk and Rates of Return, has additional practical and real-world insights into our understanding of the capital markets. It is information that the student will find interesting and relevant, both personally and as a future manager.
  - The previous chapter on bond and stock valuation has been expanded into two chapters: Chapter 7, Valuation and Characteristics of Bonds, and Chapter 8, Valuation and Characteristics of Stocks.
  - In presenting the topic of bond valuation (Chapter 7), we now begin with a description of the types and characteristics of bonds. Only then do we explain how bonds are valued. This new beginning of the chapter helps the student understand the basic nature of the bond instrument before trying to value it.
  - As with the bond valuation chapter, we also begin the chapter on stock valuation (Chapter 8) with a better foundation as to the nature of stock and its basic characteristics. Then we explain the concepts of stock valuation.

- Capital budgeting is now covered in three chapters. In addition, coverage is now provided for the Modified Internal Rate of Return (MIRR) in Chapter 9.
- With respect to Chapter 12, Cost of Capital, we have come to wonder if what we teach in finance about this topic relates well to what is being done in practice. We know that the failure of firms to earn their cost of capital contributed greatly to the economic problems of the 1980s—so cost of capital is certainly an important topic. But how exactly is it used. So the cost of capital chapter in this edition is based on time spent with practitioners to see exactly what they are doing. One firm that we observed was PepsiCo, Inc., whose managers certainly work to increase shareholder value and give careful thought to the firm's cost of capital. We will show the student just how the management of PepsiCo computes the company's cost of capital.
- Chapter 14, "Planning the Firm's Financing Mix," contains new material on (a) agency costs, (b) the static-tradeoff and pecking order theories of capital structure determination, (c) free cash flow theory, and (d) actual financing decisions.
- Chapter 16, "Working Capital Management and Short-Term Finance," has been extensively revised to incorporate material from two chapters in the sixth edition. This combination of two chapters into one was accomplished by streamlining the introduction to working capital materials significantly. The chapter now sharply focuses on the issues that arise in the management of working capital and the choice of a source of short-term credit.
- Chapter 17, "Cash and Marketable Securities Management," has been shortened and includes updated data on interest rate levels on popular liquid asset investments. The concept of cash management as a system is stressed.
- Coverage of the concept of **total quality management (TQM)**, which is a company-wide systems approach to quality, is now provided in Chapter 18. This new order in customer-supplier relationships and the implications for inventory control are examined.
- Chapter 19, "Term Loans and Leases," has received an updating and additional problems. New problems emphasize the basic calculations underlying the analysis of financial leases and term loans.
- A basic introduction to currency swaps is now provided in Chapter 20.
- Chapter 21, "Corporate Restructuring: Combinations and Divestitures," has received an extensive updating and has been streamlined owing to the ever changing subject matter. The chapter now quickly moves through the institutional discussion to the fundamental valuation problems that arise in the building and dismembering of corporations.

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 provide you with as error-free a book as possible. 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.*

Any professor or student identifying an error of substance (e. g., an incorrect number in an example or problem) in *Basic Financial Management*, 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 occurs resulting from an original error, the reward will be limited to a maximum of $20 for the group of errors. Please report any errors to Art Keown at the following address:

Art Keown

Department of Finance
Virginia Tech
Blacksburg, VA 24061

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As a final word, we express our sincere thanks to those using Basic Financial Management in the classroom. We thank you for making us a part of your team. Always feel free to give any of us a call or contact us through the Internet when you have questions or needs.

A. J. K.
D. F. S.
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