Mastering Financial Management

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Learning Objectives

What you will be able to do once you complete this chapter:

1. Explain the need for financial management in business.
2. Summarize the process of planning for financial management.
3. Describe the advantages and disadvantages of different methods of short-term debt financing.
4. Evaluate the advantages and disadvantages of equity financing.
5. Evaluate the advantages and disadvantages of long-term debt financing.

FYI

inside business

Did You Know?

Ford Motor Company, the only one of the Big Three U.S. automakers to avoid bankruptcy during the economic crisis, rings up more than $125 billion in annual revenue worldwide.

Ford's Financial Fuel

Question: Which one of the Big Three U.S. automakers did *not* file for bankruptcy during the recent economic crisis? Answer: Ford Motor Company. While General Motors and Chrysler both sought bankruptcy protection, Ford had the financial fuel to keep going, despite sagging sales and worldwide economic turmoil. How did Ford do it?

Months before the recession hit, Ford's financial executives recognized the early warning signs of business-cycle change. They also knew that Ford was unprofitable and losing market share to international competitors. In response, the executives drew up a financial plan to prepare for leaner times while implementing a turnaround. The purpose was to be sure that money was available for near-term expenses such as restructuring through layoffs and plant closings as well as for long-term projects such as researching environmentally friendly engines and creating the concept cars of tomorrow—activities that would pay off far in the future.

Ford found lenders offering attractive interest rates without overly burdensome loan requirements and borrowed $7 billion, using assets such as factories and trademarks as collateral to secure the loans. It also arranged for an $11.5 billion line of credit to be available if and when needed. In addition, Ford raised $4.5 billion by selling a special type of bond that can be converted to common stock. Although the company would be paying interest to bondholders every six months for 30 years, the deal helped strengthen its cash position.

As economic conditions deteriorated, sales of many consumer goods, including cars and trucks, plummeted. Ford began drawing on its credit to implement its plan for returning to profitability. Before bills came due, Ford parked the money in low-risk investments such as time deposits, yielding a low return but keeping the money safe.

Eventually, the economy finally perked up and Ford poured on the gas, launching a series of award-winning new cars and adding high-tech touches to woo buyers back. The company also issued 300 million new shares of common stock to raise more money. As cash flow improved month by month, Ford even began paying down debt. Can the carmaker use its financial strength to stay on course toward sustained profitability?[1]

Although most managers and employees have been affected by the economic crisis, the last few years have been especially difficult for financial managers. After all, they are the ones that must be able to raise the money needed to pay bills and expenses to keep a company's doors open. Executives at Ford—the company profiled in the Inside Business case for this chapter—used aggressive financial planning to anticipate the automaker's need for financing. To avoid the same fate as General Motors and Chrysler—bankruptcy—Ford's financial managers borrowed money in anticipation of a downturn in the company's sales and profits. Ford also sold both stocks and bonds to raise the money they needed to keep the company operating during the crisis and even build for the future. Did their financial plan work? The answer: A definite yes! Today, Ford is selling more cars, developing environmentally friendly engines, creating concept cars for the future, and has returned to profitability. Although there are many factors that account for Ford's success, most experts agree that the firm's financial planning enabled it to weather the economic storm and build for the future.

In reality, the crisis was a wake-up call for all corporate executives, managers, and business owners because one factor became obvious. The ability to borrow money (debt capital) or obtain money from the owners of a business (equity capital) is necessary for the efficient operation of a business firm *and* our economic system. In this chapter we focus on how firms find the financing required to meet two needs of all business organizations: the need for money to start a business and keep it going, and the need to manage that money effectively. We also look at how firms develop financial plans and evaluate financial performance. Then we compare various methods of obtaining short-term financing. We also examine sources of long-term financing.

What Is Financial Management?

1

Explain the need for financial management in business.

Financial management consists of all the activities concerned with obtaining money and using it effectively. Within a business organization, the financial manager not only must determine the best way (or ways) to raise money, but he or she also must ensure that projected uses are in keeping with the organization's goals.

The Need for Financing

Money is needed both to start a business and to keep it going. The original investment of the owners, along with money they may have borrowed, should be enough to open the doors. After that, ideally sales revenues should be used to pay the firm's expenses and provide a profit as well.

This is exactly what happens in a successful firm—over the long run. However, income and expenses may vary from month to month or from year to year. Temporary financing may be needed when expenses are high or sales are low. Then, too, situations such as the opportunity to purchase a new facility or expand an existing plant may require more money than is currently available within a firm.

Financial management often involves managing inventory. Retailers often invest large amounts of money in order to have just the right merchandise to sell to their customers. For retailers like Family Dollar, managing inventory can be a problem. To help families live within their budget, this retailer offers hundreds of toys for $5 or less, including Disney merchandise, Hot Wheels, and more.

© AP Images/PRNewsFoto/Family Dollar

Short-Term Financing **Short-term financing** is money that will be used for one year or less. As illustrated in Table 19.1, there are many short-term financing needs, but two deserve special attention. First, certain business practices may affect a firm's cash flow and create a need for short-term financing. **Cash flow** is the movement of money into and out of an organization. The ideal is to have sufficient money coming into the firm in any period to cover the firm's expenses during that period. This ideal, however, is not always achieved. For example, California-based Callaway Golf offers credit to retailers and wholesalers that carry the firm's golf clubs, balls, clothing, and golf accessories. Credit purchases made by Callaway's retailers generally are not paid until

Table 19.1 Comparison of Short- and Long-Term Financing

Whether a business seeks short- or long-term financing depends on what the money will be used for.

Corporate Cash Needs	
Short-Term Financing Needs	Long-Term Financing Needs
Cash-flow problems	Business start-up costs
Current inventory needs	Mergers and acquisitions
Speculative production	New product development
Monthly expenses	Long-term marketing activities
Short-term promotional needs	Replacement of equipment
Unexpected emergencies	Expansion of facilities

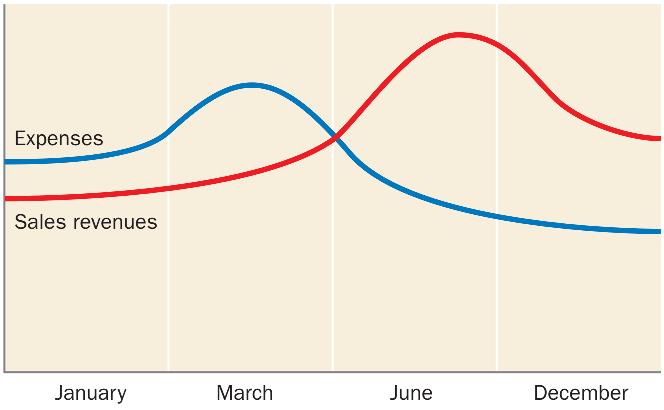
financial management all the activities concerned with obtaining money and using it effectively

short-term financing money that will be used for one year or less

cash flow the movement of money into and out of an organization

Figure 19.1 Cash Flow for a Manufacturing Business

Manufacturers such as Stanley (Stanley Black & Decker) often use short-term financing to pay expenses during the production process. Once goods are shipped to retailers and wholesalers and payment is received, sales revenues are used to repay short-term financing.



30 to 60 days (or more) after the transaction. Callaway therefore may need short-term financing to pay its bills until its customers have paid theirs.

A second major need for short-term financing is inventory. For most manufacturers, wholesalers, and retailers, inventory requires considerable investment. Moreover, most goods are manufactured four to nine months before they are actually sold to the ultimate customer. This type of manufacturing is often referred to as speculative production. **Speculative production** refers to the time lag between the actual production of goods and when the goods are sold. Consider what happens when a firm such as Stanley Black & Decker begins to manufacture electric tools and small appliances for sale during the Christmas season. Manufacturing begins in February, March, and April, and the firm negotiates short-term financing to buy materials and supplies, to pay wages and rent, and to cover inventory costs until its products eventually are sold to wholesalers and retailers later in the year. Take a look at Figure 19.1. Although Stanley Black & Decker manufactures and sells finished products all during the year, expenses peak during the first part of the year. During this same period, sales revenues are low. Once the firm's finished products are shipped to retailers and wholesalers and payment is received (usually within 30 to 60 days), sales revenues are used to repay short-term financing.

Retailers that range in size from Walmart to the neighborhood drugstore also need short-term financing to build up their inventories before peak selling periods. For example, Dallas-based Bruce Miller Nurseries must increase the number of shrubs, trees, and flowering plants that it makes available for sale during the spring and summer growing seasons. To obtain this merchandise inventory from growers or wholesalers, it uses short-term financing and repays the loans when the merchandise is sold.

speculative production the time lag between the actual production of goods and when the goods are sold

long-term financing money that will be used for longer than one year

Long-Term Financing

Long-term financing is money that will be used for longer than one year. Long-term financing obviously is needed to start a new business. As Table 19.1 shows, it is also needed for business mergers and acquisitions, new product development, long-term marketing activities, replacement of equipment that has become obsolete, and expansion of facilities.

The amounts of long-term financing needed by large firms can seem almost unreal. The 3M Company—a large multinational corporation known for research and development—has invested more than $6.9 billion over the last five years to develop new products designed to make people's lives easier and safer.[2]

The Need for Financial Management

To some extent, financial management can be viewed as a two-sided problem. On one side, the uses of funds often dictate the type or types of financing needed by a business. On the other side, the activities a business can undertake are determined by the types of financing available.

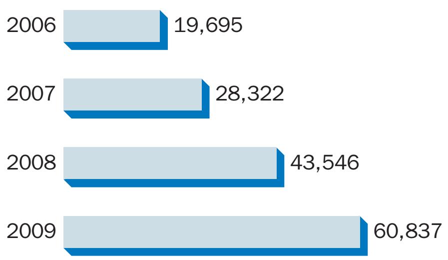
Financial Management During the Economic Crisis Financial managers must ensure that funds are available when needed, that they are obtained at the lowest possible cost, and that they are used as efficiently as possible. During the recent economic crisis, many companies found it was increasingly difficult to use many of the traditional sources of short- and long-term financing described later in this chapter. In some cases, banks stopped making loans even to companies that had always been able to borrow money. Even companies that had always been able to sell commercial paper had difficulty finding buyers. For example, both GE and AT&T—two premier names in corporate America—could not get the short-term financing they were looking for.[3] Furthermore, the number of corporations selling stock for the first time to the general public decreased because investors were afraid to invest in new companies. The worst case scenario: There was an increase in the number of businesses that filed for bankruptcy, as illustrated in Figure 19.2.

Although the number of business bankruptcies increased, fortunately there were many more business firms that were able to weather the economic storm and keep operating because of their ability to manage their finances. Proper financial management during both good and bad times must ensure the following:

- Financing priorities are established in line with organizational goals and objectives.
- Spending is planned and controlled.
- Sufficient financing is available when it is needed, both now and in the future.
- A firm's credit customers pay their bills on time, and the number of past due or delinquent accounts is reduced.
- Bills are paid promptly to protect the firm's credit rating and its ability to borrow money.
- The funds required for paying the firm's taxes are available when needed to meet tax deadlines.
- Excess cash is invested in certificates of deposit (CDs), government securities, or conservative, marketable securities.

Figure 19.2 Business Bankruptcies in the United States

The number of businesses that filed for bankruptcy increased during the economic crisis. (*Note*: At the time of publication, 2009 was the most recent year for which complete statistics were available.)



Source: The American Bankruptcy Institute Web site at http://www.abiworld.org (accessed June 24, 2010).

Entrepreneurial SUCCESS

Barter Gets a Boost

Barter—the exchange of goods or services—is becoming increasingly popular as small businesses look for creative ways to manage their money. Instead of spending cash or tapping credit, many are arranging informal barter deals with other companies or joining barter associations for access to a wider variety of possible trades. Field of Flowers, a florist in Florida, has traded flowers for public-relations services. Labongo Computer Systems, in Indianapolis, has bartered tech support for legal services.

As many as 175,000 small businesses belong to organized barter groups such as the International Reciprocal Trade Association and the Community Connect Trade Association. Members pay a monthly fee and a small commission on the value of each barter transaction. They list what they are willing to barter, including prices, and they can browse what other businesses are offering. Businesses earn barter credits when they provide goods or services to other members. In turn, they can "spend" these barter credits on anything listed by other members.

Because such deals do not put money in the bank, entrepreneurs should not go overboard with bartering. They should be sure that they can actually use what is being offered and consider the overall value before they strike a deal. Some businesses have found that barter stimulates cash sales as satisfied "customers" spread the word about goods and services they like.

Sources: Brian R. Hook, "Bartering 2.0: No Cash? No Problem," *E-Commerce Times*, April 23, 2010, http://www.ecommercetimes.com; Bridget Carey, "Bartering Helps Small Companies Survive When Cash Is Tight," *Miami Herald*, April 4, 2010, http://www.miamiherald.com/2010/04/04/v-fullstory/1562698/bartering-helps-small-companies.html#ixzz0kE3ljTSc; Minda Zetlin, "To Barter or Not to Barter? Some Swaps Can Be Deceptively Costly," *Inc.*, November 2009, 1021; Peter Schnitzler, "Bartering Booms: Trading of Goods and Services Spikes During Recession," *Indianapolis Business Journal*, September 28, 2009, 27A.

Financial Reform After the Economic Crisis At the time of publication of this text, it has been more than a year since the financial crisis peaked during 2009. As the economy began to improve, it became apparent that something needed to be done to stabilize the financial system and prevent future economic meltdowns. In the wake of the crisis that affected both business firms and individuals, a cry for more regulations and reforms became a high priority.

Although the U.S. House of Representatives and Senate debate proposed regulations, the goals are to hold Wall Street firms accountable for their actions, end taxpayer bailouts, tighten regulations for major financial firms, and increase government oversight. There has also been debate about limiting the amount of executive pay and bonuses, limiting the size of the largest financial firms, and curbing speculative investment techniques that were used by banks before the crisis. Because of the relationship between banking and finance, any new regulations will also provide more protection for consumers. As mentioned in Chapter 18, new regulations will protect American families from unfair, abusive financial and banking practices. For business firms, the impact of new regulations could increase the time and cost of obtaining both short- and long-term financing.

Although there are many critics of increased government regulation and the debate still continues, it is apparent that something needs to be done to prevent the type of economic problems the nation has experienced over the past three years. To date, no comprehensive bill has been sent to the president. For the latest information about financial reform, go to the Securities and Exchange Web site at http://www.sec.gov, the Federal Reserve Board Web site at http://www.federalreserve.gov, or use a search engine like Google or Yahoo! and enter "financial reform."

The Risk-Return Ratio According to financial experts, business firms will find it more difficult to raise capital in the future for two reasons. First, financial reform and increased regulations will lengthen the process required to obtain financing. Second, both lenders and investors are more cautious about who receives financing. As a result of these two factors, financial managers must develop a strong financial plan that describes how the money will be used and how it will be repaid. When developing a financial plan for a business, a financial manager must also consider the risk-return ratio when making decisions that affect the firm's finances.

The **risk-return ratio** is based on the principle that a high-risk decision should generate higher financial returns for a business. On the other hand, more conservative decisions (with less risk) often generate lesser returns. Although financial managers want higher returns, they often must strive for a balance between risk and return. For example, American Electric Power may consider investing millions of dollars to fund research into new solar technology that could enable the company to use the sun to generate electrical power. Yet, financial managers (along with other managers throughout the organization) must determine the potential return before committing to such a costly research project.

Executives in the hot seat! While everyone has an opinion about what caused the recent economic crisis, these protestors believe that Wall Street firms and their top executives should be held accountable for their actions. In reality, the protest would not have been necessary if some executives had remembered what it takes to be a successful financial manager.

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Careers in Finance

When you hear the word *finance,* you may think of highly paid executives who determine what a corporation can afford to do and what it cannot. At the executive level, most large business firms have a **chief financial officer (CFO)** for financial management. A CFO is a high-level corporate executive who manages a firm's finances and reports directly to the company's chief executive officer or president. Some firms prefer to use the titles vice president of financial management, treasurer, or controller instead of the CFO title for executive-level positions in the finance area.

Although some executives in finance do make $300,000 a year or more, many entry-level and lower-level positions that pay quite a bit less are available. Banks, insurance companies, and investment firms obviously have a need for workers who can manage and analyze financial data. So do businesses involved in manufacturing, services, and marketing. Colleges and universities, not-for-profit organizations, and government entities at all levels also need finance workers.

People in finance must have certain traits and skills. One of the most important priorities for someone interested in a finance career is honesty. Be warned: Investors, lenders, and other corporate executives expect financial managers to be above reproach. Moreover, both federal and state government entities have enacted legislation to ensure that corporate financial statements reflect the "real" status of a firm's financial position. In addition to honesty, managers and employees in the finance area must:

1. Have a strong background in accounting or mathematics.
2. Know how to use a computer to analyze data.
3. Be an expert at both written and oral communication.

Typical job titles in finance include bank officer, consumer credit officer, financial analyst, financial planner, loan officer, insurance analyst, and investment account executive. Depending on qualifications, work experience, and education, starting salaries generally begin at $25,000 to $35,000 a year, but it is not uncommon for college graduates to earn higher salaries. In addition to salary, many employees have attractive benefits and other perks that make a career in financial management attractive.

risk-return ratio a ratio based on the principle that a high-risk decision should generate higher financial returns for a business and more conservative decisions often generate lower returns

chief financial officer (CFO) a high-level corporate executive who manages a firm's finances and reports directly to the company's chief executive officer or president

financial plan a plan for obtaining and using the money needed to implement an organization's goals

2

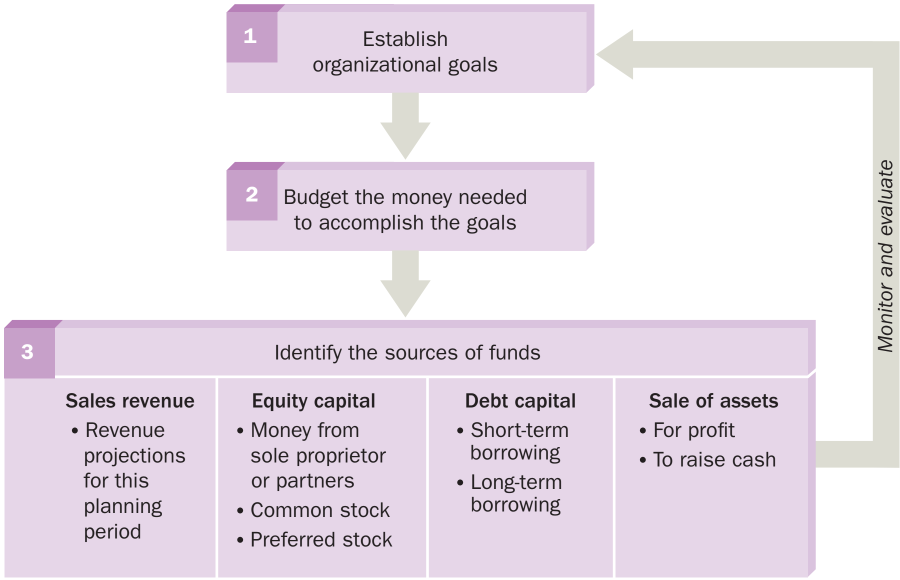
Summarize the process of planning for financial management.

Planning—The Basis of Sound Financial Management

In Chapter 6, we defined a *plan* as an outline of the actions by which an organization intends to accomplish its goals. A **financial plan**, then, is a plan for obtaining and using the money needed to implement an organization's goals.

Figure 19.3 The Three Steps of Financial Planning

After a financial plan has been developed, it must be monitored continually to ensure that it actually fulfills the firm's goals.



Developing the Financial Plan

Financial planning (like all planning) begins with establishing a set of valid goals. Financial managers must then determine how much money is needed to accomplish each goal. Finally, financial managers must identify available sources of financing and decide which to use. The three steps involved in financial planning are illustrated in Figure 19.3.

budget a financial statement that projects income, expenditures, or both over a specified future period

To be a successful retailer, it takes a financial plan. Many would-be business owners assume that if they have enough money, they will be successful. The truth is that effective financial planning involves more than just spending money. In fact, sound financial planning is built on the firm's goals and objectives, different types of budgets, and available sources of funds.

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Establishing Organizational Goals As pointed out in Chapter 6, a *goal* is an end result that an organization expects to achieve over a one- to ten-year period. If goals are not specific and measurable, they cannot be translated into dollar costs, and financial planning cannot proceed. Goals also must be realistic. Otherwise, they may be impossible to finance or achieve. For large corporations, goals can be expensive. For example, ever wonder how much Geico's advertising program costs? Well, the clever advertisements featuring the green gecko are not cheap. In fact, Berkshire Hathaway, the parent company of Geico Insurance, spent over $600 million in 2009 to attract new customers and to increase Geico's market share in the very competitive insurance industry.[4]

Budgeting for Financial Needs Once planners know what the firm's goals are for a specific period—say, the next calendar year—they can budget the costs the firm will incur and the sales revenues it will receive. Specifically, a **budget** is a financial statement that projects income, expenditures, or both over a specified future period.

Usually, the budgeting process begins with the construction of budgets for sales and various types of expenses. (A typical sales budget—for Stars and Stripes Clothing, a California-based retailer—is shown in Figure 19.4.) Financial managers can easily combine each department's budget for sales and expenses into a company-wide cash budget. A **cash budget** estimates cash receipts and cash expenditures over a specified period. Notice in the cash budget for Stars and Stripes Clothing, shown in Figure 19.5, that cash sales and collections are listed at the top for each calendar quarter. Payments for purchases and routine expenses are listed in the middle section. Using this information, it is possible to calculate the anticipated cash gain or loss at the end of each quarter.

Why is Blockbuster closing this store? Closing a store is one of the hardest decisions that executives have to make. Recently, Blockbuster has closed a large number of stores because of lower sales revenue and increased competition from other movie rental firms, including Netflix and Redbox. While Blockbuster still has over 4,000 stores in the United States, it must control costs for each store in order to earn profits.

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Most firms today use one of two approaches to budgeting. In the *traditional* approach, each new budget is based on the dollar amounts contained in the budget for the preceding year. These amounts are modified to reflect any revised goals, and managers are required to justify only new expenditures. The problem with this approach is that it leaves room for padding budget items to protect the (sometimes selfish) interests of the manager or his or her department. This problem is essentially eliminated through zero-base budgeting. **Zero-base budgeting** is a budgeting approach in which every expense in every budget must be justified.

To develop a plan for long-term financing needs, managers often construct a capital budget. A **capital budget** estimates a firm's expenditures for major assets, including new product development, expansion of facilities, replacement of obsolete equipment, and mergers and acquisitions. For example, Kraft Foods constructed a capital budget to determine the best way to finance the $19.5 billion acquisition of British candy maker Cadbury in 2010.[5]

cash budget a financial statement that estimates cash receipts and cash expenditures over a specified period

zero-base budgeting a budgeting approach in which every expense in every budget must be justified

capital budget a financial statement that estimates a firm's expenditures for major assets and its long-term financing needs

Identifying Sources of Funds

The four primary sources of funds, listed in Figure 19.3, are sales revenue, equity capital, debt capital, and proceeds from the sale of assets. Future sales revenue generally provides the greatest part of a firm's financing. Figure 19.5 shows that for Stars and Stripes Clothing, sales for the year are expected to cover all expenses and to provide a cash gain of $106,000, or about 16 percent of sales. However, Stars and Stripes has a problem in the first quarter, when sales are expected to fall short of expenses by $7,000. In fact, one of the primary reasons for

Figure 19.4 Sales Budget for Stars and Stripes Clothing

Usually, the budgeting process begins with the construction of departmental budgets for sales.

STARS AND STRIPES CLOTHING
Sales Budget — From January 1, 2010 to December 31, 2010

Department	First Quarter ($)	Second Quarter ($)	Third Quarter ($)	Fourth Quarter ($)	Total ($)
Infants'	50,000	55,000	60,000	70,000	235,000
Children's	45,000	45,000	40,000	40,000	170,000
Women's	35,000	40,000	35,000	50,000	160,000
Men's	20,000	20,000	15,000	25,000	80,000
Total	150,000	160,000	150,000	185,000	645,000

Figure 19.5 Cash Budget for Stars and Stripes Clothing

A company-wide cash budget projects sales, collections, purchases, and expenses over a specified period to anticipate cash surpluses and deficits.

STARS AND STRIPES CLOTHING
Cash Budget
From January 1, 2010 to December 31, 2010

	First Quarter ($)	Second Quarter ($)	Third Quarter ($)	Fourth Quarter ($)	Total ($)
Cash sales and collections	150,000	160,000	150,000	185,000	645,000
Less payments					
Purchases	110,000	80,000	90,000	60,000	340,000
Wages/salaries	25,000	20,000	25,000	30,000	100,000
Rent	10,000	10,000	12,000	12,000	44,000
Other expenses	4,000	4,000	5,000	6,000	19,000
Taxes	8,000	8,000	10,000	10,000	36,000
Total payments	157,000	122,000	142,000	118,000	539,000
Cash gain or (loss)	(7,000)	38,000	8,000	67,000	106,000

financial planning is to provide management with adequate lead time to solve this type of cash-flow problem.

A second type of funding is **equity capital**. For a sole proprietorship or partnership, equity capital is provided by the owner or owners of the business. For a corporation, equity capital is money obtained from the sale of shares of ownership in the business. Equity capital is used almost exclusively for long-term financing. Thus, it would not be considered for short-term financing needs, such as Stars and Stripes Clothing's first-quarter $7,000 shortfall.

A third type of funding is **debt capital**, which is borrowed money. Debt capital may be borrowed for either short- or long-term use—and a short-term loan seems made to order for Stars and Stripes Clothing's shortfall problem. The firm probably would borrow the needed $7,000 (or perhaps a bit more) at some point during the first quarter and repay it from second-quarter sales revenue.

Proceeds from the sale of assets are the fourth type of funding. Selling assets is a drastic step. However, it may be a reasonable last resort when sales revenues are declining and equity capital or debt capital cannot be found. Assets also may be sold when they are no longer needed or do not "fit" with the company's core business. In 2010, American International Group (AIG) sold its Alico life insurance unit to MetLife. The transaction generated more than $15.5 billion. Although companies often say they are selling assets to concentrate on their core business, to fund expansion, or to pay for new product development, these AIG assets were sold to raise money that could be used to repay government bailout funds it received during the economic crisis.[6]

Monitoring and Evaluating Financial Performance

It is important to ensure that financial plans are being implemented properly and to catch potential problems before they become major ones. Despite efforts to raise additional financing, reduce expenses, and increase sales to become profitable, both General Motors and Chrysler filed for bankruptcy protection in 2009. Eventually, both firms were reorganized and evolved as important U.S. automakers.

To prevent problems such as those just described, financial managers should establish a means of monitoring financial performance. Interim budgets (weekly, monthly, or quarterly) may be prepared for comparison purposes. These comparisons

equity capital money received from the owners or from the sale of shares of ownership in a business

debt capital borrowed money obtained through loans of various types point up areas that require additional or revised planning—or at least areas calling for a more careful investigation. Budget comparisons can also be used to improve the firm's future budgets.

Sources of Short-Term Debt Financing

3

Describe the advantages and disadvantages of different methods of short-term debt financing.

Typically, short-term debt financing is money that will be repaid in one year or less. During the economic crisis, many business firms found that it was much more difficult to borrow money for short periods of time to purchase inventory, buy supplies, pay salaries, and meet everyday expenses. Today the amount of available short-term financing has increased. Nevertheless, a business must be able to repay borrowed funds before lenders and investors will provide this type of financing.

The decision to borrow money does not necessarily mean that a firm is in financial trouble. On the contrary, astute financial management often means regular, responsible borrowing of many different kinds to meet different needs. In this section, we examine the sources of *short-term debt financing* available to businesses. In the next two sections, we look at long-term financing options: equity capital and debt capital.

Sources of Unsecured Short-Term Financing

Short-term debt financing is usually easier to obtain than long-term debt financing for three reasons:

1. For the lender, the shorter repayment period means less risk of non-payment.
2. The dollar amounts of short-term loans are usually smaller than those of long-term loans.
3. A close working relationship normally exists between the short-term borrower and the lender.

Most lenders do not require collateral for short-term financing. If they do, it is usually because they are concerned about the size of a particular loan, the borrowing firm's poor credit rating, or the general prospects of repayment. Remember from Chapter 18 that *collateral* was defined as real estate or property pledged as security for a loan.

unsecured financing financing that is not backed by collateral

trade credit a type of short-term financing extended by a seller who does not require immediate payment after delivery of merchandise

Unsecured financing is financing that is not backed by collateral. A company seeking unsecured short-term financing has several options.

Trade Credit Manufacturers and wholesalers often provide financial aid to retailers by allowing them 30 to 60 days (or more) in which to pay for merchandise. This delayed payment, known as **trade credit**, is a type of short-term financing extended by a seller who does not require immediate payment after delivery of merchandise. It is the most popular form of short-term financing, because most manufacturers and wholesalers do not charge interest for trade credit. In fact, from 70 to 90 percent of all transactions between businesses involve some trade credit.

Let us assume that a Barnes & Noble bookstore receives a shipment of books from a publisher. Along with the merchandise, the publisher sends an invoice that states the terms of payment. Barnes & Noble now has two options for payment. First, the book retailer may pay the invoice promptly and take advantage of any cash discount the publisher offers. Cash-discount terms are specified on the invoice. For instance, "2/10, net 30" means that the customer—Barnes & Noble—may take a "2" percent discount if it pays the invoice within ten days

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Short-term financing helped build these security cameras. Often firms like this Chinese manufacturer need trade credit and other types of short-term financing to pay employees and purchase the materials required to manufacture closed-circuit security cameras. When short-term financing is used, manufacturers don't have to pay suppliers and lenders for 30 to 60 days or more.

of the invoice date. Let us assume that the dollar amount of the invoice is $140,000. In this case, the cash discount is $2,800 ($140,000 × 0.02 = $2,800).

A second option is to wait until the end of the credit period before making payment. If payment is made between 11 and 30 days after the date of the invoice, the customer must pay the entire amount. As long as payment is made before the end of the credit period, the customer maintains the ability to purchase additional merchandise using the trade-credit arrangement.

Promissory Notes Issued to Suppliers A **promissory note** is a written pledge by a borrower to pay a certain sum of money to a creditor at a specified future date. Suppliers uneasy about extending trade credit may be less reluctant to offer credit to customers who sign promissory notes. Unlike trade credit, however, promissory notes usually require the borrower to pay interest. Although repayment periods may extend to one year, most short-term promissory notes are repaid in 60 to 180 days.

A promissory note offers two important advantages to the firm extending the credit.

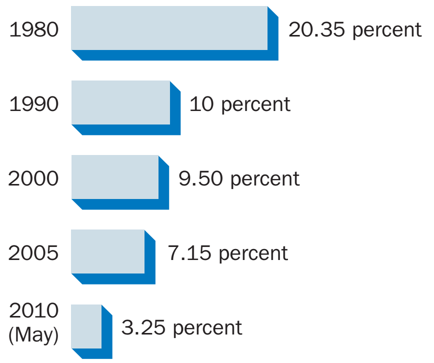
1. A promissory note is legally binding and an enforceable contract.
2. A promissory note is a negotiable instrument.

Because a promissory note is negotiable, the supplier (or company extending credit) may be able to discount, or sell, the note to its own bank. If the note is discounted, the dollar amount the supplier receives is slightly less than the maturity value because the bank charges a fee for the service. The supplier recoups most of its money immediately, and the bank collects the maturity value when the note matures.

Unsecured Bank Loans Banks and other financial institutions offer unsecured short-term loans to businesses at interest rates that vary with each borrower's credit rating. The **prime interest rate**, sometimes called the *reference rate*, is the lowest rate charged by a bank for a short-term loan. Figure 19.6 traces the fluctuations in the average prime rate charged by U.S. banks from 1980 to May 2010. This lowest rate generally is reserved for large corporations with excellent credit ratings. Organizations with good to high credit ratings may pay the prime rate plus "2" percent. Firms with questionable credit ratings may have to pay the prime rate plus "4" percent. (The fact that a banker charges a higher interest rate for a higher-risk loan is a

Figure 19.6 Average Prime Interest Rate Paid by U.S. Businesses, 1980-May 2010

The prime rate is the interest rate charged by U.S. banks when businesses with the "best" credit ratings borrow money. All other businesses pay higher interest rates than the prime rate.



Source: Federal Reserve Bank Web site, http://www.federalreserve.gov (accessed June 23, 2010).

promissory note a written pledge by a borrower to pay a certain sum of money to a creditor at a specified future date

prime interest rate the lowest rate charged by a bank for a short-term loan practical application of the risk-return ratio discussed earlier in this chapter.) Of course, if the banker believes that loan repayment may be a problem, the borrower's loan application may well be rejected.

Banks generally offer unsecured short-term loans through promissory notes, a line of credit, or a revolving credit agreement. A bank promissory note is similar to the promissory note issued to suppliers described in the preceding section. For both types of promissory notes, interest rates and repayment terms may be negotiated between the borrower and a bank or supplier. A bank that offers a promissory note or line of credit may require that a *compensating balance* be kept on deposit at the bank. Compensating balances, if required, are typically 10 to 20 percent of the borrowed funds. The bank may also require that every commercial borrower *clean up* (pay off completely) its short-term promissory note or line of credit at least once each year and not use it again for a period of 30 to 60 days.

Even with a line of credit, a firm may not be able to borrow on short notice if the bank does not have sufficient funds available. For this reason, some firms prefer a *revolving credit agreement,* which is a *guaranteed* line of credit. Under this type of agreement, the bank guarantees that the money will be available when the borrower needs it. In return for the guarantee, the bank charges a commitment fee ranging from 0.25 to 1.0 percent of the *unused* portion of the revolving credit agreement. The usual interest is charged for the portion that *is* borrowed.

Commercial Paper As defined in Chapter 18, commercial paper is a short-term promissory note issued by a large corporation. Commercial paper is secured only by the reputation of the issuing firm; no collateral is involved. It is usually issued in large denominations, ranging from $5,000 to $100,000. Corporations issuing commercial paper pay interest rates slightly below the interest rates charged by banks for short-term loans. Thus, issuing commercial paper is cheaper than getting short-term financing from a bank. The interest rate a corporation pays when it issues commercial paper is tied to its credit rating and its ability to repay the commercial paper. It is most often used to purchase inventory, pay salaries and other necessary expenses, and solve cash-flow problems.

Large firms with excellent credit reputations like Microsoft, Procter & Gamble, and Caterpillar can raise large sums of money quickly by issuing commercial paper. However, during the recent financial crisis, even companies that had always been able to sell commercial paper had difficulty finding buyers. To help provide additional short-term financing, the Federal Reserve Bank stepped in and began to purchase the commercial paper from firms in need of financing to pay for day-to-day business operations.[7]

Sources of Secured Short-Term Financing

If a business cannot obtain enough capital through unsecured financing, it must put up collateral to obtain additional short-term financing. Almost any asset can serve as collateral. However, *inventories* and *accounts receivable* are the assets most commonly pledged for short-term financing. Even when it is willing to pledge collateral to back up a loan, a firm that is financially weak may have difficulty obtaining short-term financing.

Loans Secured by Inventory Normally, manufacturers, wholesalers, and retailers have large amounts of money invested in finished goods. In addition, manufacturers carry raw materials and work-in-process inventories. All three types of inventory may be pledged as collateral for short-term loans. However, lenders prefer the much more salable finished merchandise to raw materials or work-in-process inventories.

A lender may insist that inventory used as collateral be stored in a public warehouse. In such a case, the receipt issued by the warehouse is retained by the lender. Without this receipt, the public warehouse will not release the merchandise. The lender releases the warehouse receipt—and the merchandise—to the borrower when the borrowed money is repaid. In addition to paying the interest on the loan, the borrower must pay for storage in the public warehouse. As a result, this type of loan is more expensive than an unsecured short-term loan.

Loans Secured by Receivables As defined in Chapter 17, *accounts receivable* are amounts owed to a firm by its customers. A firm can pledge its accounts receivable as collateral to obtain short-term financing. A lender may advance 70 to 80 percent of the dollar amount of the receivables. First, however, it conducts a thorough investigation to determine the *quality* of the receivables. (The quality of the receivables is the credit standing of the firm's customers, coupled with the customers' ability to repay their credit obligations when they are due.) If a favorable determination is made, the loan is approved. When the borrowing firm collects from a customer whose account has been pledged as collateral, generally it must turn the money over to the lender as partial repayment of the loan. An alternative approach is to notify the borrower's credit customers to make their payments directly to the lender.

Factoring Accounts Receivable

Accounts receivable may be used in one other way to help raise short-term financing: They can be sold to a factoring company (or factor). A **factor** is a firm that specializes in buying other firms' accounts receivable. The factor buys the accounts receivable for less than their face value; however, it collects the full dollar amount when each account is due. The factor's profit thus is the difference between the face value of the accounts receivable and the amount the factor has paid for them. Generally, the amount of profit the factor receives is based on the risk the factor assumes. Risk, in this case, is the probability that the accounts receivable will not be repaid when they mature.

Even though the firm selling its accounts receivable gets less than face value, it does receive needed cash immediately. Moreover, it has shifted both the task of collecting and the risk of non-payment to the factor, which now owns the accounts receivable. In many cases, the factor may purchase only selected accounts receivable—usually those with the highest potential of repayment. In other cases, the firm selling its accounts receivable must obtain approval from the factor *before* selling merchandise to a credit customer. Generally, customers whose accounts receivable have been factored are given instructions to make their payments directly to the factor.

factor a firm that specializes in buying other firms' accounts receivable

Cost Comparisons

Table 19.2 compares the various types of short-term financing. As you can see, trade credit is the least expensive. Factoring of accounts receivable is typically the highest-cost method shown.

Table 19.2 Comparison of Short-Term Financing Methods

Type of Financing	Cost	Repayment Period	Businesses that May Use It	Comments
Trade credit	Low, if any	30–60 days	All businesses with good credit	Usually no finance charge
Promissory note issued to suppliers	Moderate	One year or less	All businesses	Usually unsecured but requires legal document
Unsecured bank loan	Moderate	One year or less	All businesses	Promissory note, a line of credit, or revolving credit agreement generally required
Commercial paper	Moderate	One year or less	Large corporations with high credit ratings	Available only to large firms
Secured loan	High	One year or less	Firms with questionable credit ratings	Inventory or accounts receivable often used as collateral
Factoring	High	None	Firms that have large numbers of credit customers	Accounts receivable sold to a factor

For many purposes, short-term financing suits a firm's needs perfectly. At other times, however, long-term financing may be more appropriate. In this case, a business may try to raise equity capital or long-term debt capital.

Sources of Equity Financing

4 Evaluate the advantages and disadvantages of equity financing.

Sources of long-term financing vary with the size and type of business. As mentioned earlier, a sole proprietorship or partnership acquires equity capital (sometimes referred to as *owners' equity*) when the owner or owners invest money in the business. For corporations, equity-financing options include the sale of stock and the use of profits not distributed to owners. All three types of businesses can also obtain venture capital and use long-term debt capital (borrowed money) to meet their financial needs. Different types of debt capital are discussed in the next section. Regardless of the type of long-term financing chosen, most financial managers have found that financing is more expensive and harder to obtain since the recent financial crisis. Both investors and lenders are more cautious than they were before the crisis.

Selling Stock

Some equity capital is used to start every business—sole proprietorship, partnership, or corporation. In the case of corporations, stockholders who buy shares in the company provide equity capital.

Initial Public Offering and the Primary Market An **initial public offering (IPO)** occurs when a corporation sells common stock to the general public for the first time. To raise money, Financial Engines—an independent investment advisory firm that uses software and computer technology to help millions of Americans plan for retirement—used a 2010 IPO to raise $125 million that it could use to fund expansion and other business activities.[8] Established companies that plan to raise capital by selling subsidiaries to the public can also use IPOs. In 2010, Citigroup sold shares in its Primerica financial services and life insurance unit to raise more than $320 million.[9] The money that Citigroup received from the IPO was used to increase the amount of cash available to pay current expenses, solve cash-flow problems, and pay for other business activities. In addition to using an IPO to increase the cash balance for the parent company, corporations often sell shares in a subsidiary when shares can be sold at a profit or when the subsidiary no longer fits with its current business plan. Finally, some corporations will sell a subsidiary that is growing more slowly than the rest of the company's operating divisions.

initial public offering (IPO) occurs when a corporation sells common stock to the general public for the first time

primary market a market in which an investor purchases financial securities (via an investment bank) directly from the issuer of those securities

investment banking firm an organization that assists corporations in raising funds, usually by helping to sell new issues of stocks, bonds, or other financial securities

When a corporation uses an IPO to raise capital, the stock is sold in the primary market. The **primary market** is a market in which an investor purchases financial securities (via an investment bank) directly from the issuer of the securities. An **investment banking firm** is an organization that assists corporations in raising funds, usually by helping to sell new issues of stocks, bonds, or other financial securities. The investment banking firm generally charges a fee of 2 to 20 percent of the proceeds received by the corporation issuing the securities. The size of the commission depends on the financial health of the corporation issuing the new securities and the size of the new security issue.

Although a corporation can have only one IPO, it can sell additional stock after the IPO, assuming that there is a market for the company's stock. Even though the cost of selling stock (often referred to as *flotation costs*) is high, the *ongoing* costs associated with this

One way to raise capital. The Walt Disney Company, like many corporations, chose to sell stock to raise the money it needed to expand and become one of the largest entertainment companies in the world. On the other hand, investors purchase stock because they can profit from their investment if the price for a share of the corporation's stock increases and a corporation pays dividends.

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Going for SUCCESS

What Makes a Good IPO?

What makes a good IPO? Dozens of U.S. corporations go public every year. Some, like MasterCard, go public after decades in business. Others, like Google, are ambitious young firms aiming for big things.

With so many stocks vying for investor attention, corporate decision-makers know they need more than an innovative product, a trendy brand name, or a short-term record of growth. To attract savvy investors who will stick with a new stock through Wall Street's ups and downs, a company must demonstrate long-term profit potential and sustainable competitive strength.

Google's IPO is a good example. The company went public in August 2004, with shares of stock priced at $85 each. At the end of the first trading day, the price had soared above $108. Although some investors thought the price was too high, others bought the stock because they saw Google's dominance of the online search industry as the path to solid future profits. Since its IPO, Google's revenue has grown, on average, more than 25 percent each year, and its stock price has been known to trade above $600. Google has made good use of its high share price: When it acquired YouTube, it paid in stock. Of course, not every IPO will be successful, but smart investors are always in the market for an investment with a promising future.

© Jennifer S. Altman/Bloomberg via Getty Images

Sources: Scott S. Smith, "Robert Selander, Master of Credit Card Growth," *Investor's Business Daily,* March 19, 2010, A3; Peter Edmonston, "Google's I.P.O., Five Years Later," *New York Times,* August 19, 2009, http://dealbook.blogs.nytimes.com; Jim Goldman, "Google at Five: Happy IPO Birthday," *CNBC,* August 19, 2009, http://www.cnbc.com/id/32475159/Google_at_Five_Happy_IPO_Birthday; http://www.google.com.

type of equity financing are low for two reasons. First, the corporation does not have to repay money obtained from the sale of stock because the corporation is under no legal obligation to do so. If you purchase corporate stock and later decide to sell your stock, you may sell it to another investor—not the corporation.

A second advantage of selling stock is that a corporation is under no legal obligation to pay dividends to stockholders. As noted in Chapter 4, a *dividend* is a distribution of earnings to the stockholders of a corporation. For any reason (e.g., if a company has a bad year), the board of directors can vote to omit dividend payments. Earnings then are retained for use in funding business operations. Of course, corporate management may hear from unhappy stockholders if expected dividends are omitted too frequently.

secondary market a market for existing financial securities that are traded between investors

A big thrill! For most corporate executives, ringing the bell on the New York Stock Exchange is one of the highlights of their career. In this photo, executives from Express, Inc. are celebrating "taking their company public" and raising over $165 million by selling stock for the first time—often referred to as an initial public offering.

© Slaven Vlasic/Getty Images

The Secondary Market Although a share of corporate stock is only sold one time in the primary market, the stock can be sold again and again in the secondary market. The **secondary market** is a market for existing financial securities that are traded between investors. Although a corporation does not receive money each time its stock is bought or sold in the secondary market, the ability to obtain cash by selling stock investments is one reason why investors purchase corporate stock. Without the secondary market, investors would not purchase stock in the primary market because there would be no way to sell shares to other investors. Thus, both the primary and secondary markets are needed for a corporation to raise capital by selling stock. Usually, secondary-market transactions are completed through a securities exchange or the over-the-counter (OTC) market.

A **securities exchange** is a marketplace where member brokers meet to buy and sell securities. Generally, securities issued by larger corporations are traded at the New York Stock Exchange (NYSE) (now owned by the NYSE Euronext holding company), or at regional exchanges located in different parts of the country. The securities of very large corporations may be traded at more than one of these exchanges. Securities of firms also may be listed on foreign securities exchanges—in Tokyo or London, for example.

One of the largest and best-known securities exchanges in the world is the NYSE. This exchange, located in New York, along with other NYSE Euronext exchanges located in six different countries, lists more than 8,500 different issues.[10] Before a corporation's stock is approved for listing on the NYSE, the firm usually must meet specific criteria. The various regional exchanges also have listing requirements, but typically these are less stringent than the NYSE requirements. The stock of corporations that cannot meet the NYSE requirements, find it too expensive to be listed on the NYSE exchange, or choose not to be listed on the NYSE is often traded on one of the regional exchanges, or through the OTC market.

Stocks issued by several thousand companies are traded in the OTC market. The **over-the-counter (OTC) market** is a network of dealers who buy and sell the stocks of corporations that are not listed on a securities exchange. The term *over-the-counter* was coined more than 100 years ago when securities actually were sold "over the counter" in stores and banks. Most OTC securities today are traded through an *electronic* exchange called the NASDAQ (pronounced "nazzdack"). The NASDAQ quotation system provides price information on more than 3,600 different stocks.[11] Begun in 1971, the NASDAQ is now one of the largest securities markets in the world. Today, the NASDAQ is known for its forward-looking, innovative, growth companies. Although most companies are small, the stock of some large firms, including Intel, Microsoft, Cisco Systems, and Dell Computer, is traded through the NASDAQ.

There are two types of stock: common and preferred. Each type has advantages and drawbacks as a means of long-term financing.

Common Stock

A share of **common stock** represents the most basic form of corporate ownership. In return for the financing provided by selling common stock, management must make certain concessions to stockholders that may restrict or change corporate policies. Every corporation must hold an annual meeting, at which the holders of common stock may vote for the board of directors and approve or disapprove major corporate actions. Among such actions are:

1. Amendments to the corporate charter or corporate by-laws
2. Sale of certain assets
3. Mergers and acquisitions
4. New issues of preferred stock or bonds
5. Changes in the amount of common stock issued

Few investors will buy common stock unless they believe that their investment will increase in value. Information on the reasons why investors purchase stocks and how to evaluate stock investments is provided in Chapter 20.

Preferred Stock

As noted in Chapter 4, the owners of **preferred stock** must receive their dividends before holders of common stock receive theirs. When compared to common stockholders, preferred stockholders also have first claim (after creditors) on assets if the corporation is dissolved or declares bankruptcy. Even so, as with common stock, the board of directors must approve dividends on preferred stock, and this type of financing does not represent a debt that must be legally repaid. In return for preferential treatment, preferred stockholders generally give up the right to vote at a corporation's annual meeting.

The dividend on a share of preferred stock is stated on the stock certificate either as a percent of the par value of the stock or as a specified dollar amount.

securities exchange a marketplace where member brokers meet to buy and sell securities

over-the-counter (OTC) market a network of dealers who buy and sell the stocks of corporations that are not listed on a securities exchange

common stock stock whose owners may vote on corporate matters but whose claims on profits and assets are subordinate to the claims of others

preferred stock stock whose owners usually do not have voting rights but whose claims on dividends and assets are paid before those of common-stock owners

The **par value** of a stock is an assigned (and often arbitrary) dollar value printed on the stock certificate. For example, Pitney Bowes—a U.S. manufacturer of office and business equipment—issued 4 percent preferred stock with a par value of $50. The annual dividend amount is $2 per share ($50 par value × 0.04 = $2 annual dividend).

Although a corporation usually issues only one type of common stock, it may issue many types of preferred stock with varying dividends or dividend rates. For example, New York–based Consolidated Edison has one common-stock issue but three preferred-stock issues.

When a corporation believes that it can issue new preferred stock at a lower dividend rate (or common stock with no specified dividend), it may decide to "call in,"or buy back, an earlier preferred stock issue. In this case, management has two options. First, it can buy shares in the market—just like any other investor. Second, it can exercise a call provision because practically all preferred stock is *callable*. When considering the two options, management will naturally purchase the preferred stock in the less costly way.

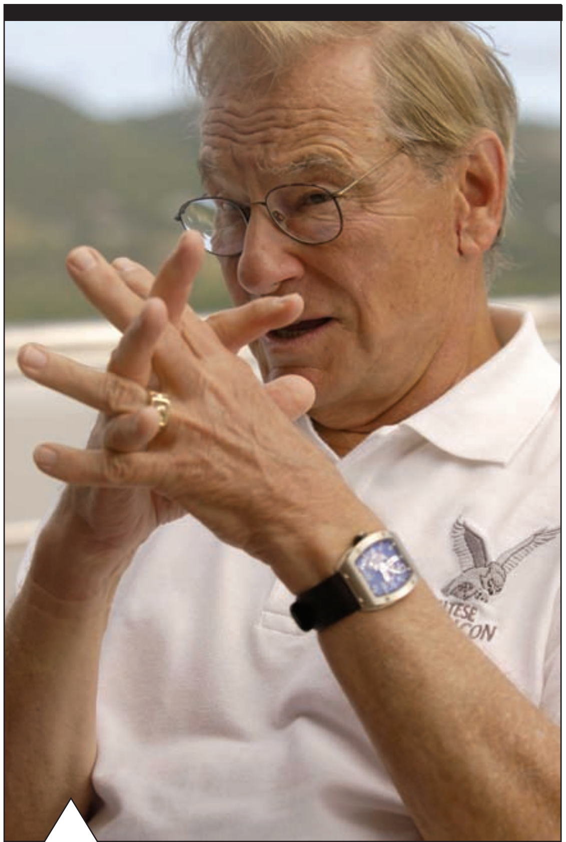
par value an assigned (and often arbitrary) dollar value printed on a stock certificate

retained earnings the portion of a corporation's profits not distributed to stockholders

Retained Earnings

Most large corporations distribute only a portion of their after-tax earnings to stockholders. The portion of a corporation's profits *not* distributed to stockholders is called **retained earnings**. Because they are undistributed profits, retained earnings are considered a form of equity financing.

The amount of retained earnings in any year is determined by corporate management and approved by the board of directors. Most small and growing corporations pay no cash dividend—or a very small dividend—to their stockholders. All or most earnings are reinvested in the business for research and development, expansion, or the funding of major projects. Reinvestment tends to increase the value of the firm's stock while it provides essentially cost-free financing for the business. More mature corporations may distribute 40 to 60 percent of their after-tax profits as dividends. Utility companies and other corporations with very stable earnings often pay out as much as 80 to 90 percent of what they earn. For a large corporation, retained earnings can amount to a hefty bit of financing. For example, in 2009, the total amount of retained earnings for General Electric was over $126 billion.[12]



Venture capitalists extraordinaire. No discussion about venture capital would be complete without mentioning Tom Perkins—a legend in the field. His experience as head of research at Hewlett Packard gave him the needed skills to identify companies that have the potential to be very successful. Over the years, he has had a hand in the success of numerous marketplace heavyweights, including Applied Materials, Compaq, Corning Glass, and Genentech.

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Venture Capital and Private Placements

To establish a new business or expand an existing one, an entrepreneur may try to obtain venture capital. In Chapter 5, we defined *venture capital* as money invested in small (and sometimes struggling) firms that have the potential to become very successful. Most venture capital firms do not invest in the typical small business—a neighborhood convenience store or a local dry cleaner—but in firms that have the potential to become extremely profitable. Although venture capital firms are willing to take chances, they have also been more selective about where they invest their money after the recent economic crisis.

Generally, a venture capital firm consists of a pool of investors, a partnership established by a wealthy family, or a joint venture formed by corporations with money to invest. In return for financing, these investors generally receive an equity or ownership position in the business and share in its profits. Venture capital firms vary in size and scope of interest. Some offer financing for start-up businesses, whereas others finance only established businesses.

Another method of raising capital is through a private placement. A **private placement** occurs when stock and other corporate securities are sold directly to insurance companies, pension funds, or large institutional investors. When compared with selling stocks and other corporate securities to the public, there are often fewer government regulations and the cost is generally less when the securities are sold through a private placement. Typically, terms between the buyer and seller are negotiated when a private placement is used to raise capital.

Sources of Long-Term Debt Financing

5

Evaluate the advantages and disadvantages of long-term debt financing.

As pointed out earlier in this chapter, businesses borrow money on a short-term basis for many valid reasons other than desperation. There are equally valid reasons for long-term borrowing. In addition to using borrowed money to meet the long-term needs listed in Table 19.1, successful businesses often use the financial leverage it creates to improve their financial performance. **Financial leverage** is the use of borrowed funds to increase the return on owners' equity. The principle of financial leverage works as long as a firm's earnings are larger than the interest charged for the borrowed money.

To understand how financial leverage can increase a firm's return on owners' equity, study the information for Texas-based Cypress Springs Plastics presented in Table 19.3. Pete Johnston, the owner of the firm, is trying to decide how best to finance a $100,000 purchase of new high-tech manufacturing equipment. He could borrow the money and pay 7 percent annual interest. As a second option, Johnston could invest an additional $100,000 in the firm. Assuming that the firm earns $95,000 a year and that annual interest for this loan totals $7,000 ($100,000 × 0.07 = $7,000), the return on owners' equity for Cypress Springs Plastics would be higher if the firm borrowed the additional financing. Return on owners' equity—a topic covered in Chapter 17—is determined by dividing a firm's net income by the dollar amount of

The future of power. Often long-term loans are used to finance alternative energy development—even when nations are involved. In this photo, visitors look at a model of a solar power farm in Beijing, China. Preliminary estimates are that this project, along with other Chinese alternative energy projects, could require investments and loans totaling more than $3 trillion yuan—that's $440 billion in U.S. currency.

© Imaginechina via AP Images

Table 19.3 Analysis of the Effect of Additional Capital from Debt or Equity for Cypress Springs Plastics, Inc.

Additional Debt		Additional Equity	
Owners' equity	$ 500,000	Owners' equity	$ 500,000
Additional equity	+ 0	Additional equity	+100,000
Total equity	$ 500,000	Total equity	$ 600,000
Loan (@ 9%)	+100,000	No loan	+ 0
Total capital	$ 600,000	Total capital	$ 600,000
Year-End Earnings			
Gross profit	$ 95,000	Gross profit	$ 95,000
Less loan interest	− 7,000	No interest	− 0
Operating profit	$ 88,000	Operating profit	$ 95,000
Return on owners' equity	17.6%	Return on owners' equity	15.8%
($88,000 ÷ $500,000 = 17.6%)		($95,000 ÷ $600,000 = 15.8%)	

private placement occurs when stock and other corporate securities are sold directly to insurance companies, pension funds, or large institutional investors

financial leverage the use of borrowed funds to increase the return on owners' equity

Sustaining the Planet

Green Energy Loans

Did you know that the U.S. Department of Energy offers loan guarantees to companies that further sustainability through high-potential alternative energy projects and innovative clean-power technologies? Take a look: http://www.lgprogram.energy.gov/.

© U.S. Department of Energy (http://www.energy.gov)

owners' equity. Based on the calculations illustrated in Table 19.3, Cypress Springs Plastics' return on owners' equity equals 17.6 percent if Johnston borrows the additional $100,000. The firm's return on owners' equity would decrease to 15.8 percent if Johnston invests an additional $100,000 in the business.

The most obvious danger when using financial leverage is that the firm's earnings may be less than expected. If this situation occurs, the fixed interest charge actually works to reduce or eliminate the return on owners' equity. Of course, borrowed money eventually must be repaid. Because lenders always have the option to turn down a loan request, many managers are reluctant to rely on borrowed money.

For a small business, long-term debt financing is generally limited to loans. Large corporations have the additional option of issuing corporate bonds.

Long-Term Loans

Many businesses satisfy their long-term financing needs, such as those listed in Table 19.1, with loans from commercial banks, insurance companies, pension funds, and other financial institutions. Manufacturers and suppliers of heavy machinery may also provide long-term debt financing by granting credit to their customers.

Term-Loan Agreements When the loan repayment period is longer than one year, the borrower must sign a term-loan agreement. A **term-loan agreement** is a promissory note that requires a borrower to repay a loan in monthly, quarterly, semiannual, or annual installments. Although repayment may be as long as 15 to 20 years, long-term business loans normally are repaid in 3 to 7 years.

Assume that Pete Johnston, the owner of Cypress Springs Plastics, decides to borrow $100,000 and take advantage of the principle of financial leverage illustrated in Table 19.3. Although the firm's return on owners' equity does increase, interest must be paid each year and, eventually, the loan must be repaid. To pay off a $100,000 loan over a three-year period with annual payments, Cypress Springs Plastics must pay $33,333 on the loan balance plus $7,000 annual interest, or a total of $40,333 the first year. Although the amount of interest decreases each year because of the previous year's payment on the loan balance, annual payments of this amount are still a large commitment for a small firm such as Cypress Springs Plastics.

The interest rate and repayment terms for term loans often are based on factors such as the reasons for borrowing, the borrowing firm's credit rating, and the value of collateral. Although long-term loans occasionally may be unsecured, the lender usually requires some type of collateral. Acceptable collateral includes real estate, machinery, and equipment. Lenders may also require that borrowers maintain a minimum amount of working capital. Finally, lenders may consider the environmental and social impact of the projects they are asked to finance before funding a loan request.

term-loan agreement a promissory note that requires a borrower to repay a loan in monthly, quarterly, semiannual, or annual installments

The Basics of Getting a Loan According to many financial experts, preparation is the key when applying for a long-term business loan. In reality, preparation begins before you ever apply for the loan. To begin the process, you should get to know potential lenders before requesting debt financing. Although there may be many potential lenders that can provide the money you need, the logical place to borrow money is where your business does its banking. This fact underscores the importance of maintaining adequate balances in the firm's bank accounts. Before applying for a loan, you may also want to check your firm's credit rating with a national credit bureau such as D&B (formerly known as Dun & Bradstreet).

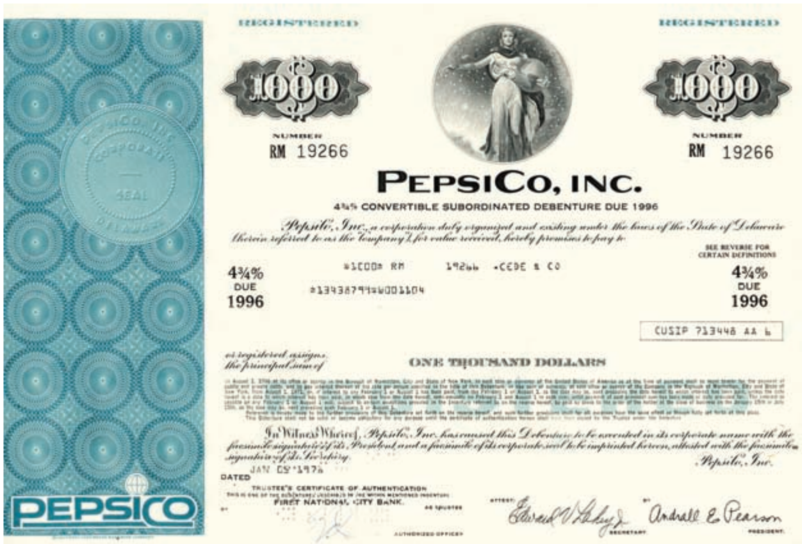
Typically, business owners will be asked to fill out a loan application. In addition to the loan application, the lender will also want to see your current business plan. Be sure to explain what your business is, how much funding you require to accomplish your goals, and how the loan will be repaid. Next, have your certified public accountant (CPA) prepare financial statements. Most lenders insist that you submit current financial statements that have been prepared by an independent CPA. Then compile a list of references that includes your suppliers, other lenders, or the professionals with whom you are associated. You may also be asked to discuss the loan request with a loan officer. Hopefully, your loan request will be approved. If not, try to determine why your loan request was rejected. Think back over the loan process and determine what you could do to improve your chances of getting a loan the next time you apply.

Corporate Bonds

In addition to loans, large corporations may choose to issue bonds in denominations of $1,000 to $50,000. Although the usual face value for corporate bonds is $1,000, the total face value of all the bonds in an issue usually amounts to millions of dollars. In fact, one of the reasons why corporations sell bonds is that they can borrow a lot of money from a lot of different bondholders and raise larger amounts of money than could be borrowed from one lender. A **corporate bond** is a corporation's written pledge that it will repay a specified amount of money with interest. Figure 19.7 shows a corporate bond for PepsiCo, Inc.

Figure 19.7 A Corporate Bond

A corporate bond is a corporation's written pledge that it will repay on the date of maturity a specified amount of money with interest.



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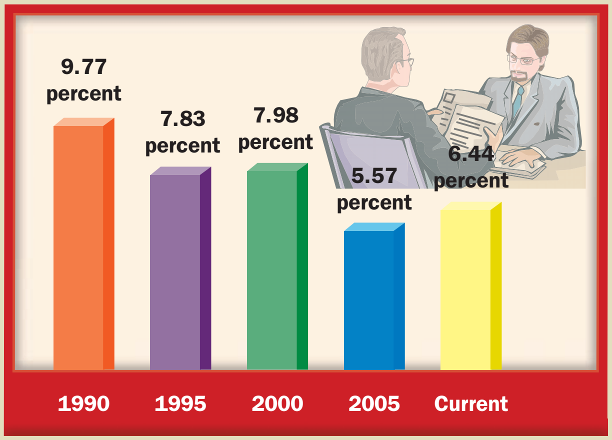
corporate bond a corporation's written pledge that it will repay a specified amount of money with interest

SPOTLIGHT

When financial managers sell new bond issues to raise capital, they are very aware of average yields on comparable bonds. Below are average bond yields for corporate bonds.



Source: Statistical Abstract of the United States 2010, U.S. Bureau of the Census Web site http:// www.census.gov (accessed June 30, 2010), Washington, DC: U.S. Government Printing Office, Table 1161.

The **maturity date** is the date on which the corporation is to repay the borrowed money. Today, many corporations do not issue actual bonds like the one illustrated in Figure 19.7. Instead, the bonds are recorded electronically, and the specific details regarding the bond issue, along with the current owner's name and address, are maintained by computer. Although some people like to have physical possession of their corporate bonds, computer entries are easier to transfer when a bond is sold. Computer entries are also safer because they cannot be stolen, misplaced, or destroyed—all concerns that you must worry about if you take physical possession of a corporate bond.

Until a bond's maturity, a corporation pays interest to the bond owner at the stated rate. For example, owners of the American & Foreign Power Company bonds that mature in 2030 receive 5 percent per year for each bond. Because interest for corporate bonds is usually paid semiannually, bond owners receive a payment every six months for each bond they own.

Types of Bonds Today, most corporate bonds are registered bonds. A **registered bond**—like the PepsiCo bond—is a bond registered in the owner's name by the issuing company. Until the maturity date, the registered owner receives periodic interest payments. On the maturity date, the registered owner receives cash equaling the face value.

Corporate bonds are generally classified as debentures, mortgage bonds, or convertible bonds. Most corporate bonds are debenture bonds. A **debenture bond** is a bond backed only by the reputation of the issuing corporation. To make its bonds more appealing to investors, a corporation may issue mortgage bonds. A **mortgage bond** is a corporate bond secured by various assets of the issuing firm. Typical corporate assets that are used as collateral for a mortgage bond include real estate, machinery, and equipment that is not pledged as collateral for other debt obligations. The corporation can also issue convertible bonds. A **convertible bond** can be exchanged, at the owner's option, for a specified number of shares of the corporation's common stock. An Advanced Micro Devices (AMD) bond that matures in 2015 is convertible: Each bond can be converted to 35.6125 shares of AMD common stock.[13] A corporation can gain in three ways by issuing convertible bonds. First, convertibles usually carry a lower interest rate than nonconvertible bonds. Second, the conversion feature attracts investors who are interested in the speculative gain that conversion to common stock may provide. Third, if the bondholder converts to common stock, the corporation no longer has to redeem the bond at maturity.

Repayment Provisions for Corporate Bonds Maturity dates for bonds generally range from 10 to 30 years after the date of issue. If the interest is not paid or the firm becomes insolvent, bond owners' claims on the assets of the corporation take precedence over the claims of both common and preferred stockholders. Some bonds are callable before the maturity date; that is, a corporation can buy back, or redeem, them. For these bonds, the corporation may pay the bond owner a call premium. The amount of the call premium is specified, along with other provisions,

maturity date the date on which a corporation is to repay borrowed money

registered bond a bond registered in the owner's name by the issuing company

debenture bond a bond backed only by the reputation of the issuing corporation

mortgage bond a corporate bond secured by various assets of the issuing firm

convertible bond a bond that can be exchanged, at the owner's option, for a specified number of shares of the corporation's common stock in the bond indenture. The **bond indenture** is a legal document that details all the conditions relating to a bond issue.

Before deciding if bonds are the best way to obtain corporate financing, managers must determine if the company can afford to pay the interest on the corporate bonds. It should be obvious that the larger the bond issue, the higher the dollar amount of interest. For example, assume that American Express issues bonds with a face value of $100 million. If the interest rate is 4.875 percent, the interest on this bond issue is $4,875,000 ($100 million × 0.04875 = $4,875,000) each year until the bonds are repaid. In addition, the American Express corporate bonds must all be redeemed for their face value ($100 million) at maturity. If the corporation defaults on (does not pay) either interest payments or repayment of the bond at maturity, owners of bonds can force the firm into bankruptcy.

A corporation may use one of three methods to ensure that it has sufficient funds available to redeem a bond issue. First, it can issue the bonds as **serial bonds**, which are bonds of a single issue that mature on different dates. For example, a company may use a 25-year $50 million bond issue to finance its expansion. None of the bonds mature during the first 15 years. Thereafter, 10 percent of the bonds mature each year until all the bonds are retired at the end of the 25th year. Second, the corporation can establish a sinking fund. A **sinking fund** is a sum of money to which deposits are made each year for the purpose of redeeming a bond issue. When Union Pacific Corporation sold a $275 million bond issue, the company agreed to contribute to a sinking fund until the bond's maturity in the year 2025.[14] Third, a corporation can pay off an old bond issue by selling new bonds. Although this may appear to perpetuate the corporation's long-term debt, a number of utility companies and railroads use this repayment method.

A corporation that issues bonds must also appoint a **trustee**, an individual or an independent firm that acts as the bond owner's representative. A trustee's duties are handled most often by a commercial bank or other large financial institution. The corporation must report to the trustee periodically regarding its ability to make

Table 19.4 Comparison of Long-Term Financing Methods

Type of Financing	Repayment	Repayment Period	Cost/Dividends Interest	Businesses that May Use It
Equity				
Common stock	No	None	High initial cost; low ongoing costs because dividends not required	All corporations that sell stock to investors
Preferred stock	No	None	Dividends not required but must be paid before common stockholders receive any dividends	Large corporations that have an established investor base of common stockholders
Debt				
Long-term loan	Yes	Usually 3–7 years	Interest rates between 3.25 and 12 percent depending on economic conditions and the financial stability of the company requesting the loan	All firms that can meet the lender's repayment and collateral requirements
Corporate bond	Yes	Usually 10–30 years	Interest rates between 3 and 9 percent depending on economic conditions and the financial stability of the company issuing the bonds	Large corporations that are financially healthy

bond indenture a legal document that details all the conditions relating to a bond issue

serial bonds bonds of a single issue that mature on different dates

sinking fund a sum of money to which deposits are made each year for the purpose of redeeming a bond issue

trustee an individual or an independent firm that acts as a bond owner's representative interest payments and eventually redeem the bonds. In turn, the trustee transmits this information to the bond owners, along with its own evaluation of the corporation's ability to pay.

Cost Comparisons

Table 19.4 on page 589 compares some of the methods that can be used to obtain long-term equity *and* debt financing. Although the initial flotation cost of issuing stock is high, selling common stock is generally a popular option for most financial managers. Once the stock is sold and upfront costs are paid, the *ongoing* costs of using stock to finance a business are low. The type of long-term financing that generally has the highest *ongoing* costs is a long-term loan (debt).

To a great extent, firms are financed through the investments of individuals—money that people have deposited in banks or have used to purchase stocks, mutual funds, and bonds. In Chapter 20, we look at how securities markets help people invest their money in business.

return to inside business

Ford

Ford executives have used their financial management skills to execute a tricky U-turn away from heavy losses. With the global economy on the verge of a severe downturn, the company borrowed billions of dollars and issued convertible bonds to have cash on hand for immediate and future needs. Little by little, sales improved and the company was soon able to lighten its debt load by repaying a big chunk of the outstanding revolving credit balance. Before the recession ended, Ford had raised more money by selling 300 million new shares of common stock.

Although Ford is continuing its drive for long-term profitability, the road remains bumpy. "We recognize we have too much debt on our balance sheet," says the CFO, "but we think the best way to fix that is by rebuilding our business." To do that, he will "make sure we maintain positive cash flow and continue to invest strongly in new products and growth around the world."

Questions

1. Why would Ford rely on both debt and equity financing to fund its turnaround?
2. Ford suspended stock dividends in 2006 and did not resume them even when it had gained access to billions of dollars in credit. Do you agree with this decision? Why or why not?

SUMMARY

Summary

CHAPTER REVIEW

1 Explain the need for financial management in business.

Financial management consists of all activities concerned with obtaining money and using it effectively. Short-term financing is money that will be used for one year or less. There are many short-term needs, but cash flow and inventory are two for which financing is often required. Long-term financing is money that will be used for more than one year. Such financing may be required for a business start-up, for a merger or an acquisition, for new product development, for long-term marketing activities, for replacement of equipment, or for expansion of facilities. Financial management can be viewed as a two-sided problem. On one side, the uses of funds often dictate the type or types of financing needed by a business. On the other side, the activities a business can undertake are determined by the types of financing available. Financial managers must also consider the risk-return ratio when making decisions. The risk-return ratio is based on the principle that a high-risk decision should generate higher financial returns for a business. On the other hand, more conservative decisions generate lesser returns. Financial managers must ensure that funds are available when needed, that they are obtained at the lowest possible cost, and that they are available for the repayment of debts. During the recent economic crisis, the number of business bankruptcies increased. Fortunately, there were many more business firms that were able to weather the economic storm and keep operating because of their ability to manage their finances.

2 Summarize the process of planning for financial management.

A financial plan begins with an organization's goals. Next, these goals are "translated" into departmental budgets that detail expected income and expenses. From these budgets, which may be combined into an overall cash budget, the financial manager determines what funding will be needed and where it may be obtained. Whereas departmental and cash budgets emphasize short-term financing needs, a capital budget can be used to estimate a firm's expenditures for major assets and its long-term financing needs. The four principal sources of financing are sales revenues, equity capital, debt capital, and proceeds from the sale of assets. Once the needed funds have been obtained, the financial manager is responsible for ensuring that they are used properly. This is accomplished through a system of monitoring and evaluating the firm's financial activities.

3 Describe the advantages and disadvantages of different methods of short-term debt financing.

Most short-term financing is unsecured; that is, no collateral is required. Sources of unsecured short-term financing include trade credit, promissory notes issued to suppliers, unsecured bank loans, and commercial paper. Sources of secured short-term financing include loans secured by inventory and accounts receivable. A firm may also sell its receivables to factors. Trade credit is the least-expensive source of short-term financing. The cost of financing through other sources generally depends on the source and on the credit rating of the firm that requires the financing. Factoring is generally the most expensive approach.

4 Evaluate the advantages and disadvantages of equity financing.

A corporation can raise equity capital by selling either common or preferred stock. The first time a corporation sells stock to the general public is referred to as an initial public offering (IPO). With an IPO, the stock is sold in the primary market. Once sold in the primary market, investors buy and sell stock in the secondary market. Usually, secondary market transactions are completed through a securities exchange or the over-the-counter market. Common stock is voting stock; holders of common stock elect the corporation's directors and must approve changes to the corporate charter. Holders of preferred stock must be paid dividends before holders of common stock are paid any dividends. Another source of equity funding is retained earnings, which is the portion of a business's profits not distributed to stockholders. Venture capital—money invested in small (and sometimes struggling) firms that have the potential to become very successful—is yet another source of equity funding. Generally, the venture capital is provided by investors, partnerships established by wealthy families, or a joint venture formed by corporations with money to invest. In return, they receive an equity position in the firm and share in the profits of the business. Finally, a private placement can be used to sell stocks and other corporate securities.

5 Evaluate the advantages and disadvantages of long-term debt financing.

For a small business, debt financing is generally limited to loans. Large corporations have the additional option of issuing corporate bonds. Regardless of whether the business is small or large, it can take advantage of financial leverage. Financial leverage is the use of borrowed funds to increase the return on owners' equity. The rate of interest for long-term loans usually depends on the financial status of the borrower, the reason for borrowing, and the kind of collateral pledged to back up the loan. Long-term business loans are normally repaid in 3 to 7 years but can be as long as 15 to 20 years. Money realized from the sale of corporate bonds must be repaid when the bonds mature. In addition, the corporation must pay interest on that money from the time the bonds are sold until maturity. Maturity dates for bonds generally range from 10 to 30 years after the date of issue. Three types of bonds—debentures, mortgage bonds, and convertible bonds—are sold to raise debt capital. When comparing the cost of equity and debt long-term financing, the ongoing costs of using stock (equity) to finance a business are low. The most expensive is a long-term loan (debt).

Key Terms

You should now be able to define and give an example relevant to each of the following terms:

financial management (569)
short-term financing (569)
cash flow (569)
speculative production (570)
long-term financing (570)
risk-return ratio (573)
chief financial officer (CFO) (573)
financial plan (573)
budget (574)
cash budget (575)
zero-base budgeting (575)
capital budget (575)
equity capital (576)
debt capital (576)
unsecured financing (577)
trade credit (577)
promissory note (578)
prime interest rate (578)
factor (580)
initial public offering (IPO) (581)
primary market (581)
investment banking firm (581)
secondary market (582)
securities exchange (583)
over-the-counter (OTC) market (583)
common stock (583)
preferred stock (583)
par value (584)
retained earnings (584)
private placement (585)
financial leverage (585)
term-loan agreement (586)
corporate bond (587)
maturity date (588)
registered bond (588)
debenture bond (588)
mortgage bond (588)
convertible bond (588)
bond indenture (589)
serial bonds (589)
sinking fund (589)
trustee (589)

Review Questions

1. How does short-term financing differ from long-term financing? Give two business uses for each type of financing.
2. For a business firm, what type of activities does financial management involve?
3. In your own words, describe the risk-return ratio.
4. What is the function of a cash budget? A capital budget?
5. What is zero-base budgeting? How does it differ from the traditional concept of budgeting?
6. What are four general sources of funds?
7. How does a financial manager monitor and evaluate a firm's financing?
8. How important is trade credit as a source of short-term financing?
9. Why would a supplier require a customer to sign a promissory note?
10. What is the prime rate? Who gets the prime rate?
11. Explain how factoring works. Of what benefit is factoring to a firm that sells its receivables?
12. How does an investment banking firm help a corporation sell stock in the primary market?
13. What are the advantages of financing through the sale of stock?
14. From a corporation's point of view, how does preferred stock differ from common stock?
15. Where do a corporation's retained earnings come from? What are the advantages of this type of financing?
16. Describe how financial leverage can increase return on owners' equity.
17. For a corporation, what are the advantages of corporate bonds over long-term loans?
18. Describe the three methods used to ensure that funds are available to redeem corporate bonds at maturity.

Discussion Questions

1. During the recent economic crisis, many financial managers and corporate officers have been criticized for (a) poor decisions, (b) lack of ethical behavior, (c) large salaries, (d) lucrative severance packages worth millions of dollars, and (e) extravagant lifestyles. Is this criticism justified? Justify your opinion.
2. What does a financial manager do? How can he or she monitor a firm's financial success?
3. If you were the financial manager of Stars and Stripes Clothing, what would you do with the excess cash that the firm expects in the second and fourth quarters? (See Figure 19.5.)
4. Develop a *personal* cash budget for the next six months. Explain what you would do if there are budget shortfalls or excess cash amounts at the end of any month during the six-month period.
5. Why would a lender offer unsecured loans when it could demand collateral?
6. How can a small-business owner or corporate manager use financial leverage to improve the firm's profits and return on owners' equity?
7. In what circumstances might a large corporation sell stock rather than bonds to obtain long-term financing? In what circumstances would it sell bonds rather than stock?

Video Case 19.1

Financial Planning Equals Profits for Nederlander Concerts

Nederlander Concerts is in the business of booking, promoting, and producing live music shows in the western United States. The company presents artists from James Taylor to Flogging Molly, Bruce Springsteen, Bonnie Raitt, and the Allman Brothers Band. But, says its CEO, "We're not trying to be necessarily a national player or an international player. We seek out opportunities that fit within and leverage our existing portfolio of small- to mid-size venues . . . . It's one of the few remaining family-run entertainment enterprises worldwide . . . . What this means for us on a day-to-day basis is that we can focus on running the business. We're not as guided by Wall Street, we don't have the same constraints, we don't have the same reporting responsibilities, and it allows us to focus on . . . our business strategy for development."

Of course, being a privately owned company and not needing to respond to shareholders (Wall Street) doesn't mean that Nederlander has *no* reporting responsibilities. As the CEO explains, "We assess at the beginning of the year not only concert revenue and expenses but also special event revenue. When we rent the facilities to, for example, movie premieres here in Los Angeles, what kind of revenue are we going to see? What kind of expenses are attended to generating that revenue? What's our fixed overhead for the year? Who's on the payroll, whether full-time, or part-time, or seasonal, and how much does it cost us to run the business on a day-to-day basis in order to secure those revenues and pay those expenses? That's wrapped up into an annual budget at the beginning of every year, which is kind of a guideline for me to know how we achieve growth. It also allows me to communicate to our owners what our growth orientation is for that given year . . . . Every event has its own profit and loss statement . . . which is a mini version of that annual plan."

In addition to daily, weekly, and quarterly event reports, Nederlander's financial team generates daily and weekly reports of ticket sales. Monthly reports on company-wide performance feed into quarterly and annual reports. Each annual report is compared to that year's budget. The finance department tallies hundreds of transactions in order to arrive at some of these annual numbers, which are reported to the company's owners to ensure that the company is running as profitably as it can be.

Nederlander's managers say growth in the concert industry must be measured in the long term because the business is cyclical and the cost of real estate is so high that short-term profit is hard to generate. Still, the company is in a strong financial position (it is part of a profitable global theater-owning company called the Nederlander Organization), so it can afford to fund its own growth and expansion, or it can borrow on favorable terms. "We're very fortunate to have an ownership that is very well capitalized with over 80 years in the business," says the CEO. "Our balance sheet is so strong that we have the ability to tap into debt financing if it makes the most sense . . . . or [use] the corporate treasury. . . . If it makes more sense to borrow the money, we will, and we're typically able to do that on very favorable rates because of very long-term banking relationships."

It can be thrilling to meet some of the artists the company books. "But at the end of the day it's a business," the CEO points out. "If we're not successful in growing our revenue and managing our expense, ultimately we won't be profitable, and our ownership will not be happy with those results."[15]

Questions

1. Here's what Nederlander's chief operating officer has to say about its business model: "A show has a short lifetime. You go and sell two months out, and the tickets have no value on any day but the day of the show. So it's a very interesting model in that sense." How do you think the short life of the company's products affects its financial planning?
2. The company uses its own arenas and theaters about 90 percent of the time. What are some of the possible disadvantages of owning its own venues?
3. Why would Nederlander choose to sometimes borrow funds for expansion if it has capital of its own?

Case 19.2

Darden Restaurants Serve Up Long-Term Growth

Growth has been on the menu ever since Bill Darden opened his first Red Lobster restaurant in Florida in 1968. The combination of fresh seafood and casual dining caught on quickly—and quickly caught the eye of General Mills, which bought the fast-growing company in 1970. In 1995, General Mills renamed the company after its founder and spun it off in a public offering. Once it went public, Darden Restaurants used the proceeds to chart a new financial path to long-term growth.

Today, Darden employs 180,000 people and serves more than 400 million meals across North America in 1,800 casual, full-service restaurants. The company's six restaurant brands are: Red Lobster (seafood), Olive Garden (Italian menu), LongHorn Steakhouse (Western-theme steaks and more), The Capital Grille (premium steak house), Bahama Breeze (Caribbean-theme casual dining), and Seasons 52 (fresh-grilled foods). In all, Darden's yearly revenue tops $7 billion.

Healthy cash flow is definitely on the menu. The average Capital Grille unit rings up $6.8 million in annual sales, the average Olive Garden rings up $4.8 million in annual sales, the average Red Lobster rings up $3.8 million, and the average LongHorn Steakhouse rings up $2.8 million. With the cash generated from restaurant revenue, Darden has been reinvesting in its businesses by opening new units, remodeling existing units, and greening its restaurants with eco-friendly materials and energy-saving touches. Because of its size, it can take advantage of economies of scale in buying foods and beverages from global sources, which in turn helps keep costs under control and supports good profit margins.

Over the years, the company has fueled its continued expansion with a combination of debt and equity. The company can draw on a revolving credit agreement of more than $600 million, which helps smooth out the financial bumps of its seasonal business. Typically, Darden's revenue spikes in the spring and falls to a low point in the fall, although sales are definitely affected by weather conditions, economic circumstances, holidays, and other uncontrollable elements. Having revolving credit in place provides the flexibility to borrow if and when needed.

Darden has also raised money by issuing corporate bonds, some of which mature in 5 years, some in 10 years, and some in 20 years. Twice a year, the company pays interest to its bondholders. On the equity side, Darden's common stock trades on the New York Stock Exchange, and it pays dividends to its shareholders. Its cash flow has been so strong, in fact, that Darden increased its dividend not long ago and has focused on paying down debt even as it invests in business.

Looking ahead, Darden expects to continue its growth spurt, despite an unpredictable economy and intense competition from big names in fast food and casual dining. It avoided the heavy, broad-based discounting that some chains used to attract customers during the recession. Instead, it used occasional, selective price promotions to heighten its message of affordability. The company's financial stability means that it has money available for making acquisitions, building new restaurants, developing new menu items, training new staff members, and launching new advertising campaigns.

Within the past decade, Darden has used its financial strength to buy and expand the Capital Grill and LongHorn Steakhouse restaurant chains. It is also catering to increased consumer interest in healthy dining by opening more of its Seasons 52 restaurants, which feature only steamed, baked, or grilled dishes. As its name implies, Seasons 52 adds new menu items regularly, depending on what's in season. The ever-changing menu brings customers back again and again to try seasonal specialties and enjoy old favorites.

Sometimes Darden closes under-performing units or sells entire chains so it can put its money and management attention into other growth opportunities. A few years ago, Darden divested its Smokey Bones Barbecue & Grill chain after determining that this restaurant concept did not have the potential for nationwide expansion and profit potential that Darden required. What will Darden do next in its quest for profitable, long-term growth?[16]

Questions

1. Darden is spending heavily to upgrade the interior of many of its Red Lobster and LongHorn Steakhouse restaurants. How would you suggest that the company measure the financial results of this remodeling program?
2. Why would Darden issue corporate bonds that mature in 5, 10, and 20 years?
3. If Darden needs cash to remodel existing restaurants and open new restaurants, as well as to pay down debt, why would it increase its stock dividend?

Building Skills for Career Success

CHAPTER REVIEW

1 JOURNALING FOR SUCCESS

Because many people spend more than they make on a regular basis, they often use credit cards to make routine daily purchases. As a result, the amount they owe on credit cards increases each month and there is no money left to begin a savings or investment program. This exercise will help you to understand (1) how you manage your credit cards and (2) what steps you can take to improve your personal finances.

Assignment

1. How many credit cards do you have?
2. Based on the information on your monthly credit-card statements, what types of credit-card purchases do you make?
3. Do you pay your balance in full each month or make minimum payments on your credit cards?
4. Most experts recommend that you have one or two credit cards that you use only if you are in an emergency situation. The experts also recommend that you avoid using credit cards to make inexpensive purchases on a daily basis. Finally, the experts recommend that you pay your credit-card balance in full each month. Based on the preceding information, what steps can you take to better manage your personal finances?

2 EXPLORING THE INTERNET

Finding capital for new business start-ups is never an easy task. Besides a good business plan, those seeking investor funds must be convincing and clear about how their business activities will provide sufficient revenue to pay back investors who help to get them going in the first place. To find out what others have done, it is useful to read histories of successful start-ups as well as failures in journals that specialize in this area. Visit the text Web site for updates to this exercise.

Assignment

1. Examine articles that profile at least two successes or failures in the following publications and highlight the main points that led to either result.

   Business 2.0 (http://www.business2.com)
   Red Herring (http://www.redherring.com)
   Fast Company (http://www.fastcompany.com)

2. What are the shared similarities?
3. What advice would you give to a start-up venture after reading these stories?

3 DEVELOPING CRITICAL-THINKING SKILLS

Financial management involves preparing a plan for obtaining and using the money needed to accomplish a firm's goals. To accomplish your own goals, you should prepare a *personal* financial plan. You must determine what is important in your life and what you want to accomplish, budget the amount of money required to obtain your goals, and identify sources for acquiring the funds. You should monitor and evaluate the results regularly and make changes when necessary.

Assignment

1. Using the three steps shown in Figure 19.3, prepare a personal financial plan.
2. Prepare a three-column table to display it.
   a. In column 1, list at least two objectives under each of the following areas: Financial (savings, investments, retirement), Education (training, degrees, certificates), Career (position, industry, location), and Family (children, home, education, trips, entertainment).
   b. In column 2, list the amount of money it will take to accomplish your objectives.
   c. In column 3, identify the sources of funds for each objective.
3. Describe what you learned from doing this exercise in a comments section at the bottom of the table.

4 BUILDING TEAM SKILLS

Suppose that for the past three years you have been repairing lawn mowers in your garage. Your business has grown steadily, and you recently hired two part-time workers. Your garage is no longer adequate for your business; it is also in violation of the city code, and you have already been fined for noncompliance. You have decided that it is time to find another location for your shop and that it also would be a good time to expand your business. If the business continues to grow in the new location, you plan to hire a full-time employee to repair small appliances. You are concerned, however, about how you will get the money to move your shop and get it established in a new location.

Assignment

1. With all class members participating, use brainstorming to identify the following:
   a. The funds you will need to accomplish your business goals
   b. The sources of short-term financing available to you
   c. Problems that might prevent you from getting a short-term loan
   d. How you will repay the money if you get a loan
2. Have a classmate write the ideas on the board.
3. Discuss how you can overcome any problems that might hamper your current chances of getting a loan and how your business can improve its chances of securing short-term loans in the future.
4. Summarize what you learned from participating in this exercise.

5 RESEARCHING DIFFERENT CAREERS

Financial managers are responsible for determining the best way to raise funds, for ensuring that the funds are used to accomplish their firm's goals and objectives, and for developing and implementing their firm's financial plan. Their decisions have a direct impact on the firm's level of success. When managers do not pay enough attention to finances, a firm is likely to fail.

Assignment

1. Investigate the job of financial manager by searching the library or Internet, by interviewing a financial manager, or both.
2. Find answers to the following questions:
   a. What skills do financial managers need?
   b. How much education is required?
   c. What is the starting salary? Top salary?
   d. What will the job of financial manager be like in the future?
   e. What opportunities are available?
   f. What types of firms are most likely to hire financial managers? What is the employment potential?
3. Prepare a report on your findings.