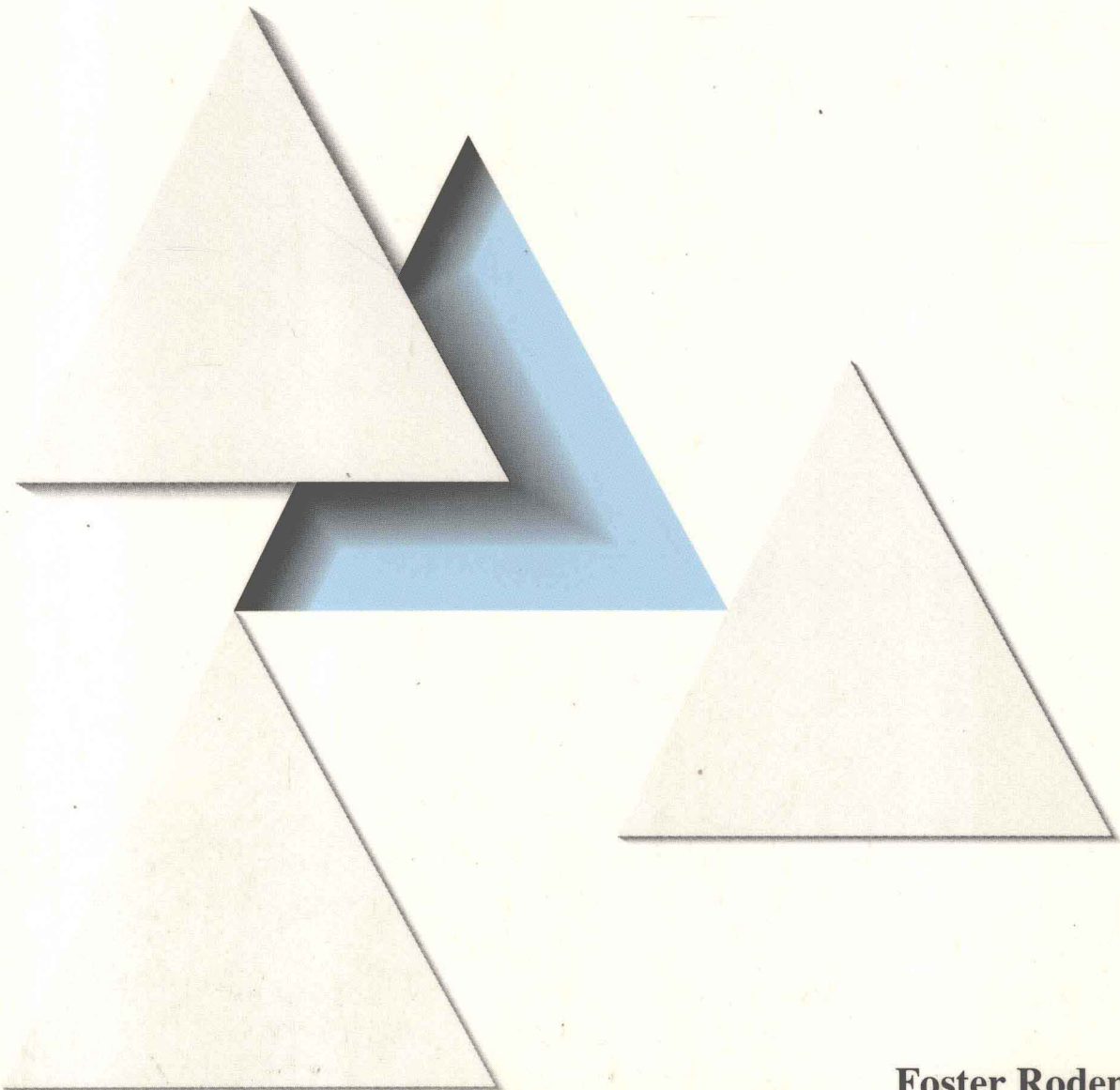


Foundations of Business Finance

Third Edition

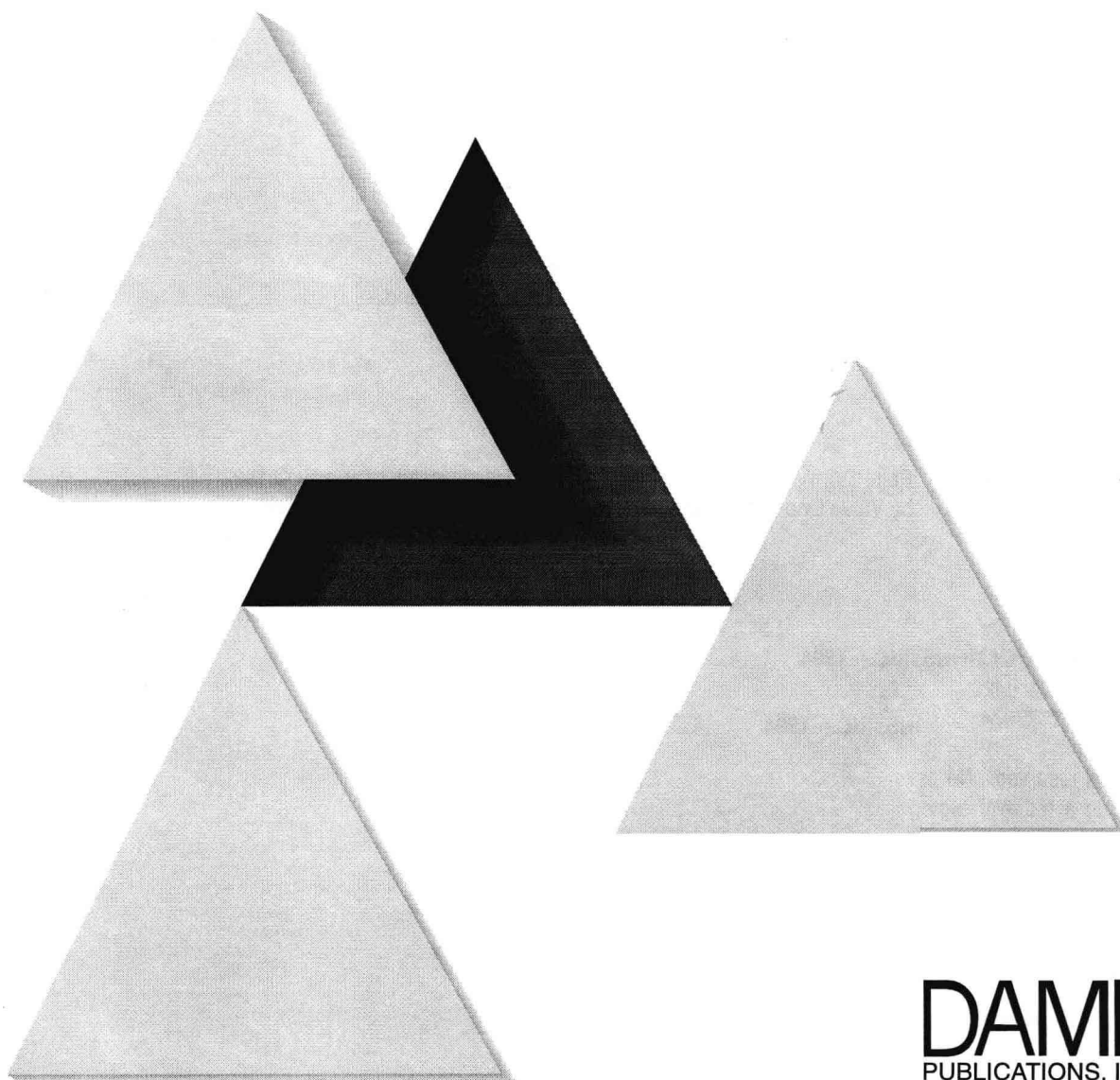


Foster Roden

Foundations of Business Finance

Third Edition

Foster Roden



DAME
PUBLICATIONS, INC.

Dedication

To Christie, Roger, Richard, Riley, Dickey, Lundie, and Roger, and the memory of Richard.

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University of North Texas

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BIOGRAPHICAL SKETCH

Peyton Foster Roden attended public schools in Dallas, Texas. He then attended Baylor University, where he was a three-year letterman in tennis and active in professional and scholarly activities. He graduated from Baylor in 1963 with a bachelor's degree in English Literature. He worked for three years as manager of a building supply company in the Dallas area. Professor Roden earned a master's degree in Economics from the University of North Texas and the Ph.D. in Finance from the same University. He is a Certified Management Accountant with certificate in good standing.

His teaching experience has been at three universities, Baylor University, the University of New Orleans, and the University of North Texas. Professor Roden is proud of the fact that he was the first faculty member at UNT to be a recipient of the Ph.D. from that University.

Professor Roden is author or co-author of more than twenty-five articles. He serves as a referee for several journals including the *Review of Financial Economics*, *Journal of Financial Research*, *Financial Management*, and *Financial Practice and Education*. Professor Roden has co-authored two other textbooks on business financial management, one published by Harper & Row and the other by the Dryden Press.

A long-time member of the faculty at the University of North Texas, Professor Roden has served on many University, College, and Department committees. During the current academic year Professor Roden directs the MBA program for the department and serves on the College of Business Master's Policy Committee. The University in 1991 named him Regents Professor.

Foster likes to play tennis and golf and to read. He's read recently Robert K. Massie's *Dreadnought* and Simon Schama's *Citizens*. He needs to work on his volley and putting, but is available for tennis or golf with anyone interested. He resides with his wife, the former Christie Lou Lape of Bartlesville, Oklahoma, and their sons Roger and Richard at 1408 Egan Drive in Denton.

PREFACE

Foundations of Business Finance is a book for the introductory course in business finance. It has cash flows and stock price maximization as its unifying theme. The book shows beginning students the way cash flows link business financial decisions to the accumulation of shareholder wealth and value of the common stock.

The material the third edition covers reflects five conventions on the part of the author.

- 1 The most useful concepts of financial management are from accounting and economics. So the book relates financial topics to valuation with a discussion of the balance sheet, cash flows, and the mathematics of finance. Readers see the way operating, investment, and financing decisions affect the accumulation of wealth and value of the firm.
- 2 Experience teaches that a realistic account of financial management is likely to engage reader interest and promote recall. Readers read of real-life applications of the principles and procedures studied. They see successful and unsuccessful results as business men and women grapple with financial decisions.
3. An introductory book must provide a breadth of coverage to be useful and informative to non-finance majors. The introductory course is often their last exposure to a comprehensive discussion of finance. In addition, an introductory book must provide rigor and background to prepare finance majors and specialists for their study of advanced material. Style and content of this book reflect these beliefs.
4. Topics such as the mathematics of finance, security valuation, opportunity cost of capital, and capital budgeting are best delayed until well into a beginning course. Students need a running start into the semester to let them develop confidence and positive feelings toward a new, often intimidating subject like finance.
5. The beginning course in finance should leave some subjects to advance study. As a colleague told me, "Hey, leave us something to teach in the advanced courses!" Users should know early-on that the book in fact leaves several topics for future study. During this semester you will not learn details of the following topics: Bond refunding, evaluating investment proposals with differing lives, the impact of individual taxes on the opportunity cost of capital to companies, calculating betas (non-diversifiable risk), arbitrage and option pricing models of risk and return, evaluation of the effectiveness of credit policy, the economic order quantity and its application to cash management, measuring bond duration (and its concomitants, yield value of a 32nd and convexity), the Modigliani and Miller argument regarding capital structure, replacement cash flows in capital budgeting, regulation of security markets, and extensive analysis of the roles of investment banking firms and other financial institutions.

The table of contents shows emphasis on business finance. Each part addresses topics from the viewpoint of a financial manager. The parts develop systematically how management analyzes and plans the performance of the company, contributes to the value of the company's securities, ranks and selects profitable projects, and finances long-term assets. So readers get a complete view of business finance.

Users of this third edition will find several features that make it informative and entertaining. First, the book starts out with an overview of the financial system. It then moves into accounting and economic measures and concepts students learned in courses prior to finance. Topics such as portfolio theory of risk

and return and the mathematics of finance come later in the semester after readers have confidently built a foundation on the fundamental tasks of a financial manager. No prior study of statistics is needed to complete this book, but readers must have an understanding of accounting and economics equivalent to two semesters study of each subject.

Cornerstone of the study of finance is valuation. Advanced courses require a thorough knowledge of how the timing and level of expected cash flows influence value. Hence, compound interest, opportunity cost, and accumulation of wealth dominate the book after readers are introduced to the time value of money (Chapter 5). In one way or another, it is the foundation of all financial principles and decisions.

Second, the book includes much illustrative material. Finance is a contact sport. Readers must see applications of principles and must work problems to understand what is going on. Liberal use of illustrations enhances understanding the theories and procedures in the beginning finance course. Chapters include examples to illustrate how people solve financial problems. These examples, liberally employed, provide faster and more thorough progress. In addition, each chapter contains special boxed features drawn from *The Wall Street Journal*, *Barron's*, *Business Week*, or similar sources. These features elaborate points made in the text. They add a real-world, human-interest, or historical-experience dimension to abstract and general statements of rules and principles.

Third, each chapter begins with an introduction mapping out main points to focus attention on key terms and ideas. Chapters end with a summary reviewing the points. In this way, readers complete each chapter with a clear understanding of what they have studied.

It is my hope to incorporate in these chapters some tangible feeling for the real, workaday world of business. I hope my efforts lead readers to understand that financial management, investments, and financial markets and institutions consist of flesh-and-blood people struggling to get things done. Textbooks sometimes convey the notion that finance, or any other art of business decision, lies in sets of abstract principles or mathematical models removed from individual hope, fear, intelligence, stupidity, intuition, and uncertainty. This notion often impresses readers as misleading. It is more useful to admit that finance is full of rough edges and befuddlements. It is not a well-oiled machine of brute empiricism leading systematically to successful decisions. That is a false impression of the real world that firsthand experience obliterates.

Great teachers are great simplifiers. Although readers will find many simplifications to create a useful and readable book, the results avoid oversimplification. I have not hesitated to present complicated theories when necessary. Neither have I refrained from using mathematical models where they give the briefest and clearest explanation of theory. However, readers need only basic algebra to understand the mathematics in this book.

The foundation of any discipline is knowledge of its terms. The glossary at the end of the book is neither sophisticated nor comprehensive. However, it should help readers struggling to grasp the meaning of a new system of knowledge.

General Plan of The Third Edition

The plan of the book is different from its two previous editions. Unlike the previous two editions, this one begins with a discussion of the financial system. Instructors using the earlier editions found that many students needed some understanding of securities, markets, and financial institutions before moving into the area of business finance. In addition, I moved the discussion of working capital management to a later part of the text to permit the course to move more quickly into the topics of time value of money and valuation (Part Three).

After an overview of the financial system, the book addresses tasks of financial managers in assessing and planning financial activity, security valuation, and capital budgeting. It then moves into the areas of financial securities, long-term financing, and working capital management. This sequencing

permits readers approaching finance for the first time to ease into the subject with reliance on accounting and economic concepts already learned.

Readers will find that the opening chapters build on the introductory knowledge of accounting and economics they bring into the course, but with a difference: The emphasis is on cash flows and maximizing the wealth of the company's owners. Subsequent chapters rely heavily on the balance sheet and shareholder wealth (equity measured in market terms) to link new ideas to material from earlier chapters.

Detailed Plan of the Third Edition

Part One Introduction consists of Chapter 1 The Financial System. Readers learn the roles of securities and financial markets in transferring funds from savers to investors. They also read of the usefulness of financial institutions in this process. The chapter introduces readers to their first decision-tool: Calculating an annualized return on investment in a U.S. Treasury bill.

Part Two Financial Management, Shareholder Wealth, and Financial Activity begins with Chapter 2 Goals and Functions of Business Finance. This chapter introduces readers to the various areas of finance with particular emphasis on business finance. Readers learn of the importance to financial managers of increasing shareholder wealth by increasing stock price. They also examine the link between shareholder equity on a company's balance sheet and shareholder wealth measured by total value of the outstanding shares of common stock. The chapter concludes with a discussion of the potential conflicts that can arise between shareholders and managers of a company. Chapter 3 Business Organization, Taxation, and Cash Flows deals with the various forms of business organization—corporation, partnership, and proprietorship. Readers learn about business (not personal) taxation and the usefulness of cash flows. The chapter stresses that the goal of maximizing owners' wealth (stock price in a corporation) springs in part from the company's ability to increase cash flow. Chapter 4 Managing and Controlling Growth introduces basic financial measures and examines the story that financial managers and investors can unlock from examining a company's financial information. Readers learn how to calculate and interpret five financial ratios comprising the Du Pont system of financial analysis. Additional ratios are in the appendix to the chapter. The chapter then turns to sustainable growth. The reader learns how operating decisions, capital structure, and dividend policy interact to determine a company's return on invested capital and growth in price of its common stock.

Part Three: Security Valuation and Returns introduces completely new ideas to the reader. This part changes perspective from the previous parts. Parts One and Two emphasized the viewpoint of financial managers. Part Three takes the viewpoint of investors. Chapter 5 Time Value of Money and Cash Flows develops the mathematics of time value and shows the relationship between future and present value. The chapter works through simple then complicated calculations with emphasis on the way accumulation of wealth relates to present value. The text pays considerable attention to reinvestment of cash flows, a process illustrated often in subsequent chapters. A feature of Chapter 5 is its emphasis on periodic rates and number of periods in valuing cash flows. This emphasis permits readers to understand how to employ other-than-annual compounding in their analysis and to distinguish between annual-percentage and effective rates of interest. Chapter 6 Security Prices and Valuation applies the time value of money to valuation of bonds, preferred stock, and common stock. The reader learns how to value a bond and calculate its expected return on investment (yield to maturity). The chapter then discusses the stock market and how to interpret stock quotations in the financial press. With this background, the reader learns how to value preferred and common stock using actual quotations supplemented with publicly available information. Chapter 7 Valuation of Portfolios develops the idea of portfolio diversification by shareholders. It then illustrates how investors use a rate of return based on non-diversifiable risk to price

securities in a diversified portfolio. The argument is intuitive and does not require a prior statistics course for readers to understand and apply.

Part Four: Managing Long-Term Assets: Capital Budgeting considers issues and policies surrounding investments in depreciable property. Chapter 8 *The Opportunity Cost of Capital* shows how companies combine long-term debt and equity financing to get the lowest cost. It also analyzes the way in which a target or optimal capital structure influences the value of the firm and shareholder wealth. Readers see how the opportunity cost of capital determines the screening or hurdle rate used in project selection. Chapter 9 *Ranking and Selecting Capital Projects* uses information from the preceding chapters to develop discounted cash flow (DCF) and non-discounted cash flow models for capital budgeting. Readers see the role reinvestment plays in DCF methods in determining the accumulated wealth of shareholders. They also learn of the influence of conflicts in DCF rank order on project selection. The chapter concludes with a brief study of project selection under conditions of uncertainty. Chapter 10 *Risk in Capital Budgeting* extends the discussion in Chapter 9 to include risk assessment in ranking and selecting capital projects. Emphasis here is on an intuitive understanding of the process rather than on the statistical calculation.

Part Five: Financing Long-Term Assets addresses sources of financing with maturities longer than 12 months. Part Five begins with Chapter 11 *Intermediate-Term Financing and Leasing*. It addresses term bank loans, conditional sales contracts, factoring, and leasing. Chapter 12 *Bonds* deals with the types of long-term debt available and their costs to corporate borrowers. The chapter stresses the implications of sinking-fund and bullet bonds during periods of changing interest rates. Readers learn that coupon bonds expose investors to reinvestment risk and that zero-coupon bonds do not. Calculations stress the implications for risk and wealth accumulation. Chapter 13 *Options, Futures, Convertibles, and Warrants* continues the discussion of long-term debt securities. The reader learns of the differences between these investments. Much calculation is called for in this chapter. Chapter 14 *Common and Preferred Stock Financing* considers new issues of common and preferred stock by corporations. Chapter 15 *Dividend Policy and Internal Equity* presents internal equity financing (earnings retained) and its counterpart, dividend policy. Emphasis in this chapter is on dividend policies and their impact on stock value.

Part Six: Managing and Financing Short-Term Assets turns to short-term financial management. Here the reader learns to calculate annual percentage rates of interest based on periodic rates. I have found that stressing periodic and annual-percentage rates rather than compound rates permits readers to concentrate on the management techniques required of them in dealing with working capital. This approach also permits instructors to move this part to a place earlier in the semester (before Part Three) if they so desire. The Part begins with Chapter 16 *Overview of Working Capital*, which analyzes financial policy related to managing current assets and current liabilities. This chapter emphasizes the matching or suitability principle and the need for a company to preserve financial liquidity. The discussion concludes by linking violations of the matching principle to the company's exposure to interest rate risk. Chapter 17 *Cash, Receivables, and Inventory* shows several methods to accelerate cash collections and delay cash outlays. Readers learn how to calculate the periodic and annual-percentage rates of interest associated with cash and receivables management. The discussion of inventory management is short with further development left to the reader's future study of finance and operations management. Chapter 18 *Short-Term Financing* concludes the Part. The chapter analyzes several sources of short-term debt, especially bank loans and commercial paper. Emphasis is on calculating short-term interest rates under various loan conditions. As in Chapter 17, readers practice using periodic and annual-percentage rates of interest.

Part Seven: Special Topics concludes the book. It permits coverage of material useful in an introductory finance course if time permits. The three chapters in this part extend coverage to leverage, international finance, and the market for corporate control. Chapter 19 *Breakeven and the Analysis of Leverage* considers two topics. It first deals with breakeven analysis and the impact of fixed and variable operating costs on operating income. The chapter then addresses operating and financial leverage. Here

the reader learns about the implications of operating and financial leverage in a business. Chapter 20 Financing Global Business Activity develops the international arena with its unique difficulties and opportunities for financial managers. Chapter 21 Merger, Acquisition, and Bankruptcy concludes Part Seven. It details the way these events affect expected cash flows of the company and the accumulation of shareholder wealth.

Special Features

Features of the third edition remain unchanged from the previous two. In *Through the Looking Glass and What Alice Saw There*, Alice comments after reading the *Jabberwocky* poem ". . . [I]t's *rather* hard to understand. . . . Somehow it seems to fill my head with ideas—only I don't exactly know what they are!" The *Jabberwocky* doesn't deal with business finance. This book does. Like Alice, readers of *Foundations of Business Finance* will find that it fills their heads with many ideas. To help them know exactly what the ideas are, the book includes several features.

- **Chapter Introductions.** Each chapter begins with a brief narrative telling the reader about material in the chapter. It serves as a map for the reader to follow. The introduction concludes with a list of learning objectives of the chapter.
- **Glossary.** Someone said that learning jargon is 50 percent of learning a discipline. That may or may not be true. The book includes a glossary of useful terms just in case it is.
- **Running Glossary.** To help further learning the language of finance, a running glossary in the margin defines terms in context. The running glossary is an easy way to review key terms of the chapter.
- **Examples.** Each chapter includes detailed examples. They show step by step how to solve problems. Examples immediately follow discussions of financial models and concepts. So readers quickly see how to apply them. Their frequent use reflects the belief that readers learn finance by solving problems.
- **Boxed Features.** Selected material is in boxes to add richness and real-world seasoning to each chapter. Included here are companies like General Motors, Citibank, Glaxo, Texaco, and Drexel Burnham Lambert to emphasize the relevance of topics. The boxes contain interesting professional reading from the viewpoint of the business financial manager or investor.
- **Summary.** Each chapter concludes with numbered summary statements. They provide a crisp, succinct refresher of chapter topics.
- **End-of-Chapter Material.** Material to reinforce understanding of the information and techniques is in each chapter.
 - Key Term** list provides in one location a chance to review running-glossary terms from the chapter.
 - Questions** that stress comprehension and do not require calculations.
 - Practice Problems** at the end of each chapter help readers learn problem solving techniques. They provide step-by-step solutions to representative problems from each chapter. These steps furnish a map for solving the problem, which readers may then apply to other problems.

Problems (identified by type) supply a variety of problems requiring calculations. Answers to all odd-number problems are in Appendix C of the book.

Computer Problems are in chapters that lend themselves to computer work. An icon marks and separates them from other problems. Computer problems are difficult and require for solution an electronic spreadsheet template available from the publisher.

Selected Bibliography provides a guide to sources containing either special applications or advanced material.

- **Readiness Test.** A readiness test at the end of Chapter 1 requires recalling ideas from previous study of accounting and economics and from experience. It encourages readers to search for ideas in later chapters of the book. And it allows them to test their level of preparation and ability to reason in financial terms.
- **Cases.** Short cases are at the ends of several chapters. Each requires careful analysis and integration of preceding material.

These features, the structure of book, and selection of materials combine to give students and instructors a framework for making the semester enlightening and useful. You will find that this book only scratches the surface of finance. But it scratches deeply.

Foster Roden
July, 1994

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