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Eighth Edition

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The Logic and Practice of Financial Management

Eighth Edition

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To my parents, from whom I learned the most.

Arthur J. Keown

*To the Martin women—wife Sally and daughter-in-law Mel,
the Martin men—sons Dave and Jess, and
Martin boys—grandsons Luke and Burke.*

John D. Martin

*To my wife, Donna, who has been my friend,
encourager, and supporter for more years than
we care to admit. How quickly time has passed
since we first met all the way back in high school.*

J. William Petty

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Preface

The study of finance focuses on making decisions that enhance the value of the firm. This is done by providing customers with the best products and services in a cost-effective way. In a sense we, the authors of *Foundations of Finance*, are trying to do the same thing. That is, we have tried to present financial management to students in a way that makes their studies as easy and productive as possible by using a step-by-step approach to walking them through each new concept or problem.

We are very proud of the history of this volume, as it was the first “shortened book” of financial management when it was published in its first edition. The book broke new ground by reducing the number of chapters down to the foundational materials and by trying to present the subject in understandable terms. We continue our quest for readability with the Eighth Edition.

Pedagogy That Works

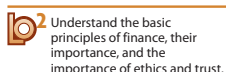
This book provides students with a conceptual understanding of the financial decision-making process, rather than just an introduction to the tools and techniques of finance. For the student, it is all too easy to lose sight of the logic that drives finance and to focus instead on memorizing formulas and procedures. As a result, students have a difficult time understanding the interrelationships among the topics covered. Moreover, later in life when the problems encountered do not match the textbook presentation, students may find themselves unprepared to abstract from what they learned. To overcome this problem, the opening chapter presents five underlying principles of finance, which serve as a springboard for the chapters and topics that follow. In essence, the student is presented with a cohesive, interrelated perspective from which future problems can be approached.

With a focus on 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 is perhaps most apparent in the attention given 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 problems that face the financial manager. The goal of this text is not merely to teach the tools of a discipline or trade but also to enable students to abstract what is learned to new and yet unforeseen problems—in short, to educate the student in finance.

Innovations and Distinctive Features in the Eighth Edition

NEW! A Multistep Approach to Problem Solving and Analysis

As anyone who has taught the core undergraduate finance course knows, there is a wide range of math comprehension and skill. Students who do not have the math skills needed



Five Principles That Form the Foundations of Finance

To the first-time student of finance, the subject matter may seem like a collection of unrelated decision rules. This could not be further from the truth. In fact, our decision rules, and the logic that underlies them, spring from five simple principles that do not require knowledge of finance to understand. These five principles guide the financial manager in the creation of value for the firm's owners (the stockholders).

As you will see, while it is not necessary to understand finance to understand these principles, it is necessary to understand these principles in order to understand finance. Although these principles may at first appear simple or even trivial, they provide the driving force behind all that follows, weaving together the concepts and techniques presented in this text, and thereby allowing us to focus on the logic underlying the practice of financial management. Now let's introduce the five principles.



Principle 1: Cash Flow Is What Matters

You probably recall from your accounting classes that a company's profits can differ dramatically from its cash flows, which we will review in Chapter 3. But for now understand that cash flows, not profits, represent money that can be spent. Consequently, it is cash flow, not profits, that determines the value of a business. For this reason when we analyze the consequences of a managerial decision we focus on the resulting cash flows, not profits.

In the movie industry, there is a big difference between accounting profits and cash

to master the subject sometimes end up memorizing formulas rather than focusing on the analysis of business decisions using math as a tool. We address this problem both in terms of text content and pedagogy.

- First, we present math only as a tool to help us analyze problems, and only when necessary. We do not present math for its own sake.
- Second, finance is an analytical subject and requires that students be able to solve problems. To help with this process, numbered chapter examples appear throughout the book. Each of these examples follows a very detailed and multistep approach to problem solving that helps students develop their problem-solving skills.

Step 1: Formulate a Solution Strategy. For example, what is the appropriate formula to apply? How can a calculator or spreadsheet be used to “crunch the numbers”?

Step 2: Crunch the Numbers. Here we provide a completely worked out step-by-step solution. We first present a description of the solution in prose and then a corresponding mathematical implementation.

Step 3: Analyze Your Results. We end each solution with an analysis of what the solution means. This stresses the point that problem solving is about analysis and decision making. Moreover, in this step we emphasize that decisions are often based on incomplete information, which requires the exercise of managerial judgment, a fact of life that is often learned on the job.

NEW! Financial Decision Tools

This feature recaps keys equations shortly after their application in the chapter.

NEW! Chapter Summaries

These have been rewritten to make it easier for students to connect the summary with each of the in-chapter sections and learning objectives.

FINANCIAL DECISION TOOLS		
Name of Tool	Formula	What It Tells You
Current ratio	$\frac{\text{current assets}}{\text{current liabilities}}$	Measures a firm's liquidity. A higher ratio means greater liquidity.
Acid-test ratio	$\frac{\text{cash} + \text{accounts receivable}}{\text{current liabilities}}$	Gives a more stringent measure of liquidity than the current ratio in that it excludes inventories and other current assets from the numerator. A higher ratio means greater liquidity.

NEW! Key Terms List for Each Chapter

New terminology introduced in the chapter is listed along with a brief definition.

NEW! Study Problems

The end-of-chapter study problems have been improved and dramatically expanded to allow for a wider range of student practice. In addition, the study problems are now organized according to learning objective so that both the instructor and student can readily align text and problem materials.

NEW! A Focus on Valuation

Although many professors and instructors make valuation the central theme of their course, students often lose sight of this focus when reading their text. We have revised this edition to reinforce this focus in the content and organization of our text in some very concrete ways:

- We build our discussion around five finance principles that provide the foundation for the valuation of any investment.
- New topics are introduced in the context of “what is the value proposition?” and “how is the value of the enterprise affected?”

“Cautionary Tale” Boxes

These give students insights into how the core concepts of finance apply in the real world. Each “Cautionary Tale” box goes behind the headlines of finance pitfalls in the news to show how one of the five principles was forgotten or violated.

Real-World Opening Vignettes

Each chapter begins with a story about a current, real-world company faced with a financial decision related to the chapter material that follows. These vignettes have been carefully prepared to stimulate student interest in the topic to come and can be used as a lecture tool to provoke class discussion.

Use of an Integrated Learning System

The text is organized around the learning objectives that appear at the beginning of each chapter to provide the instructor and student with an easy-to-use integrated learning system. Numbered icons identifying each objective appear next to the related material throughout the text and in the summary, allowing easy location of material related to each objective.

CAN YOU DO IT?

SOLVING FOR THE REAL RATE OF INTEREST

Your banker just called and offered you the chance to invest your savings for 1 year at a quoted rate of 10 percent. You also saw on the news that the inflation rate is 6 percent. What is the real rate of interest you would be earning if you made the investment? (The solution can be found on page 40.)

DID YOU GET IT?

SOLVING FOR THE REAL RATE OF INTEREST

Nominal or quoted rate of interest	=	real rate of interest	+	inflation rate	+	product of the real rate of interest and the inflation rate
0.10	=	real rate of interest	+	0.06	+	$0.06 \times \text{real rate of interest}$
0.04	=	$1.06 \times \text{real rate of interest}$				

Solving for the real rate of interest:
 real rate of interest = 0.0377 = 3.77%

“Can You Do It?” and “Did You Get It?”

The text provides examples for the students to work at the conclusion of each major section of a chapter, which we call “Can You Do It?” followed by “Did You Get It?” a few pages later in the chapter. This tool provides an essential ingredient to the building-block approach to the material that we use.

Concept Check

1. According to Principle 3, how do investors decide where to invest their money?
2. What is an efficient market?
3. What is the agency problem and why does it occur?
4. Why are ethics and trust important in business?

Concept Check

At the end of most major sections, this tool highlights the key ideas just presented and allows students to test their understanding of the material.

REMEMBER YOUR PRINCIPLES

Principle Two principles are especially important in this chapter. **Principle 1** tells us that **Cash Flow Is What Matters**. At times, cash is more important than profits. Thus, considerable time is devoted to measuring cash flows. **Principle 5** warns us that there may be a conflict when managers and owners have different incentives. That is, **Conflicts of Interest Cause Agency Problems**. Because managers' incentives are at times different from those of owners, the firm's common stockholders, as well as other providers of capital (such as bankers), need information that can be used to monitor the managers' actions. Because the owners of large companies do not have access to internal information about the firm's operations, they must rely on public information from any and all sources. One of the main sources of such information comes from the company's financial statements provided by the firm's accountants. Although this information is by no means perfect, it is an important source used by outsiders to assess a company's activities. In this chapter, we learn how to use data from the firm's public financial statements to monitor management's actions.

Remember Your Principles

These in-text inserts appear throughout to allow the student to take time out and reflect on the meaning of the material just presented. The use of these inserts, coupled with the use of the five principles, keeps the student focused on the interrelationships and motivating factors behind the concepts.

Mini Case

This Mini Case is available in MyFinanceLab.

On the first day of your summer internship, you've been assigned to work with the chief financial officer (CFO) of SanBlas Jewels Inc. Not knowing how well trained you are, the CFO has decided to test your understanding of interest rates. Specifically, she asked you to provide a reasonable estimate of the nominal interest rate for a new issue of Aaa-rated bonds to be offered by SanBlas Jewels Inc. The final format that the chief financial officer of SanBlas Jewels has requested is that of equation (2-1) in the text. Your assignment also requires that you consult the data in Table 2-2.

Some agreed-upon procedures related to generating estimates for key variables in equation (2-1) follow.

- The current 3-month Treasury bill rate is 2.96 percent, the 30-year Treasury bond rate is 5.43 percent, the 30-year Aaa-rated corporate bond rate is 6.71 percent, and the inflation rate is 2.33 percent.
- The real risk-free rate of interest is the difference between the calculated average yield on 3-month Treasury bills and the inflation rate.
- The default-risk premium is estimated by the difference between the average yield on Aaa-rated bonds and 30-year Treasury bonds.
- The maturity-risk premium is estimated by the difference between the average yield on 30-year Treasury bonds and 3-month Treasury bills.
- SanBlas Jewels' bonds will be traded on the New York Bond Exchange, so the liquidity-risk premium will be slight. It will be greater than zero, however, because the secondary market for the firm's bonds is more uncertain than that of some other jewel sellers. It is estimated at 4 basis points. A basis point is one one-hundredth of 1 percent.

Now place your output into the format of equation (2-1) so that the nominal interest rate can be estimated and the size of each variable can also be inspected for reasonableness and discussion with the CFO.

CALCULATOR SOLUTION

Data Input	Function Key
10	N
6	I/Y
-500	FV
0	PMT
Function Key	Answer
CPT	
PV	279.20

Comprehensive Mini Cases

A comprehensive Mini Case appears at the end of almost every chapter, covering all the major topics included in that chapter. This Mini Case can be used as a lecture or review tool by the professor. For the students, it provides an opportunity to apply all the concepts presented within the chapter in a realistic setting, thereby strengthening their understanding of the material.

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.

Content Updates

In addition to the innovations of this edition, we have made some chapter-by-chapter updates in response to both the continued development of financial thought, reviewer comments, and the recent economic crisis. Some of these changes include:

Chapter 1

An Introduction to the Foundations of Financial Management

- Revised and updated discussion of the five principles
- New section on the current global financial crisis

Chapter 2

The Financial Markets and Interest Rates

- Revised to reflect recent changes in financial markets
- Simplified to make it livelier and more relevant to students
- Revised coverage of securities markets, reflecting recent technological advances coupled with deregulation and increased competition, which have blurred the difference between an organized exchange and the over-the-counter market
- Updated investment banking coverage, reflecting the dramatic impact of the recent financial crisis on investment banking firms
- Simplified, more intuitive discussion on interest rate determinants
- Additional problems on the determination of interest rates

Chapter 3

Understanding Financial Statements and Cash Flows

- Presents a live company, The Home Depot, instead of a hypothetical company, to illustrate financial statements
- Expanded coverage of balance sheets, focusing on what can be learned from them
- More comprehensive and intuitive presentation of cash flows
- New explanation of fixed and variable costs as part of presenting an income statement
- New appendix that presents free cash flows

Chapter 4

Evaluating a Firm's Financial Performance

- Continues the use of The Home Depot's financial data to illustrate how we evaluate a firm's financial performance, compared to industry norms or a peer group. In this case, we compare Home Depot's financial performance to that of Lowe's, a major competitor
- Includes comments from Home Depot's management regarding the firm's financial performance
- Revised presentation of evaluating a company's liquidity to align more closely with how business managers talk about liquidity

Chapter 5

The Time Value of Money

- Revised to appeal to students regardless of level of numerical skills
- Increased emphasis on the intuition behind the time value of money, stressing visualizing and setting up the problem
- Additional problems emphasizing complex streams of cash flows

Chapter 6

The Meaning and Measurement of Risk and Return

- Updated information on the rates of return that investors have earned over the long term with different types of security investments
- Updated examples of rates of return earned from investing in individual companies

Chapter 7

The Valuation and Characteristics of Bonds

- Expanded explanation of efficient markets
- New example of a company's credit rating being lowered, which has been a more frequent occurrence in recent times

Chapter 8

The Valuation and Characteristics of Stock

- More current explanation of options for getting stock quotes from the *Wall Street Journal*

Chapter 9

The Cost of Capital

- Streamlined exposition and reduced quantity of learning objectives
- Rewritten discussion of the divisional cost of capital

Chapter 10

Capital-Budgeting Techniques and Practice

- New introduction looks at Disney's decision to build the Shanghai Disney Resort
- Simplified presentation of the payback period and discounted payback period

Chapter 11

Cash Flows and Other Topics in Capital Budgeting

- New introduction examines the complications Toyota faced in estimating future cash flows when it introduced the Prius
- New discussion of the iPad as an example of synergistic effects
- New appendix that presents the modified accelerated cost recovery system

Chapter 12

Determining the Financing Mix

- Simplified presentation of chapter materials, including a reduced number of learning objectives

Chapter 13**Dividend Policy and Internal Financing**

- Simplified presentation of chapter materials, including a reduced number of learning objectives
- Rewritten introduction focuses on Apple Computer, Inc.'s decision to re-initiate its cash dividend
- Problem set extensively revised with the addition of 13 new exercises

Chapter 14**Short-Term Financial Planning**

- New study problem added, focusing on the limitations of the percent of sales forecast method
- New discussion of the regression method of forecasting financial variables in conjunction with the percent of sales method

Chapter 15**Working-Capital Management**

- Simplified presentation of chapter materials, including reducing the number of learning objectives

Chapter 16**International Business Finance**

- Comprehensively revised and updated to reflect changes in exchange rates and global financial markets in general
- Simplified and streamlined coverage in the section on interest rate parity, discussion of purchasing-power parity and the law of one price, and international capital budgeting

Web Chapter 17**Cash, Receivables, and Inventory Management**

- Simplified presentation of chapter materials, including reducing the number of learning objectives

A Complete Support Package for the Student and Instructor

MyFinanceLab

This fully integrated online homework system gives students the hands-on practice and tutorial help they need to learn finance efficiently. Ample opportunities for online practice and assessment in MyFinanceLab are seamlessly integrated into each chapter. For more details, see the inside front cover.

Instructor's Resource Center

This password-protected site, accessible at www.pearsonhighered.com/irc, hosts all of the instructor resources that follow. Instructors should click on the "IRC Help Center" link for easy-to-follow instructions on getting access or may contact their sales representative for further information.

Test Bank

This online Test Bank, prepared by Curtis Bacon of Southern Oregon University, provides more than 1,600 multiple-choice, true/false, and short-answer questions with complete and detailed answers. The online Test Bank is designed for use with the TestGen-EQ

test-generating software. This computerized package allows instructors to custom design, save, and generate classroom tests. The test program permits instructors to edit, add, or delete questions from the test bank; analyze test results; and organize a database of tests and student results. This software allows for greater flexibility and ease of use. It provides many options for organizing and displaying tests, along with a search and sort feature.

Instructor's Manual with Solutions

Written by the authors, the Instructor's Manual follows the textbook's organization and represents a continued effort to serve the teacher's goal of being effective in the classroom. Each chapter contains a chapter orientation, an outline of each chapter (also suitable for lecture notes), answers to end-of-chapter review questions, and solutions to end-of-chapter study problems.

The Instructor's Manual is available electronically and instructors can download this file from the Instructor's Resource Center by visiting www.pearsonhighered.com/irc.

The PowerPoint Lecture Presentation

This lecture presentation tool, prepared by Philip Samuel Russel of Philadelphia University, provides the instructor with individual lecture outlines to accompany the text. The slides include many of the figures and tables from the text. These lecture notes can be used as is or instructors can easily modify them to reflect specific presentation needs.

Companion Web Site

(www.pearsonhighered.com/keown) The Web site contains various resources related specifically to the Eighth Edition of *Foundations of Finance: The Logic and Practice of Financial Management*, including Web Chapter 17 and Appendix A.

Excel Spreadsheets

Created by the authors, these spreadsheets correspond to end-of-chapter problems from the text. This student resource is available on both the companion Web site and MyFinanceLab.

CourseSmart for Instructors

CourseSmart goes beyond traditional teaching resources to provide instant, online access to the textbooks and course materials you need at a lower cost to students. And while students save money, you can save time and hassle with a digital textbook that allows you to search the most relevant content at the very moment you need it. Whether it's for evaluating textbooks or creating lecture notes to help students with difficult concepts, CourseSmart can make life a little easier. See how by visiting the CourseSmart Web site at www.coursesmart.com/instructors.

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—A.J.K. / J.D.M. / J.W.P.