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FUNDAMENTALS OF FINANCIAL MANAGEMENT

CONCISE 6TH EDITION

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FUNDAMENTALS OF FINANCIAL MANAGEMENT

Concise Sixth Edition

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PREFACE

The first edition of *Fundamentals* was published 30 years ago. Since then, the body of financial knowledge has expanded mightily, and this led us to continually add to the book. As *Fundamentals* got larger and larger, we heard more and more often that it was difficult to cover the entire book in a single term. Therefore, we asked our students and other professors for advice. Some said that we shouldn't worry about the book's size, because a larger, more complete book gives professors flexibility in designing their courses, is a better reference for students after they have completed the course, and allows interested students to read chapters not covered in class on their own. Others disagreed, arguing that, as textbooks get larger, it becomes increasingly difficult for professors to develop a manageable syllabus, and it also forces students to buy a larger, more expensive text than they want or need. In the end, we concluded that both arguments have merit, so we decided to write a concise version for those who think a smaller, more concise textbook would better suit their needs.

When we first created *Concise,* we debated between streamlining the book by covering all the topics but in less depth versus covering fewer topics but maintaining the depth and rigor of *Fundamentals.* We chose to retain the depth and level while eliminating some less essential topics. While the omitted topics are interesting and important, they are not critically important, and finance majors will study these topics later in their advanced courses.

STRUCTURE OF THE BOOK

Our target audience is undergraduate students taking their first, and often only, finance course. Some will decide to major in finance and go on to take courses in investments, money and capital markets, and advanced corporate finance. Others will choose marketing, management, or some other nonfinance major. Still others will major in areas other than business and are taking finance and a few other business courses to gain information that will help them in law, real estate, or other fields.

Our challenge was to provide a book that serves all of these audiences well. Our conclusion was that we should focus on the core principles of finance, i.e., on basic topics such as the time value of money, risk analysis, and valuation. Moreover, we concluded that we should address these topics from two points of view: (1) as an investor seeking to make intelligent investment choices and (2) as a business manager trying to maximize the value of his or her firm's stock. Note that both investors and managers need to know the same set of principles, so the core topics are important to students regardless of what they choose to do after they finish the course.

In setting up the structure of the book, we first listed the core topics in finance with which virtually everyone should be familiar. Included here are an overview of financial markets, methods used to estimate the cash flows that determine assets' values, the time value of money, the determinants of interest rates, the basics of risk analysis, and the basics of bond and stock valuation procedures. We cover these core topics in the first nine chapters. Next, since most students in the course will probably work for a business firm, we wanted to show them how the core ideas are implemented in practice. Therefore, in the remainder of the book we discuss cost of capital, capital budgeting, capital structure, dividend policy, working capital management, financial forecasting, and international operations.

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Nonfinance majors sometimes wonder why they need to learn about finance. As we structured the book, it should be obvious to everyone why they need to understand time value, risk, markets, and valuation. Virtually all students enrolled in the basic course expect at some point to have some money to invest, and they quickly realize that the knowledge gained from Chapters 1 through 9 will help them make better investment decisions. Moreover, students who plan to go into business soon realize that their own success requires that their firms be successful, and the topics covered in Chapters 10 through 17 will be helpful here. For example, good capital budgeting decisions require accurate forecasts from people in sales, marketing, production, and human resources, and those people need to understand how their actions affect the firm's profits and future.

ORGANIZATION OF THE CHAPTERS: A VALUATION FOCUS

As we discuss in Chapter 1, in an enterprise system such as that of the United States, the primary goal of financial management is to help managers maximize their firms' values, subject to constraints such as not polluting the environment, not engaging in unfair labor practices, not engaging in antitrust activities, and the like. Therefore, valuation underlies everything in *Concise.* In Chapter 1 we discuss the concept of valuation, explain how it depends on future cash flows and risk, and show why value maximization is good for society in general. The valuation theme runs throughout the text.

Values are not established in a vacuum—stock and bond values are determined in the financial markets, so an understanding of those markets is essential to anyone involved with finance. Therefore, Chapter 2 covers the major types of financial markets, the returns that investors have historically earned, and the risks inherent in different types of securities. This information is important for anyone working in finance, and it is also important for anyone who has or hopes to own any financial assets.

Asset values depend in a fundamental way on earnings and cash flows as reported in the accounting statements. Therefore, we review those statements in Chapter 3 and then, in Chapter 4, show how accounting data can be analyzed and used to measure how well a company has operated in the past and how it is likely to perform in the future.

Chapter 5 covers the Time Value of Money (TVM), perhaps the most fundamental concept in finance. The basic valuation model, which ties together cash flows, risk, and interest rates, is based on TVM concepts, and these concepts are used throughout the remainder of the book. Therefore, students should be sure to allocate plenty of time to Chapter 5.

Chapter 6 deals with interest rates, a key determinant of asset values. We discuss how interest rates are affected by risk, inflation, liquidity, the supply of and demand for capital in the economy, and the actions of the Federal Reserve.

The discussion of interest rates leads directly to bonds in Chapter 7 and stocks in Chapters 8 and 9. We show how both stocks and bonds (and all other financial assets) are valued using the basic TVM model.

Chapters 1 through 9 provide background information that is essential to both investors and corporate managers. These are "Finance" topics, not "Business" or "Corporate Finance" topics as those terms are commonly used. Thus, Chapters 1 through 9 discuss the concepts and models used to establish values, whereas Chapters 10 through 17 focus on specific actions managers can take to maximize their firms' values.

As we noted above, most business students don't plan to specialize in finance, so they might not think the "business finance" chapters are particularly relevant to

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them. This is not true, and in the later chapters we show that all really important business decisions involve all of the firm's departments—marketing, accounting, production, and so on. Thus, while capital budgeting can be thought of as a financial decision, marketing people provide inputs on likely unit sales and sales prices, manufacturing people provide inputs on costs, and so on. Moreover, capital budgeting decisions influence the size of the firm, its products, and its profits, and those factors affect all the firm's employees, from the CEO to the mail room staff.

STRUCTURAL CHANGES

We made two important structural changes in this new edition:

1. We moved the material on financial markets and institutions from Chapter 5 to Chapter 2. Markets and institutions follow naturally from Chapter 1, and this material provides useful background information for the remainder of the book.
2. We moved the time value of money (TVM) chapter from Chapter 2 to Chapter 5. Under the previous structure, we covered TVM concepts, then covered the accounting and financial markets chapters before applying TVM concepts to bond and stock valuation. We liked the idea of covering TVM early, but we concluded that it was pedagogically better to cover TVM concepts and then immediately focus on applications, as we do now.

These changes improve the flow of the text significantly—there is a much smoother transition from chapter to chapter in the first part of the book.

OTHER CHANGES

We made many other changes, but the following are the most significant:

1. **Editing.** We always edit each new edition to improve clarity, but we did more in this edition than ever before. We put the entire text on digital files, which facilitated shifting things around to improve transitions and flow. Students will find it easier to read the book than in the past.
2. **Beginning-of-Chapter Vignettes and Within-Chapter Boxes.** Many events have transpired in the financial markets during the past three years. Credit markets have tightened almost to the point of collapse; the housing and auto markets are in terrible shape; a major investment bank (Bear Stearns) failed; the heads of a number of major corporations were fired; and so on. We use these events as the subjects of many vignettes and boxes, and they illustrate the points made in the chapters very well.
3. **Learning Objectives.** To help students see what we expect them to take away from the chapters, we added a set of learning objectives at the beginning of each chapter.
4. **Excel.** Spreadsheets, especially Excel, are becoming increasingly important in business, and students who are familiar with Excel have a significant advantage in the job market and later on the job. We used Excel in two ways. First, we worked all the in-text examples, end-of-chapter problems, and test bank problems with both Excel and a calculator, using the calculator to make sure the problem is workable with a calculator and Excel to check for accuracy. Second, we used Excel to create many of the tables and graphs used in the text, we displayed them as Excel pictures, and we have made available the models we used. Students do not need to know how to use Excel to go through the book, but if they are somewhat familiar with it, they can see how many common

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financial problems can be set up and solved very efficiently with Excel. Students who are not familiar with Excel should also be motivated to learn something about it.

5. **Tie-In between Self-Test Questions, End-of-Chapter Questions, and the Test Bank.** Testing is obviously important, so we spent a lot of time improving the Test Bank. Every question and problem was reviewed for clarity, accuracy, and consistency with the text. Also, we set up self-test questions at the end of each major section within the text to enable students to take real-time tests on their own before moving on. Then, the end-of-chapter (EOC) questions and problems are similar to, but often go beyond, the self-test questions, and the test bank questions and problems are similar to the EOC materials. If students read the text, do the self-test questions as they go along, and then work a sampling of the EOC questions and problems, they should do well on exams drawn from the test bank.
6. **Accounting Statements and Free Cash Flow.** Most students in the basic finance course are familiar with balance sheets and income statements, but many don't really understand the statement of cash flows and its relationship to free cash flows. Reviewers told us that in the last edition we tried to do too many things—like present alternative ways to calculate free cash flow—and that we should delete some of these items and better explain what remained. We agreed, and this edition does a much better job in this regard.
7. **Cash Flows and Risk in Capital Budgeting.** In the last edition, the two chapters on capital budgeting (Chapters 11 and 12) were not tied together very well. In that edition, we used relatively simple and straightforward illustrative projects in Chapter 11 but switched to entirely different and much more complex projects in Chapter 12. For this edition, we rewrote Chapter 12, continuing with the Chapter 11 examples. We also re-ordered materials to present them in a more logical sequence. One reviewer stated that this chapter was the single biggest improvement in the 6th edition.
8. **Financial Forecasting.** As we were rewriting Chapter 16, GE's chairman announced that he expected to report higher earnings shortly, but two weeks later he announced a significant earnings decline, and that led to a sharp drop in GE's stock price. We used this example to illustrate the importance of accurate forecasts and to liven up our discussion of strategic financial planning. In addition, we used an improved Excel model to streamline our illustrative forecast and to make the forecasting process simpler and clearer to students.

We could continue to list changes in this edition, but the items we have just discussed provide instructors (particularly those familiar with the last edition) with a good idea of what revisions were made to this text, and it will also let students know how authors try to continually improve their texts.

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ERRORS IN THE TEXTBOOK

At this point, most authors make a statement like this: "We appreciate all the help we received from the people listed above, but any remaining errors are, of course, our own responsibility." And generally there are more than enough remaining errors! Having experienced difficulties with errors ourselves, both as students and instructors, we resolved to avoid this problem in *Concise.* As a result of our detection procedures, we are convinced that few such errors remain, but primarily because we want to detect any errors that may have slipped by so that we can correct them in subsequent printings, we decided to offer a reward of $10 per error to the first person who reports it to us. For purpose of this reward, errors are defined as misspelled words, nonrounding numerical errors, incorrect statements, and any other error that inhibits comprehension. Typesetting problems such as irregular

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spacing and differences of opinion regarding grammatical or punctuation conventions do not qualify for this reward. Given the ever-changing nature of the World Wide Web, changes in web addresses also do not qualify as errors, although we would like to learn about them. Finally, any qualifying error that has follow-through effects is counted as two errors only. Please report any errors to Joel Houston either through e-mail at **concise@joelhouston.com** or by regular mail at the address below.

CONCLUSION

Finance is, in a real sense, the cornerstone of the enterprise system—good financial management is vitally important to the economic health of all firms, hence to the nation and the world. Because of its importance, finance should be widely and thoroughly understood, but this is easier said than done. The field is complex, and it undergoes constant change due to shifts in economic conditions. All of this makes finance stimulating and exciting, but challenging and sometimes perplexing. We sincerely hope that this Sixth Edition of *Concise* will meet its own challenge by contributing to a better understanding of our financial system.

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PART 1

INTRODUCTION TO FINANCIAL MANAGEMENT

CHAPTER 1 An Overview of Financial Management

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CHAPTER 1 An Overview of Financial Management

Striking the Right Balance

In 1776, Adam Smith described how an "invisible hand" guides companies as they strive for profits; and that hand leads them to decisions that benefit society. Smith's insights led him to conclude that profit maximization is the right goal for a business and that the free enterprise system is best for society. But the world has changed since 1776. Firms today are much larger, they operate globally, they have thousands of employees, and they are owned by millions of stockholders. This makes us wonder if the "invisible hand" still provides reliable guidance. Should companies still try to maximize profits; or should they take a broader view and take more balanced actions designed to benefit customers, employees, suppliers, and society as a whole?

Most academics today subscribe to the following modified version of Adam Smith's theory:

- *A firm's principal goal should be to maximize the wealth of its stockholders, which means maximizing the value of its stock.*
- *Free enterprise is still the best economic system for the country as a whole.*
- *However, some constraints are needed—firms should not be allowed to pollute the air and water, engage in unfair employment practices, or create monopolies that exploit consumers.*

Profits depend on sales; and sales require that firms develop desirable products and services, produce them efficiently, and sell them at competitive prices, all of which benefit society. So the view today is that management should try to maximize stock prices, but their actions should be subject to government-imposed constraints.

Still, some argue that the constrained maximization theory is inadequate. For example, GE Chief Executive Officer (CEO) Jeffrey Immelt believes that just obeying the law is not enough. GE is the world's most valuable company, and it has an excellent reputation.[1] Immelt argues that value and reputation go

[1] Marc Gunther, "Money and Morals at GE," *Fortune,* November 15, 2004, pp. 176–182.

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hand in hand and that having a good reputation with customers, suppliers, employees, and regulators is essential if value is to be maximized. According to Immelt, "The reason people come to work for GE is that they want to be part of something bigger than themselves. They want to work hard, win promotions, and be well compensated, but they also want to work for a company that makes a difference, a company that's doing great things in the world. . . . It's up to GE to be a good citizen. Not only is that a nice thing to do, it's good for business and thus the price of our stock."

GE is by no means alone. An increasing number of companies see their mission as more than just making money for their shareholders. Google Inc.'s well-known corporate motto is "Don't Be Evil." Taking things a step further, the company recently announced that it was setting aside another $30 million to be used for philanthropic ventures worldwide. The company's in-house foundation now has assets in excess of $2 billion. Days later Microsoft Corporation's chairperson, Bill Gates, gave a speech to the World Economic Forum in which he made the case for a "creative capitalism." Gates stated that, "Such a system would have a twin mission: making profits and also improving lives for those who don't fully benefit from market forces."

Gates has certainly been true to his word. In 2000, he and his wife established the Bill & Melinda Gates Foundation. Today the fund has assets totaling $37.6 billion. It received a notable boost in 2006 when famed investor Warren Buffett announced that he would donate a huge share of his fortune to the Foundation. To date, Buffett has contributed more than $3 billion; and over time, he is scheduled to contribute additional shares of stock that are now worth in excess of $40 million. These efforts show that while there is more to life than money, it often takes money to do good things.

Sources: Patricia Sellers, "Melinda Gates Goes Public," CNNMoney.com, January 7, 2008; Kevin J. Delaney, "Google: From 'Don't Be Evil' to How to Do Good," *The Wall Street Journal,* January 18, 2008, p. B1; and Robert A. Guth, "Bill Gates Issues Call for Kinder Capitalism," *The Wall Street Journal,* January 24, 2008, p. A1.

PUTTING THINGS IN PERSPECTIVE

This chapter will give you an idea of what financial management is all about. We begin the chapter by describing how finance is related to the overall business and by discussing the different forms of business organization. For corporations, management's goal should be to maximize shareholder wealth, which means maximizing the value of the stock. When we say "maximizing the value of the stock," we mean the "true, long-run value," which may be different from the current stock price. Good managers understand the importance of ethics, and they recognize that maximizing long-run value is consistent with being socially responsible. We conclude the chapter by discussing how firms must provide the right incentives if they are to get managers to focus on long-run value maximization. When you finish this chapter, you should be able to:

- **Explain the role of finance and the different types of jobs in finance.**
- **Identify the advantages and disadvantages of different forms of business organization.**
- **Explain the links between stock price, intrinsic value, and executive compensation.**
- **Discuss the importance of business ethics and the consequences of unethical behavior.**
- **Identify the potential conflicts that arise within the firm between stockholders and managers and between stockholders and bondholders and discuss the techniques that firms can use to mitigate these potential conflicts.**

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