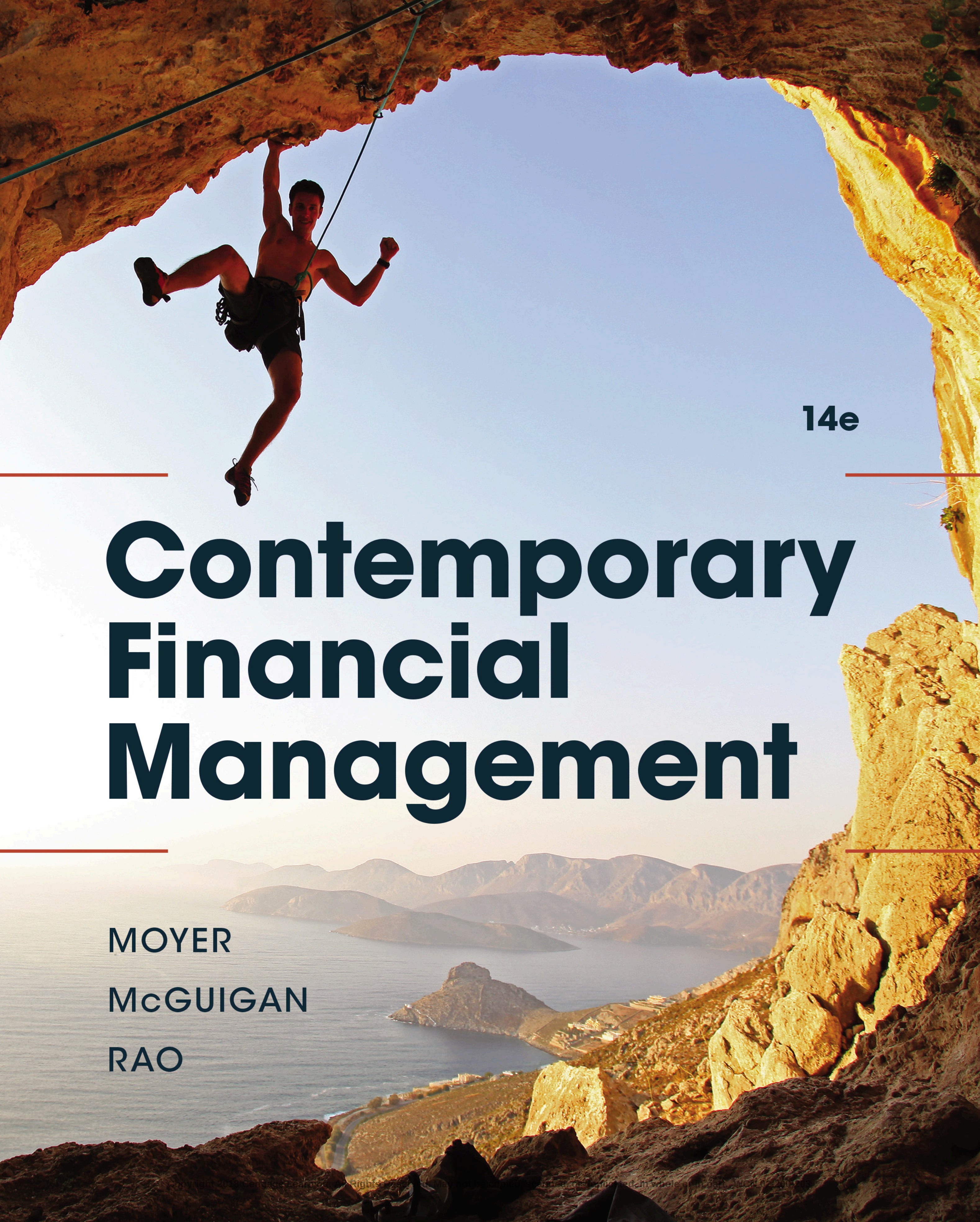

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Contemporary Financial Management

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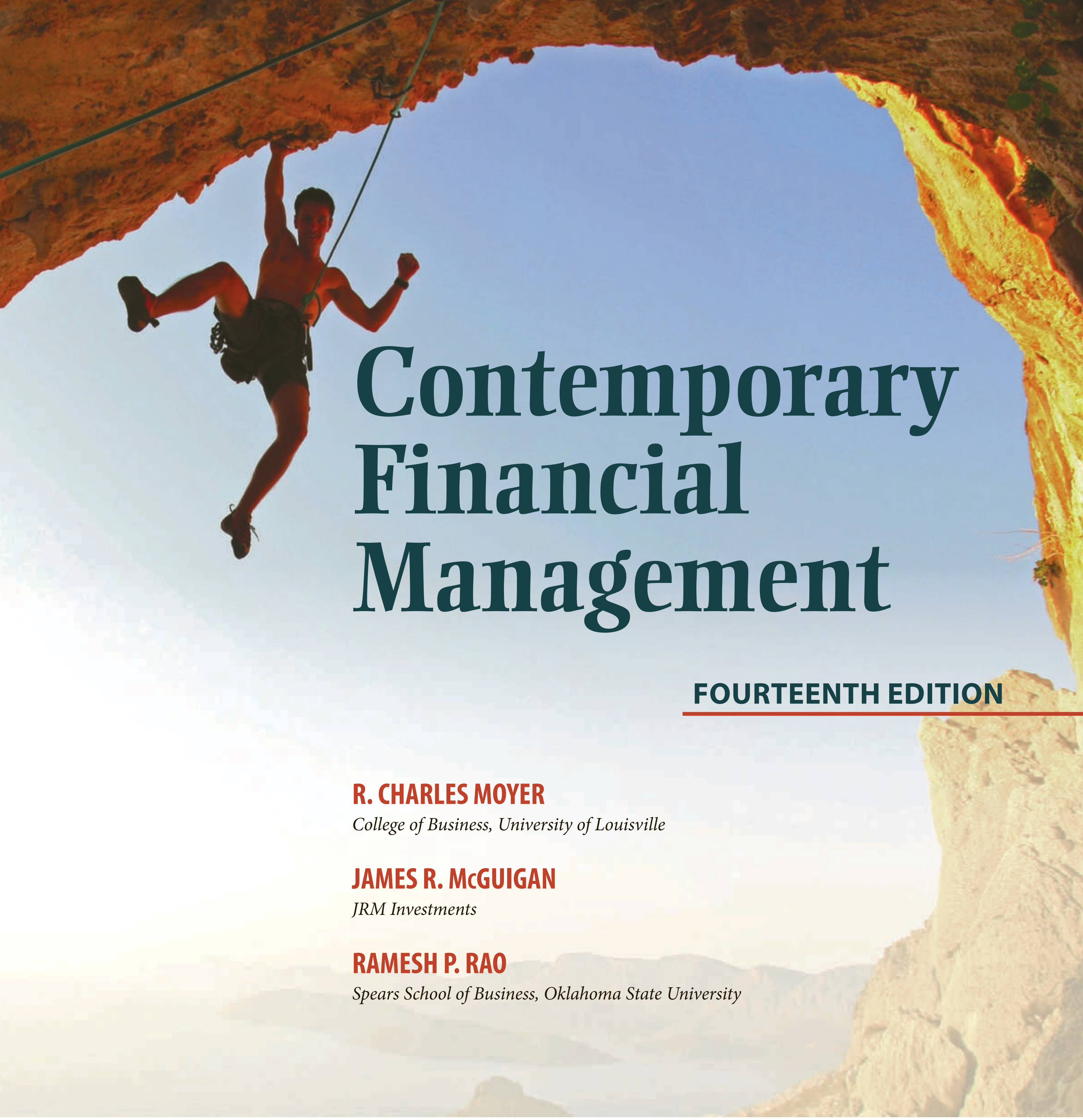

Contemporary Financial Management

FOURTEENTH EDITION

R. CHARLES MOYER
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JRM Investments

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To Sally, Craig, and Laura
RCM

To Claire
JRM

To Uma, Anil, and Nikhil
RPR

About the Authors

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In addition to coauthoring *Contemporary Financial Management*, 14th Edition, Dr. Moyer also coauthored *Managerial Economics*, 14th Edition (Cengage, 2017), and *Fundamentals of Contemporary Financial Management*, 2nd Edition (South-Western, 2007). He has published extensively in leading finance and economic journals, including *Financial Management*, *Journal of Financial and Quantitative Analysis*, *Journal of Finance*, *Financial Review*, *Journal of Financial Research*, *International Journal of Forecasting*, *Journal of Economics and Business*, and *Journal of Industrial Organization*, publishing over 90 articles and books. Dr. Moyer has served as a vice president of the Financial Management Association, as a director of the Financial Management Association, the Eastern Finance Association, and the Southern Finance Association, as a Secretary/Treasurer of the Financial Management Association, and as President of the Southern Finance Association.

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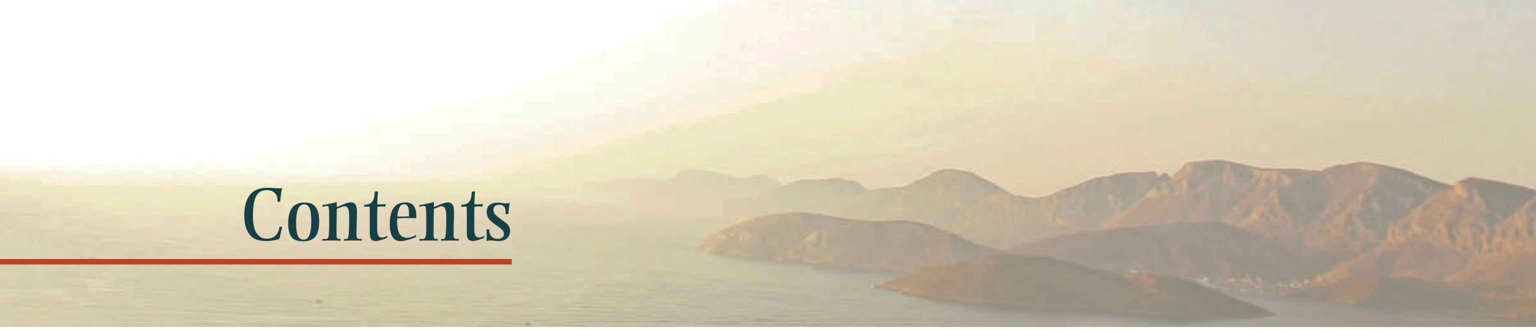

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Preface

The financial management field continues to experience exciting change and growth. Financial practitioners are increasingly employing new financial management techniques, sophisticated computer resources, and mega databases to aid in their decision making. "Financial engineers" continue to create new derivative financial instruments and transactions, including options, financial futures contracts, options on futures contracts, foreign currency swaps, and interest rate swaps, to help managers deal with risk and enhance shareholder wealth. Many industries have been restructured because of the pressures of global competition. Leveraged buyout transactions from sophisticated investors have forced managers to make more careful use of their firms' resources. The growing private equity market has added another dimension to the focus on sound management of a firm's resources. Corporate reformers have focused attention on the structure of corporate governance relationships and the impact of alternative managerial compensation packages on firm performance. The Internet has transformed the way securities are bought and sold and the way companies access new capital. At the same time, financial researchers have made important advances in the areas of valuation, cost of capital, capital structure theory and practice, option valuation (including "real" options associated with capital investments), risk management, and dividend policy. Access to and content of the Internet have greatly expanded, making timely financial information increasingly available to customers, investors, and financial managers.

The financial crisis and recession that began in late 2007 and continued into 2010 had a major impact on the financial marketplace and the practice of financial management. This crisis in the financial markets identified structural weaknesses in many financial institutions, including commercial banks, quasi-governmental financial entities, regulatory practices, and various aspects of risk management. The lessons from this experience will have long-lasting impacts on financial markets and the strategies employed by financial managers and investors. This 14th Edition of *Contemporary Financial Management* addresses the cause of this crisis and its impacts on the practice of finance.

The future promises to be a more exciting time for finance professionals. Financial managers have refocused their attention on the core objective of maximizing shareholder wealth. Managers who act contrary to the interests of shareholders face the prospect of an unfriendly takeover, a corporate restructuring, pressure from domestic and foreign competitors, pressure from private equity investors, or pressures from shareholder groups and institutional investors. Firms increasingly must find operating savings necessary to remain competitive, as managers continue to struggle to find the optimal capital structure for their firm. The central importance of cash flows in the financial management of a firm has never been more apparent. The European economic and monetary unification and the near collapse of that union in the wake of the financial crisis of 2008–2010, and the growing importance of countries such as China and India, all require contemporary financial managers to possess greater knowledge of doing business in an international marketplace. Recent turmoil in the commodity, currency, and interest rate markets highlight the importance of financial risk management tools. In addition, the standards of ethical behavior adopted by managers of business enterprises become even more important.

Contemporary Financial Management, 14th Edition, incorporates these changes—the increased focus on shareholder wealth maximization and cash flow management, an emphasis on the international aspects of financial management, a concern for the ethical behavior of managers, the role of private equity investors, and the lessons learned in the financial crisis that impacted all aspects of risk management—into a text designed primarily for an introductory course in financial management. The book is also suitable for management development programs and as a reference aid to practicing finance professionals.

The 13th Edition of *CFM* was well received by our many adopters. In the 14th Edition we retain the core features of that edition. We appreciate the many users and adopters who continue to offer suggestions for content additions and enhancements. As in the past, we have incorporated many of these suggestions into this edition. This edition has been extensively updated throughout, including the addition of numerous contemporary examples and references.

We recognize that students enter this course with a wide variety of backgrounds in mathematics, economics, accounting, and statistics. The only presumption we make regarding prior preparation is that all student users have had one course in financial accounting.

Organization of the Text

This text provides an introduction to both analytical tools and descriptive materials that are useful in financial management. Because this is an introductory-level text, however, it does *not* attempt to make the reader an expert in every aspect of financial decision making. Instead, it is intended to do the following:

- Acquaint the reader with the types of decisions faced by financial managers
- Develop a framework for analyzing these decisions in a systematic manner
- Provide the reader with the background necessary to pursue more advanced readings and courses in financial management

Although the subject matter in this text is divided into distinct parts, in reality and practice, the various types of financial decisions are interrelated and should not be considered in isolation from one another.

Each chapter begins with a summary preview of the key concepts from the chapter. This is followed by a financial challenge faced by a real firm(s) and related to the material in the chapter. Next, Learning Objectives are identified for each chapter. At the end of each chapter is a point-by-point summary of the chapter and extensive sets of discussion questions and problems, including "Self-Test Problems" with detailed solutions that you can use to test your understanding of the text material. A glossary of key terms is provided at the end of the book. Some chapters also have more complex, integrative case problems. Where appropriate, special international financial management issues and entrepreneurial finance issues are discussed. The book also has "Ethical Issues" sections integrated throughout. "Check" answers to selected problems appear at the end of the book. You will find an overview of the CFM Excel templates that are available for solving many of the complex chapter problems and cases at the book's Web site (www.cengagebrain.com).

Parts of the Text

Part One, Introduction. Chapter 1 discusses the role and objectives of financial management, introduces the various forms of business organization, discusses the importance of ethical business practices, and reviews the structure of the financial management function. Chapter 2 reviews the major elements of the U.S. and international financial marketplace. It includes a discussion of the structure of the U.S. financial system and the role of stock exchanges. Also included are introductions to various types of derivative securities and international financial management. Chapter 2 also contains an extensive discussion of the causes and impacts of the financial crisis beginning in late 2007. Chapter 3 considers the financial statements and ratios that can be used to evaluate the financial performance of a firm. Chapter 4 presents various techniques for analyzing cash flows and forecasting future financial performance.

Part Two, Determinants of Valuation. Valuation is a central theme of the book. Chapter 5 develops the concept of the time value of money. This concept is used in the valuation of securities and the evaluation of investment projects expected to provide benefits over a number of years. The present value rule is also introduced. Chapter 6 applies the basic valuation model to fixed income securities, such as bonds and preferred stock. Chapter 7 deals with the valuation of common stock and the role of investment bankers. Chapter 8 provides a comprehensive introduction to the concept of risk in finance and the relationship between risk, required return, and the shareholder wealth maximization goal of the firm.

Part Three, The Capital Investment Decision. This portion of the text focuses on capital expenditures—that is, investments in long-term assets. Chapters 9 and 10 present the fundamentals of capital budgeting, namely, the process of investing in long-term assets. Chapter 9 deals with the measurement of the cash flows (benefits and costs) associated with long-term investment projects. Chapter 10 considers various decision-making criteria that can be used when choosing projects that will maximize the value of the firm. Chapter 11 extends the concepts developed in Chapter 10 by considering some of the decision-making techniques that attempt to deal with the problem of the risk associated with a specific project's cash flows.

Part Four, The Cost of Capital, Capital Structure, and Dividend Policy. Chapter 12 illustrates the principles of measuring a firm's cost of capital. The cost of funds to a firm is an important input in the capital budgeting process. Chapters 13 and 14 address the relationship of the cost of capital to the firm's capital structure. Chapter 15 discusses the factors that influence the choice of a dividend policy and the impact of various dividend policies on the value of a firm.

Part Five, Working Capital Management. Chapters 16 through 18 examine the management of a firm's current asset and liability accounts—that is, net working capital. Chapter 16 provides an overview of working capital management, with emphasis on the risk-return trade-offs involved in working capital decision making. Chapter 16 also covers the management of secured and unsecured short-term credit. Chapter 17 deals with the management of cash and marketable securities, and Chapter 18 focuses on the management of accounts receivable and inventories.

Part Six, Additional Topics in Contemporary Financial Management. Chapter 19 deals with lease financing and intermediate-term credit. Chapter 20 focuses on option-related funding alternatives, i.e., derivative securities, including convertible securities, and warrants. Chapter 21 examines various techniques for managing risk, including the use of derivative securities. Chapter 22 discusses the factors that affect exchange rates and foreign exchange risk. Chapter 23 examines corporate restructuring decisions, including mergers and acquisitions, the role of private equity investors, bankruptcy, and reorganization.

Distinctive Features

In this 14th Edition, we continue our commitment to provide a comprehensive, correct, and well-written introduction to the field of financial management. The current edition reflects the many refinements that have been made over the years in previous editions. In addition, we have created a text package that fully reflects contemporary financial management developments in the book's pedagogical aids, organizational design, and ancillary materials.

Pedagogical Features

CFM has been carefully designed to assist the student in learning and to stimulate student interest.

Distinctive pedagogical features include:

1. **Financial Challenges.** Each chapter begins with an illustration of a financial management problem faced by a firm or individual. These exciting lead-ins come from real-firm situations, including Medtronic, Lexus, Hertz, Apple Inc., Ford Motor, Twitter, Facebook, Boeing, Novo Nordisk, Source Gas Distribution, ExxonMobil, Sears, Procter & Gamble, Berkshire Hathaway, Verizon, and JPMorgan Chase. These examples focus on financial problems in the topic area of the chapter and highlight the importance of learning sound financial management principles. The "Financial Challenges" have been extensively revised and updated from the 13th Edition, including numerous totally new examples.
2. **Foundation Concepts.** These concepts are introduced early in the text. Their central importance in the study of finance is highlighted by specially designated icons indicating that these are "Foundation Concepts" and hence worthy of extra attention by the student. Important foundation concepts are identified throughout the book, including the determinants of the return on equity, the valuation of assets, the valuation of common stock, cash flow estimation principles, capital budgeting decision models, business risk, financial risk, and the weighted cost of capital.
3. **International Issues.** To emphasize and reinforce the global nature of financial decision making, we have included "International Issues" sections throughout the book to illustrate the global issues associated with making financial decisions. By covering international finance in two chapters—and throughout, with the "International Issues" features—we ensure that all students will be exposed to important international dimensions of financial management decisions, and we provide an opportunity for in-depth coverage of some of the more important international finance topics.
4. **Ethical Issues.** "Ethical Issues" sections are integrated throughout to present some of the ethical dilemmas facing financial managers. These sections raise sensitivities to ethical issues and usually conclude with questions and issues for further classroom discussion.
5. **Entrepreneurial Issues.** In recognition of the important and growing role of small and medium-sized firms in the American business environment, we have included "Entrepreneurial Issues" sections that appear in appropriate places throughout the book and emphasize unique finance-related problems and concerns of entrepreneurs.
6. **Extensive and Fully Integrated Examples of the Financial Policies and Problems That Face Real Firms.** Throughout the book, we have illustrated financial management concepts by using problems facing real firms. By minimizing the number of hypothetical firm situations and using data and situations facing actual firms that students will recognize and relate to, CFM has further enhanced the realism and excitement of the field of finance.
7. **Calculator Application Illustrations.** Many chapters have easy-to-follow, step-by-step calculator keystrokes to solve many of the time value of money examples developed in the text. These "Calculator Applications" sections are set up in a generic calculator format and can be used with virtually any financial calculator.

8. **Spreadsheet Strategies.** Many chapters have illustrative examples of how spreadsheet software (Microsoft Excel) can be used to solve finance problems, including time value of money problems, stock and bond valuation, and capital budgeting.
9. **Intuitive Use of Notation.** Notation in the text is simplified and intuitive to aid student learning. Inside the front cover, we have provided a handy summary of the key notation used throughout the book.
10. **Internet Applications.** This edition provides numerous references to interesting Internet applications. The applications provide students with handy references that can be used to explore the Internet for additional information and data dealing with chapter topics.
11. **Extensive Problem Sets.** Many of the end-of-chapter problems contain a surfeit of information, forcing students to identify the relevant material needed to solve the problem. The problem sets provide students and instructors with a greater breadth of problem coverage than in many other texts. In addition, the problems have been identified with a difficulty rating ranging from basic to intermediate to challenging. In several finance textbooks, problems are labeled to indicate the type of problem to be solved. We have specifically chosen not to include this information because we believe that recognition of the problem type is an important part of the learning process. However, we understand the differing needs and goals of instructors, and thus have provided these categories in Appendix A of the Instructors' Resource Manual, so that it can be easily shared with students if desired. Selected check answers to some of the end-of-chapter problems appear at the end of the text.
12. **Self-Test Problems.** Each chapter includes end-of-chapter "Self-Test Problems," with detailed solutions at the end of the text that students can use for further practice and enhanced understanding of the concepts developed in the chapter.
13. **Integrative Cases.** At the end of appropriate chapters, an expanded set of comprehensive "Integrative Cases" are provided. Many of these cases can be used in conjunction with the Excel models, available on the Moyer Student Companion Web site, to demonstrate the power of computers in performing sensitivity analysis.
14. **Excel™ Problems.** Throughout the text, problems that can be solved using Excel are highlighted with an Excel icon. To help solve these problems, more than 20 user-friendly, flexible, downloadable Excel models are available at www.cengagebrain.com and require no prior knowledge of Excel.

Organizational Design

Contemporary Financial Management is organized around the objective of maximizing the value of the firm for its shareholders. This objective is introduced early in the book, and each major financial decision is linked to the impact it has on the value of the firm. The distinctive content features are designed to complement this objective:

1. **Emphasis on the fundamental concepts of cash flow, net present value, risk-return relationships, and market efficiency.** There are four concepts that are central to a complete understanding of most financial management decisions:
   a. The importance of cash flows as the relevant source of value to a firm
   b. The significance of the net present value rule for valuing cash flows
   c. The relationship between risk and return in the valuation process
   d. The efficiency of the capital markets
2. **Unique treatment of problems of international financial management.** In a business world that is increasingly global, it is important that finance students be aware of the most important dimensions of international finance. Some texts provide a single chapter dealing with a potpourri of international issues, but due to time