# CONTENTS

Preface xvii
Introduction xxi
Chapter 1
The Challenge of Financial/Economic Decision-making 1
Lessons for the Millennium 2
The New Economy 2
Some Key Questions 3
The Basics Never Change 6
The Economic Manager 7
Understanding Business Economics 8
Appropriate Economic Tools 9
The Practice of Financial/Economic Analysis 10
Day to Day Decisions and Operational Planning 10
Supporting Strategy Development 11
Performance Assessment and Incentives 12
Valuation and Investor Communications 14
The Value Creating Company 15
Relevant Decision Information 15
Economic Incentives 17
Total Systems Management 18
Chapter 2
A Systems Context for Financial Management 21
A Dynamic Perspective of Business 22
Decision Context 22
The Business System 26
Investment Decisions 29
Operating Decisions 31
Financing Decisions 33
Interrelationship of Strategy and Value Creation 36

x Contents

The Nature of Financial Statements 37

The Balance Sheet 38

The Income Statement 40

The Cash Flow Statement 42

The Statement of Changes in Shareholders' (Owners') Equity 46

The Context of Financial Analysis 50

Key Issues 55

Analytical Support 57

### Chapter 3

### **Managing Operating Funds** 59

Funds Flow Cycles 61

The Funds Cycle for Manufacturing 64

The Funds Cycle for Sales 67

The Funds Cycle for Services 69

Variability of Funds Flows 70

Growth/Decline Variations 70

Seasonal Variations 74

Cyclical Variations 75

Generalized Funds Flow Relationships 77

Interpreting Funds Flow Data 78

Funds Management and Shareholder Value 89

Cash Management 89

Working Capital Management 90

Investment Management 91

Key Issues 91

Analytical Support 93

### Chapter 4

#### **Assessment of Business Performance** 95

Ratio Analysis and Performance 9
Management's Point of View 97
Operational Analysis 98
Resource Management 107
Profitability 112
Owners' Point of View 115
Investment Return 116

Contents xi

Disposition of Earnings Market Indicators Lenders' Point of View 126 Liquidity 126 Financial Leverage 128 Debt Service 130 Ratios as a System 132 Elements of Return on Assets 133 Elements of Return on Equity 134 Integration of Financial Performance Analysis 137 Some Special Issues 139 Inventory Costing Depreciation Methods 141 The Impact of Inflation 144 Key Issues 145 Analytical Support 147 Chapter 5

# **Projection of Financial Requirements** 161

Pro Forma Financial Statements 163

Pro Forma Income Statement 164

Pro Forma Balance Sheet 167

Pro Forma Cash Flow Statement 171

Cash Budgets 174

Operating Budgets 178

Sales Budget 179

Production Budget 181

Interrelationship of Financial Projections 181

Financial Modeling 184

Sensitivity Analysis 186

Key Issues 187

Analytical Support 189

### Chapter 6

# Dynamics and Growth of the Business System 191

Leverage 192

Operating Leverage 193

xii Contents

Target Profit Analysis 202 Financial Leverage 203 Financial Growth Plans 209 Basic Financial Growth Model 210 Sustainable Growth and the Sustainable Growth Equation 214 Integrated Financial Plan 217 Key Issues 220 Analytical Support 222 Chapter 7 Cash Flows and the Time Value of Money 223 The Time Value of Money 224 Discounting, Compounding, and Equivalence 224 Components of Analysis 231 Net Investment 232 Net Operating Cash Inflows 232 Economic Life 233 Terminal (Residual) Value 233 Methods of Analysis 234 Simple Measures 234 Economic Investment Measures 237 Net Present Value 237 Present Value Payback 242 Profitability Index (BCR) 244 Internal Rate of Return (IRR, Yield) 245 Annualized Net Present Value 247 Applying Time-Adjusted Measures 250 Key Issues 250 Analytical Support 252 **Chapter 8 Analysis of Investment Decisions** 255 Strategic Perspective 256

Strategic Perspective 256

Decisional Framework 259

Problem Definition 260

Nature of the Investment 261

Future Costs and Benefits 262

Contents

Incremental Cash Flows 263 Relevant Accounting Data 264 Sunk Costs 265 Refinements of Investment Analysis 266 A Machine Replacement 266 Net Investment Refined 267 Operating Cash Inflows Refined 268 Unequal Economic Lives 271 Capital Additions and Recoveries Analytical Framework 272 A Business Expansion 275 Mutually Exclusive Alternatives Maintain versus Replace 277 Full-Fledged versus Economy Solution 279 Comparing Different Scenarios 280 Dealing with Risk and Changing Circumstances 282 Specifying Risk 283 Ranges of Estimates 284 Business Investments as Options 285 Probabilistic Simulation 287 Risk-Adjusted Return Standards When to Use Investment Measures 289 Some Further Considerations 291 Leasing—A Financing Choice 291 Accelerated Depreciation 292 Inflation and Investment Analysis 292 Accuracy 293 Key Issues 293 Analytical Support 295 Chapter 9

## Cost of Capital and Business Decisions 297

Decisional Context 298

Investment Decisions 298

Operating Decisions 299

Financing Decisions 300

Cost of Operating Funds 300

Cost of Long-term Debt 304

**xiv** Contents

Cost of Shareholders' Equity 305
Preferred Stock 305
Common Equity 306
Weighted Cost of Capital 312
Cost Choices 312
Weighting the Proportions 313
Calculating the Weighted Cost of Capital 315
Cost of Capital and Return Standards 317
Cost of Capital as a Cutoff Rate 318
Risk Categories 319
Cost of Capital in Multibusiness Companies 321
Multiple Rate Analysis 322
Key Issues 322
Analytical Support 324
Chapter 10
Analysis of Financing Choices 325
Framework for Analysis 326
Cost of Incremental Funds 326
Risk Exposure 327
Flexibility 328
Timing 328
Control 329
The Choice 330
Techniques of Calculation 330
Current Performance 331
Long-Term Debt in the Capital Structure 332
Preferred Stock in the Capital Structure 335
Common Stock in the Capital Structure 336
Range of Earnings Chart 339
The Optimal Capital Structure 345
Some Special Forms of Financing 347
Leasing 347
Convertible Securities 350
Stock Rights 351
Warrants 352
Key Issues 352
Analytical Support 354

Contents xv

#### Chapter 11

### Valuation and Business Performance 357

Definitions of Value 358

Economic Value 358

Market Value 359

Book Value 360

Liquidation Value 360

Breakup Value 361

Reproduction Value 361

Collateral Value 361

Assessed Value 362

Appraised Value 362

Going Concern Value 362

Shareholder Value 363

Value to the Investor 363

Bond Values 363

Preferred Stock Values 368

Common Stock Values 372

Specialized Valuation Issues 378

Rights and Warrants 378

Options 379

Business Valuation 380

Valuing the Equity 381

Valuing the Total Company 382

Using Shortcuts in Valuing an Ongoing Business 387

Key Issues 388

Analytical Support 389

### Chapter 12

# Managing for Shareholder Value 391

Shareholder Value Creation in Perspective 392

Evolution of Value-Based Methodologies 396

A Review of Key Measures 398

Economic Profit and CFROI 402

Creating Value in Restructuring and Combinations 411

Restructuring and Value 411

xvi Contents

Combinations and Synergy 414 Combinations and Share Values 415 Integration of Value Analysis 417 Perspectives 418 Expectations 419 Time Period 419 Cash Flow Pattern 419 Ongoing Values 420 Comparables 420 Negotiations 421 Key Issues 421 Analytical Support 423 APPENDIX I Financial Analysis Using Financial Genome 425 APPENDIX II Glossary of Key Terms and Concepts 433 APPENDIX III **Financial Information and On-Line Sources** 449 APPENDIX IV **Basic Inflation Concepts** 463

**Some Issues in Multinational Financial Analysis** 

469

APPENDIX V

INDEX 477