

INTRODUCTION
TO



**CORPORATE
FINANCE**



2ND ASIA-PACIFIC EDITION

JOHN R. GRAHAM – SCOTT B. SMART
CHRISTOPHER ADAM – BRINDHA GUNASINGHAM

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2nd Asia-Pacific Edition
John R. Graham
Scott B. Smart
Christopher Adam
Brindha Gunasingham

Publishing manager: Dorothy Chiu
Publishing editor: Geoff Howard
Developmental editors: Tharaha Richards, Jessica Brennan
and Kate Doherty
Senior project editor: Tanya Simmons
Permissions/Photo researcher: Sian Bradfield
Art direction: Ruth O'Connor
Editor: Duncan Campbell-Avenell
Proofreader: Chris Wyness
Indexer: Julie King
Text designer: Leigh Ashforth (Watershed Design)
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Cengage Learning Australia
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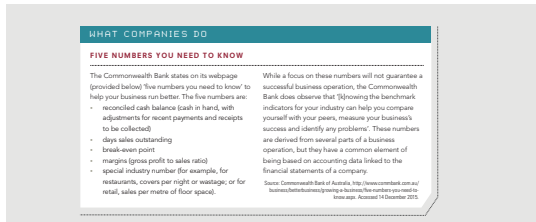
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Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of corporate finance and help you understand how the theory is applied in the real world.

CHAPTER-OPENING FEATURES



Gain an insight into how finance theories relate to the real world through studying the **what companies do** box at the beginning of each chapter.

LEARNING OBJECTIVES

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

- LO3.1** understand how to find the future value of a lump sum invested today
- LO3.2** calculate the present value of a lump sum to be received in the future
- LO3.3** find the future value of cash flow streams, both mixed streams and annuities
- LO3.4** determine the present value of future cash flow streams, including mixed streams, annuities and perpetuities
- LO3.5** apply time-value techniques that account for compounding more frequently than annually, stated versus effective annual interest rates, and deposits needed to accumulate a future sum
- LO3.6** use time-value techniques to find implied interest or growth rates for lump sums, annuities and mixed streams, and an unknown number of periods for both lump sums and annuities.

Identify the key concepts that the chapter will cover with the **learning objectives** listed at its start.

- LO1.1** In summary, although Apple's iPhone 6s was prima the company's financial organisation played a pivota from the initial assessment and funding of research, t management of cash flows generated by iPhone 6 sales worked with people in other functional areas to gather impact. So, in many ways, corporate finance helps ma

Learning objective icons appear in the margins of the text to indicate where they are expanded on in the chapter.

FEATURES WITHIN CHAPTERS

THINKING CAP QUESTION

THINKING CAP QUESTION

What are some advantages for financial analysts of using ratios, rather than absolute numbers in dollars, when comparing different companies

Challenge yourself to apply the concepts you have learned by answering the **thinking cap margin** questions throughout the chapters.



CONCEPT REVIEW

CONCEPT REVIEW QUESTIONS 2-2

- 4** How do depreciation and other non-cash charges act as sources of cash inflow to the company? Why does a depreciation allowance exist in the tax laws? For a profitable company, is it better to depreciate an asset quickly or slowly for tax purposes? Explain.
- 5** What is operating cash flow (OCF)? How does it relate to net operating profits after taxes (NOPAT)? What is free cash flow (FCF), and how is it related to OCF?
- 6** Why is the financial manager likely to have great interest in the company's statement of cash flows? What type of information can interested parties obtain from this statement?

Concept review questions help you to revise material covered in each section of the chapter and check your learning as you go.

FINANCE IN PRACTICE



Definitions or explanations of important key terms are located in the margin for quick reference.

Finance in practice boxes show you examples of corporate finance within international organisations.

EXAMPLE

EXAMPLE

Inventory ratios, like most other financial ratios, vary a great deal from one industry to another. For example, on 30 June 2014, Woolworths Ltd, a supermarket retail operation, reported inventory of \$4.69 billion and cost of goods sold of \$44.5 billion. This implies an inventory turnover ratio for Woolworths of about 9.49, and an average age of inventory of about 38.5 days. With the limited shelf life of retail groceries, its primary product, Woolworths cannot afford to hold inventory too long.

In contrast, for the year ended 30 June 2014, Cochlear Ltd, the Australian manufacturer of ear

implant devices, reported cost of goods sold of \$248.3 million and inventory of \$128.6 million. Cochlear's inventory turnover ratio is thus 1.93, and its average age of inventory is about 189 days.

Clearly, the differences in these inventory ratios reflect differences in the economic circumstances of the industries. Apparently, groceries lose their value much faster than do ear implants.

Source: Cochlear Annual Report 2014: A Hearing Life, Statement of Comprehensive Income, Cochlear Limited and its controlled entities for the year ended 30 June 2014. Available at www.cochlear.com

You can analyse the practical applications of concepts in the **examples**.

KEY EQUATIONS

Eq. 2.4
where

$$FCF = OCF - \Delta FA - \Delta WC$$

$$\begin{aligned} \Delta FA &= \text{change in gross fixed assets} \\ \Delta WC &= \text{change in working capital} \\ &= \Delta CA - \Delta AP - \Delta \text{accruals} \end{aligned}$$

Key equations are highlighted where they appear in the text.

SMART ICONS



Explore the online resources by following the **CourseMate** margin icons throughout the text. Find answers, activities, videos and more. In particular look out for:

- **smart video** margin icons which highlight where online smart videos are linked to the text
- **smart concept** margin icons which indicate when interactive explanations of concepts are available on CourseMate.

COURSEMATE
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CONCEPTS

END-OF-CHAPTER FEATURES

At the end of each chapter you'll find several tools to help you to review, practise and extend your knowledge of the key learning objectives.

1

SUMMARY

LO2.1

The four key financial statements are: (1) the balance sheet; (2) the income statement; (3) the statement of retained earnings; and (4) the statement of cash flows. Companies typically include with these statements detailed notes describing the technical aspects of the financial statements.

period of time, typically on operating, investment and cash flows. When interpreting the analyst typically looks for either the major categories specific items to find clues to the company may be expected

2

QUESTIONS

Q2-1 What information (explicit and implicit) can be derived from financial statement analysis? Does the standardisation required by GAAP add greater validity to comparisons of financial data between companies and industries? Are there

What three categories of value should the net value of cash flows reconcile?

Q2-5 How do analysts use ratios company's financial leverage

3

MINI CASE

THE SCOPE OF CORPORATE FINANCE

The potential career paths for an individual with expertise in finance are varied and exciting. Career possibilities include the areas of corporate finance, commercial banking, investment banking, money management and consulting. Think of ways that the skills described as being vital to success in this chapter can be applied in each career field. How are the ongoing trends of globalisation and increased

technological sophistication likely to have an impact on these jobs over the next decade?

ASSIGNMENT

1 Find assignments for these and other finance-related careers on the website <http://www.westnet.com>.

ONLINE STUDY TOOLS

Visit <http://login.cengagebrain.com> and use the access code that comes with this book for 32 months' access to the resources and study tools for this chapter. The CourseMate website contains:

- Smart concepts – step-by-step explanations of concepts
- See risk management explained step by step
- Smart videos
 - Joshua Heines, Senior Credit Analyst, The Private Bank

- Bill Eckmann, Principal, Solar Capital
- David Nisbet, Controller for Intel Communications Group, Intel Corp. (Bloomberg)
- Andy Bryant, Executive Vice President of Technology, Manufacturing, and Enterprise Services, Intel Corp.
- Van Lufft, VP, CFO, and Corporate Secretary, Infoblox

Interactive quotes
Audio
Flashcards and more

CourseMate

- 1 Review your understanding of the key chapter topics with the **summary**, list of **important equations** and **key terms**.
- 2 The **self-test problems, questions** and **problems** enable you to test your comprehension of key concepts.
- 3 The **mini case** and **assignment** help you apply the concepts you have learned to real-world scenarios.

Online study tools show where you can go online to watch smart concepts (step-by-step explanations of concepts) and smart solutions (animated step-by-step solutions to questions and problems in the text). These simulations coach you to identify and apply the right technique to a particular problem.

PART CASE STUDIES

REAL-WORLD CASE STUDY

ALL IN THE FAMILY

The Eglib family operated a series of businesses of quite diverse nature over five generations, and left a reasonable record of its activities for us to analyse. The start of the business is not particularly clear, although it seems that it came from a marriage link when a man of some means married a less wealthy woman and took up business with his brother-in-law. The Eglib brothers-in-law claims to have taught his son-in-law nephew to read and write, and later adopted him, but without granting him an inheritance share besides his three natural sons. In the following generations, the eldest sons married upward, to women of good families who had good connections and provided rich dowries. By contrast, their daughters were married off to business partners with dowries that typically cost only a fraction of what their eldest sons received.

The Eglibs invested their profits in farmland, which they rented out on a sharecropping basis. The leasing arrangements focused on the long term, and encouraged tenants on their lands to invest in cultivating more capital-intensive crops, shifting from grain to dates. The Eglib family effected this adaptation of planting by allowing the tenants to pay little rent in the early years of a contract, substituting short-term grain rents for higher, long-term returns from date palms, which take several years to mature and yield a crop. The date palms also require a good supply of water, and need to be grown near rivers and irrigation canals.

Over the years, the Eglib also obtained licenses from the government to become tax farmers – that is, they were allowed to collect taxes on behalf of the government and to remit a target fraction to the government while keeping the remainder. The Eglib family concentrated its tax-farming business in rural areas along the canals of the country, hiring boats and

boatmen to transport goods. Landowners had to pay specific rates to maintain canals and the local irrigation system. The Eglib set up contracts with the local officials responsible for maintaining the canals and collecting fees from their users in which the family paid the officials to pay the government, in return for the right to extract the fees in kind. In effect, the Eglib set up a strong shipping, storage and food-processing network, with tax-farming as a sideline operation. This work built enough financial support from the external market that, in two generations, the family was considered one of the wealthiest in the country adjacent to the capital city. The primary organisational structure used by the Eglib was the partnership arrangement, with local entrepreneurs who specialised in related production, such as beer-brewing or buying local crops, and selling them in the capital. The business maintains working capital at steady levels and distributes profits to the individual partners, to allow them to invest on their own in other businesses.

To extend their own investments, the Eglib moved into real estate. They developed a special relationship with the household of the local crown prince, and acquired a house adjacent to the crown prince's palace. They arranged a loan-secured mortgage transaction by borrowing the funds from the man who rented the house, with the rent corresponding to the usual interest charge of 20%, which covered asset price, rent and carrying charges for the property. The loan was the administrator of the crown prince's palace. Because the Eglib were not debtors in financial distress, the transaction was effectively an interest-free loan, and did not require any real flow of funds until the debt was eventually repaid. The contract was occasionally renewed, and ran for many decades.

Analyse your understanding of theory by examining **real-world case studies** that present issues in context and ask you to make your own decisions.

Guide to the online resources

FOR THE INSTRUCTOR

Cengage Learning is pleased to provide you with a selection of resources that will help you to prepare your lectures and assessments. These teaching tools are accessible via cengage.com.au/instructors for Australia or cengage.co.nz/instructors for New Zealand.



A new approach to highly personalised online learning, MindTap is a digital learning platform that works alongside your campus LMS to deliver the course curriculum across a range of electronic devices in your life. MindTap is built on an 'app' model allowing enhanced digital collaboration and delivery of engaging course content across a spectrum of Cengage and non-Cengage resources.

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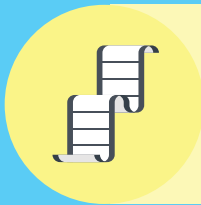
INSTRUCTOR'S MANUAL

The **instructor's manual** includes:

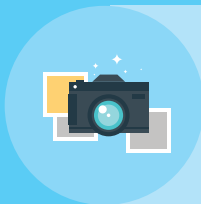
- learning objectives
- chapter overview
- 'what companies do' discussion questions
- lecture guide
- answers to the end-of-chapter self-test problems
- answers to the end-of-chapter questions
- solutions to the end-of-chapter question problems
- answers to the end-of-chapter mini case assignment.



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Use the chapter-by-chapter PowerPoint presentations to enhance your lecture presentations and handouts, and to reinforce the key principles of your subject.



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PREFACE

Finance matters! All business students need to understand finance. Whether you are evaluating a potential investment or an alternative marketing campaign or making a new product decision, you must understand introductory finance. Likewise, in your personal life, whether you want to estimate the amount to save to buy a new car or home or want to decide whether to buy shares, bonds or both for your retirement account, you benefit by understanding finance.

As instructors (and former students), however, we realise that finance can be an intimidating subject, especially for students who struggle with quantitative material. The initial goal in writing this book was to change that perception by reducing the intimidation factor and clearly communicating the excitement and relevance that finance holds for each of us.

Over the past few years, the US editions have received two types of feedback suggesting that they achieved their objective of creating an effective, user-friendly text. Many users told the authors, first, about their positive experiences with the book, and, second, that the book continued to experience strong and growing success in the market. This success carried over to the first Asia–Pacific edition, published in 2014, and we are grateful to all those who bought the book and who gave us their comments on it.

Our challenge in this second Asia–Pacific edition was to build on the book's earlier success and become the market-leading introductory corporate finance text. We strongly believe that this second edition offers state-of-the-art pedagogy and features necessary to achieve these goals.

NEW DISTINGUISHING FEATURES OF THE BOOK

This book shows you how the concepts you have learned in your prerequisite business courses – such as economics, statistics and accounting – directly connect to finance. Understanding these linkages will allow you to quickly realise that *you already know more about finance than you think you do!* To help you realise the practicality of the concepts covered in this book, most chapters include many illustrations of how you might utilise key chapter ideas in your own lives. In this second Asia–Pacific edition, we have updated a wide selection of the examples and cases. We have introduced a 'flow chart' for the overall learning pattern of the book, so that you can see at a glance where the current topic you are reading fits into the universe of finance knowledge. We have adjusted the questions and problems at the end of each chapter. We have added cases at the end of each Part of the book, in addition to those at the start and the end of each chapter. And we have continued to bring into our discussions materials reflecting current finance practice across the Asia–Pacific region.

Every student needs some extra explanation or support at different points in this course. Consequently, a truly outstanding technology package accompanies this book, as it has in previous editions – a package that will allow you to learn and absorb