**CHAPTER 17: FINANCIAL MANAGEMENT**

**Chapter Overview**

This chapter focuses on the finance function of organizations. It begins by describing the role of financial managers, their place in the organizational hierarchy, and the increasing importance of finance. Next, the financial planning process and the components of a financial plan are outlined. Then the discussion focuses on how organizations manage assets as efficiently and effectively as possible. The two major sources of funds—debt and equity—are then compared, and the concept of leverage is introduced. The major sources of short-term and long-term funding are described in the following sections. A description of mergers, acquisitions, buyouts, and divestitures concludes the chapter.

**Glossary of Key Terms**

**Capital structure:** mix of a firm’s debt and equity capital

**Divestiture:** sale of assets by a firm

**Finance:** planning, obtaining, and managing a company’s funds to accomplish its objectives as effectively and efficiently as possible

**Financial manager:** executive who develops and implements the firm’s financial plan and determines the most appropriate sources and uses of funds

**Financial plan:** document that specifies the funds needed by a firm for a period of time, the timing of inflows and outflows, and the most appropriate sources and uses of funds

**Leverage:** increasing the rate of return on funds invested by borrowing funds

**Leveraged buyout (LBO):** transaction in which public shareholders are bought out and the firm reverts to private status

**Risk-return trade-off:** process of maximizing the wealth of a firm’s shareholders by striking the optimal balance between risk and return

**Tender offer:** an offer made by a firm to the target firm’s shareholders specifying a price and the form of payment

**Venture capitalist:** raises money from wealthy individuals and institutional investors and invests the funds in promising firms

**Learning Objective 1: Define the role of the financial manager.**

*Finance deals with planning, obtaining, and managing a company’s funds to accomplish its objectives efficiently and effectively. The major responsibilities of financial managers are to develop and implement financial plans and determine the most appropriate sources and uses of funds. The chief financial officer (CFO) heads a firm’s finance organization. Three senior executives reporting to the CFO are the vice president for financial management, the treasurer, and the controller. When making decisions, financial professionals continually seek to balance risks with expected financial returns.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **Opening Vignette:**  **Andreessen Horowitz: Silicon Valley’s Venture Capital Firm** Venture capital firm Andreesen Horowitz, which raised $2.7 billion over the course of three years, is one of the many firms giving startups a chance to prosper by providing necessary funding. Established by Marc Andreesen, who also founded Netscape, and Ben Horowitz, the firm also provided mentoring to start-up businesses, armed with entrepreneurial expertise and a resource pool of project managers, designers, and engineers. While it may seem impossible to maintain funding for such ventures, Andreesen Horowitz proves that it’s possible, investing in firms including Facebook, Twitter, Skype, and Fouresquare all during the economic recession. |  |
| **THE ROLE OF THE FINANCIAL MANAGER** |  |
| * 1. *Finance* refers to planning, obtaining, and managing a company’s funds in order to accomplish its objectives effectively and efficiently. | PowerPoint Slide 3  *Lecture Enhancer: How does finance differ from accounting?* |
| * 1. The *financial manager* develops and implements the firm’s financial plan and determines the most appropriate sources and uses of funds. | PowerPoint Slide 4 |
| * 1. The chief financial officer (CFO) is the top finance executive, usually reporting to the CEO or COO. | Figure 17.1 What the Finance Organization at a Typical Firm Looks Like |
| * + 1. Under the CFO are senior managers— the *vice president for financial management* (or *planning*), the treasurer, and the controller. | *­Class Activity: Discuss with students which position—treasurer, vice president for planning, or controller—might best lead to becoming a chief financial officer.* |
| * + 1. The vice president for financial management prepares financial forecasts and analyzes major investment decisions. |  |
| * + 1. The *treasurer* is responsible for all financing activities, including cash management, tax planning and preparation, and shareholder  relations. |  |
| * + 1. The *controller* keeps the books, prepares financial statements, and conducts internal audits. | Hit & Miss:  Apptio Calculates Financial Costs for Technology |
| 1. A growing number of CEOs are promoted from financial positions. |  |
| 1. Financial professionals balance risk with expected financial returns. | PowerPoint Slide 5 |
| 1. A *risk-return trade-off* refers to the optimal balance between the expected payoff from an investment and the investment’s risk. | *Lecture Enhancer: If you were asked to invest by lending money to a friend for his or her business, would you do so? If so, what interest rate would you charge and why?* |
| g. Financial managers must also learn to adapt to changes in the financial system. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Hit & Miss:**

**Apptio Calculates the Cost of Information Technology**

**Summary**

Apptio, located in Bellevue, Washington, provides hosted Internet technology solutions, among them its Technology Business Management package. Recently, Apptio introduced its new Cost Transparency Template. This template generates the formulas necessary for a company to calculate how much more—or less—it would cost to invest in cloud computing as opposed to other options, including traditional in-house hardware and storage. A spending-analytics tool from Apptio allowed a hospital in Kansas City to save millions of dollars by highlighting unnecessary or redundant spending.

**Questions for Critical Thinking**

**1. Why have companies recently become so concerned with cost management?**

*Revenues for many companies have declined as customers have cut back on spending due to economic challenges. As revenues decline, companies typically need to reduce costs and expenses in order to protect or maintain their profit margins and overall profitability, as well as cash positions. This strategy can help avoid possible bankruptcy for some companies that are seriously affected by spending reductions.*

**2. Why might it be difficult for very large companies to keep accurate account of spending on such items as computer hardware and software licenses?**

*In large companies, keeping an accurate account of spending is more challenging since many departments and smaller business units may order directly and classify the expenses differently. The individual downloading of software via the Internet also complicates this process.*

Assessment Check Answers

**1.1 What is the structure of the finance function at the typical firm?**

*The head of the finance function of a firm has the title of chief financial officer (CFO) and generally reports directly to the firm’s chief executive officer. Reporting to the CFO are the treasurer, the controller, and the vice president for financial management.*

**1.2 Explain the risk-return trade-off.**

*Financial managers strive to maximize the wealth of their firm’s shareholders by striking the optimal balance between risk and return. Often, decisions involving the highest potential returns expose the firm to the greatest risks.*

**Learning Objective 2: Describe the role of financial planning.**

*A financial plan is a document that specifies the funds needed by a firm for a given period of time, the timing of inflows and outflows, and the most appropriate sources and uses of funds. The financial plan addresses three questions: What funds will be required during the planning period? When will funds be needed? Where will funds be obtained? Three steps are involved in the financial planning process: forecasting sales over a future period of time, estimating the expected level of profits over the planning period, and determining the additional assets needed to support additional sales.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **FINANCIAL PLANNING** | PowerPoint Slide 6 |
| * 1. A *financial plan* is a document specifying the funds needed by a firm for a given period of time, the timing of inflows and outflows, and the most appropriate sources and uses of funds. |  |
| * + 1. *Operating plans* focus on projections no more than a year or two in the future. | **Hit & Miss:**  **Colleges Sell Century Bonds** |
| * + 1. *Strategic plans* have a longer time horizon, up to five or ten years. |  |
| * 1. Financial plans are built on answers to three questions: |  |
| * + 1. What funds will the firm require during the planning period? |  |
| * + 1. When will it need additional funds? |  |
| * + 1. Where will it obtain the necessary funds? |  |

|  |  |
| --- | --- |
| c. Preparing a financial plan: |  |
| * + 1. The CFO develops a forecast of sales or revenue over some future time period. |  |
| * + 1. The sales forecast determines the expected level of profits for future periods. |  |
| * + 1. After the sales and profit forecast, the CFO estimates how many additional assets the firm will need to support projected sales. | *Class Activity: Discuss why a skilled financial manager needs to not only have strong skills in accounting and finance, but also a keen understanding of the other business functions.* |
| iv. *Asset intensity* refers to the amount of assets needed to generate a given level of sales. |  |
| d. The financial plan should indicate when the flows of funds entering and leaving the organization will occur and in what amounts. | *Lecture Enhancer: Why does having strong skills in software like Excel strengthen your chances of obtaining an accounting or finance position?* |
| 1. It also involves financial control, the process of comparing actual revenues, costs, and expenses with forecasts. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Hit & Miss:**

**Colleges Sell Century Bonds**

**Summary**

**The University of California recently established an $860 century bond program. These bonds are higher than the average 30-year Treasury bonds and higher than the average return rate of 4.85 percent. The Massachusetts Institute of Technology, University of Southern California, and California Institute of Technology are also colleges participating in bond programs. This will help ensure that universities and colleges remain some of the longest-living institutions.**

**Questions for Critical Thinking**

**1. One analyst called century bonds debt “that won’t mature until well after everyone involved in the sale is dead.” Why are they popular?**

*Century debt bonds with universities are popular because unlike other institutions, colleges and universities prove to have high survival rates, making them better financial investment partners.*

**2. Do you agree that universities will outlive today’s corporations? Why or why not?**

*Answers will vary.*

Assessment Check Answers

**2.1 What three questions does a financial plan address?**

*The financial plan addresses three questions: What funds will be required during the planning period? When will funds be needed? Where will funds be obtained?*

**2.2 Explain the steps involved in preparing a financial plan.**

*The first step is to forecast sales over a future period of time. Second, the financial manager must estimate the expected level of profits over the planning period. The final step is to determine the additional assets needed to support additional sales.*

**Learning Objective 3: Outline how organizations manage their assets.**

*Assets consist of what a firm owns and also represent the uses of its funds. Sound financial management requires assets to be acquired and managed as effectively and efficiently as possible. The major current assets are cash, marketable securities, accounts receivable, and inventory. The goal of cash management is to have sufficient funds on hand to meet day-to-day transactions and pay any unexpected expenses. Excess cash should be invested in marketable securities, which are low-risk securities with short maturities. Managing accounts receivable, which are uncollected credit sales, involves collecting funds owed the firm as quickly as possible while also offering sufficient credit to customers to generate increased sales. The main goal of inventory management is to minimize the overall cost of inventory. Production, marketing, and logistics also play roles in determining proper inventory levels. Capital investment analysis is the process by which financial managers make decisions on long-lived assets. This involves comparing the benefits and costs of a proposed investment. Managing international assets poses additional challenges for the financial manager, including the problem of fluctuating exchange rates.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **MANAGING ASSETS** | PowerPoint Slide 7  Business Etiquette  Tips from LearnVest |
| **1. Short-Term Assets** | PowerPoint Slide 8 |
| * 1. Short-term, or current, assets consist of cash and assets that can be converted into cash with a year. |  |
| * 1. **Cash and Marketable Securities** |  |
| * + 1. The purpose of cash is to pay day-to-day expenses. |  |
| * + 1. *Marketable securities* are low-risk securities with short maturities or those that can be sold in secondary markets. |  |

|  |  |
| --- | --- |
| * + 1. The cash budget is a tool for managing cash and marketable securities. |  |
| * + 1. It shows expected cash inflows and outflows for a period of time. |  |
| * 1. **Accounts Receivable** |  |
| * + 1. Accounts receivable are uncollected credit sales and can be a significant asset. |  |
| * + 1. Management of accounts receivable is composed of two functions: determining an overall credit policy and deciding which customers will be offered credit. |  |
| * + 1. Calculating accounts receivable turnover over successive time periods is one simple tool for assessing how well receivables are being managed. | *Lecture Enhancer:*  *If accounts receivable are increasing over time, is this a positive or negative indication for a business?*  *Class Activity:*  *Ask students what actions a company might take to speed up collections and reduce accounts receivable.* |
| * 1. **Inventory Management** |  |
| * + 1. For many firms, such as retailers, inventory represents the largest single asset. |  |
| * + 1. Some types of firms, such as electric utilities and transportation companies, have no inventory. |  |
| * + 1. Proper management of inventory is vital. | *Class Activity: Discuss the impact of style changes, spoilage, and obsolescence on inventory values.* |
| * + 1. Trends in the inventory turnover ratio can show impending trouble. |  |
| **2. Capital Investment Analysis** | PowerPoint Slide 9 |
| 1. *Capital investment analysis* is the process by which decisions are made regarding investments in long-lived assets. |  |
| * + 1. Firms make decisions about expansion and replacement. |  |
| * + 1. Financial managers must estimate the costs and benefits of a proposed investment. |  |
| iii. Only investments that offer an acceptable return—measured by the difference between benefits and costs—should be undertaken. |  |
| **3. Managing International Assets** | PowerPoint Slide 10 |
| * 1. Managing international assets creates challenges for the financial manager. |  |
| * 1. Exchange rates can vary from year to year, creating a problem for firms with international assets. | *Lecture Enhancer: Can a change in exchange rates ever benefit a company?* |
| * 1. Global firms reduce the risks of exchange rate fluctuations with a *balance sheet hedge*. |  |
| * + 1. A balance-sheet hedge is an offsetting liability to the non-dollar-denominated asset, one that is denominated in the same currency. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Assessment Check Answers

**3.1 Why do firms often choose to invest excess cash in marketable securities?**

*Cash earns no rate of return, which is why excess cash should be invested in marketable securities. These are low-risk securities that have short maturities and can be easily sold in the secondary markets. As a result, they are easily converted back into cash, when needed.*

**3.2 What are the two aspects of accounts receivable management?**

*The two aspects of accounts receivable management are deciding on an overall credit policy (whether to offer credit and, if so, on what terms) and determining which customers will be offered credit.*

**3.3 Explain the difference between an expansion decision and a replacement decision.**

*An expansion decision involves decisions about offering new products or building or acquiring new production facilities. A replacement decision is one that considers whether to replace an existing asset with a new one.*

**Learning Objective 4: Discuss the sources of funds and capital structure.**

*Businesses have two sources of funds: debt capital and equity capital. Debt capital represents funds obtained through borrowing, and equity capital consists of funds provided by the firm’s owners. The mix of debt and equity capital is known as the firm’s capital structure, and the financial manager’s job is to find the proper mix. Leverage is a technique of increasing the rate of return on funds invested by borrowing. However, leverage increases risk. Also, overreliance on borrowed funds may reduce management’s flexibility in future financing decisions. Equity capital also has drawbacks. When additional equity capital is sold, the control of existing shareholders is diluted. In addition, equity capital is more expensive than debt capital. Financial managers are also faced with decisions concerning the appropriate mix of short- and long-term funds. Short-term funds are generally less expensive than long-term funds but expose firms to more risk. Another decision involving financial managers is determining the firm’s dividend policy.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **SOURCES OF FUNDS AND CAPITAL STRUCTURE** | PowerPoint Slide 11 |
| * 1. *Debt capital* consists of funds obtained through borrowing. |  |
| * 1. *Equity capital* consists of funds provided by the firm’s owners when they reinvest earnings, make additional contributions, or issue stock to investors. | *Lecture Enhancer: Which type of funds (debt or equity) offers a firm a more flexible pay arrangement? Which offers more control?* |
| * 1. *Capital structure* is the mix of a firm’s debt and equity capital. |  |
| **1. Leverage and Capital Structure Decisions** | PowerPoint Slide 12 |
| * 1. *Leverage* is the technique of increasing the rate of return on an investment by financing it with borrowed funds. |  |

|  |  |
| --- | --- |
| * + 1. The key to managing leverage is to ensure that a company’s earnings remain larger than its interest payments, which increases the leverage on the rate of return on shareholders’ investment. | Figure 17.2 How Leverage Works |
| * + 1. Leverage increases potential returns to shareholders but also increases risk. | *Lecture Enhancer: Provide an example of a company that recently failed because of excessive leverage.* |
| iii. An overreliance on borrowed funds may reduce flexibility in future financing decisions. |  |
| * 1. Equity capital has drawbacks as well: |  |
| * + 1. Shareholders are owners of the company, vote on company issues, and elect the board of directors. |  |
| * + 1. When new equity is sold, the control of existing shareholders is diluted, and the outcome of these votes could change. |  |
| * + 1. One issue is whether shareholders should vote on executive pay packages. |  |
| iv. Equity capital is more expensive than debt capital. |  |
| **2. Mixing Short-Term and Long-Term Funds** | PowerPoint Slide 13 |
| a. Financial managers determine the appropriate mix of short- and long-term funds. |  |
| i. Short-term funds consist of current liabilities, and long-term funds consist of long-term debt and equity. |  |
| ii. Short-term funds are less expensive but carry more risk. |  |
| iii. Short-term rates move up and down frequently, and interest expense can change substantially from year to year. |  |
| iv. Another risk of relying on short-term funds is availability. |  |
| b. Most firms finance long-term assets, and a portion of short-term assets, with long-term funds. | Figure 17.3 Johnson & Johnson’s Mix of Short- and Long-Term Funds |
| **3. Dividend Policy** | PowerPoint Slide 14 |
| a. Financial managers make decisions about dividend policy. |  |
| i. *Dividends* are periodic cash payments to shareholders. | *Lecture Enhancer: Why do you think older investors prefer stock in companies that provide dividend payments?* |
| ii. Most dividends are *regular dividends,* paid quarterly. |  |
| iii. Firms are under no legal obligation to pay dividends. | **Solving an Ethical Controversy**  **Are Dividends Necessary?** |
| iv. If a firm has investment opportunities and finances them with equity funding, it will pay fewer dividends. |  |
| v. A firm with more limited investment opportunities pays more of its earnings in dividends. |
| b. In addition to dividends, some firms buy back their outstanding stock. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Assessment Check Answers

**4.1 Explain the concept of leverage.**

*Leverage is a technique of increasing the rate of return by borrowing funds. But leverage also increases risk.*

**4.2 Why do firms generally rely more on long-term funds rather than short-term funds?**

*Although short-term funds are generally less expensive than long-term funds, short-term funds expose the firm to additional risks. The cost of short-term funds can vary substantially from year to year. In addition, at times short-term funds can be difficult to obtain.*

**4.3 What is an important determinant of a firm’s dividend policy?**

*The main determinant of a firm’s dividend policy is its investment opportunities. Firms with more profitable investment opportunities often pay less in dividends than do firms with fewer such opportunities.*

**Learning Objective 5: Identify short-term funding options.**

*The three major short-term funding options are trade credit, short-term loans from banks and other financial institutions, and commercial paper. Trade credit is extended by suppliers when a firm receives goods or services, agreeing to pay for them at a later date. Trade credit is relatively easy to obtain and costs nothing unless a supplier offers a cash discount. Loans from commercial banks are a significant source of short-term financing and are often used to finance accounts receivable and inventory. Loans can be either unsecured or secured, with accounts receivable or inventory pledged as collateral. Commercial paper is a short-term IOU sold by a company. Although large amounts of money can be raised through the sale of commercial paper, usually at rates below those charged by banks, access to the commercial paper market is limited to large, financially strong corporations.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **SHORT-TERM FUNDING OPTIONS** | PowerPoint Slide 15 |
| * 1. Three major sources of short-term funds exist: trade credit, short-term loans, and commercial paper. |  |
| * 1. Large firms often rely on a combination of all three sources of short-term financing. |  |
| 1. **Trade Credit** |  |
| * 1. *Trade credit* is extended by suppliers when a firm receives goods or services, agreeing to pay for them at a later date. | *Class Activity:*  *Ask students why large companies might be more likely to obtain favorable trade credit as compared to smaller companies.* |
| * + 1. The main advantage of trade credit is its easy availability. |  |

|  |  |
| --- | --- |
| ii. The main drawback is that the amount a company can borrow is limited to the amount it purchases. | *Lecture Enhancer: Why would trade credit be limited to the amount of goods or services a company purchases?* |
| 1. **Short-Term Loans** |  |
| * 1. Short-term loans finance inventory and accounts receivable. |  |
| * 1. Two types of short-term loans: lines of credit and revolving credit agreements. | *Class Activity:*  *Lead a class discussion on the risks in lending to a ski manufacturer.* |
| * + 1. The cash budget is an important tool for determining the size of a line of credit. |  |
| * + 1. A revolving credit agreement is essentially a guaranteed line of credit. |  |
| * 1. In *factoring,* a business sells its accounts receivable to a bank or finance company at a discount. |  |
| * + 1. Factoring allows the firm to convert its receivables into cash quickly. |  |
| * + 1. The cost of short-term loans depends not only on the interest rate but also on the fees charged by the lender. |  |
| 1. **Commercial Paper** |  |
| a. Commercial paper is a short-term IOU sold by a company. |  |

|  |  |
| --- | --- |
| i. Large amounts of money can be raised at interest rates 1 or 2 percent lower than short-term bank loans. |  |
| ii. It is sold in multiples of $100,000 to $1 million, matures in 1 to 270 days, and is unsecured. |  |
| iii. Only large firms with considerable financial strength and stability can sell commercial paper. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Assessment Check Answers

**5.1 What are the three sources of short-term funding?**

*The three sources of short-term funding are trade credit, short-term loans from banks and other financial institutions, and commercial paper.*

**5.2 Explain trade credit.**

*Trade credit is extended by suppliers when a buyer agrees to pay for goods and services at a later date. Trade credit is relatively easy to obtain and costs nothing unless a cash discount is offered.*

**5.3 Why is commercial paper an attractive short-term financing option?**

*Commercial paper is an attractive financing option because large amounts can be raised by selling commercial paper at rates that are generally lower than those charged by banks.*

**Learning Objective 6: Discuss sources of long-term financing.**

*Long-term funds are repaid over many years. There are three sources: long-term loans obtained from financial institutions, bonds sold to investors, and equity financing. Public sales of securities represent a major source of funds for corporations. These securities can generally be traded in secondary markets. Public sales can vary substantially from year to year depending on the conditions in the financial markets. Private placements are securities sold to a small number of institutional investors. Most private placements involve debt securities. Venture capitalists are an important source of financing for new companies. If the business succeeds, venture capitalists stand to earn large profits. Private equity funds are investment companies that raise funds from wealthy individuals and institutional investors and use the funds to make investments in both public and private companies. Unlike venture capitalists, private equity funds invest in all types of businesses. Sovereign wealth funds are investment companies owned by governments.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **SOURCES OF LONG-TERM FINANCING** | PowerPoint Slide 16 |
| * 1. Firms need larger funds for making a major investment. |  |
| * 1. Long-term funds are repaid over many years. |  |
| * 1. Organizations acquire long-term funds from three sources: long-term loans, bonds, and equity financing. |  |
| 1. **Public Sale of Stocks and Bonds** |  |
| * 1. Public sales of securities, such as stocks and bonds, are a major source of funds for corporations. |  |
| * 1. Securities sales provide cash inflows for the issuing firm in exchange for either a share in its ownership (for a stock purchaser) or a specified rate of interest and repayment (for a bond purchaser). |  |

|  |  |
| --- | --- |
| * 1. These securities trade in the secondary markets and can easily be sold. |  |
| 1. **Private Placements** |  |
| * 1. *Private placements* are long-term stocks or bonds issued not publicly, but only to a small group of large investors such as pension funds or insurance companies. |  |
| * 1. Most private placements involve corporate debt issues. |  |
| * 1. It is often cheaper for a company to sell a security privately than publicly. |  |
| * 1. There is less government regulation with which to contend because SEC registration is not required. |  |
| 1. **Venture Capitalists** |  |
| 1. *Venture capitalists* raise money from wealthy individuals and institutional investors and invest these funds in promising firms. |  |
| 1. Venture capitalists also provide management consulting advice as well as funds. | *Lecture Enhancer:* *What are some possible risks for a firm owner if he or she seeks advice from a venture capital company?* |
| 1. In exchange for their investment, venture capitalists become part owners of the business. |  |

|  |  |
| --- | --- |
| 1. **Private Equity Funds** |  |
| 1. *Private equity funds* are investment companies that raise funds from wealthy individuals and institutional investors and use those funds to make large investments in both public and privately held companies. | *Lecture Enhancer: What are the risks of private equity funds?* |
| * + 1. Private equity funds invest in all types of businesses, including mature ones. |  |
| * + 1. Private equity funds invest in transactions that take public companies private or leveraged buyouts. | Going Green:  **KKR’s Smart Investments Yield Greener Profits at Dollar General** |
| 1. *Sovereign wealth funds* are companies owned by governments that invest in a variety of financial and real assets, such as real estate. | Figure 17.4 The World’s Ten Largest Sovereign Wealth Funds |
| i. Although they make investments based on the best risk-return trade-off, political, social, and strategic considerations also play roles in their investment decisions. |  |
| 1. **Hedge Funds** | Case 17.2:  Top Hedge Fund Managers Earn Record Paychecks |
| 1. *Hedge funds* are private investment companies open only to qualified large investors. |  |
| 1. They account for about 60 percent of secondary bond market trading and one-third of all activity on stock exchanges. |  |

|  |  |
| --- | --- |
| 1. Hedge fund providers have begun selling these funds, in the form of mutual funds, to smaller investors. |  |
| 1. They are not regulated by the SEC. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Going Green:**

**KKR’s Smart Investments Yield Greener Profits at Dollar General**

**Summary**

Dollar General is just one of the firms that Kohlberg Kravis Roberts & Co (KKR) have assisted in minimizing their environmental impact through KKR’s Green Portfolio plan. This helped Dollar General reduce their generated waste by about 75% and reducing its use of cardboard at its 10,000 U.S. chain stores. In return, the store has earned $80 million through sustainability efforts while saving $155 million in fuel and energy costs alone. Along with more effective shipping and routing routines, Dollar General stores use energy friendly lighting. KKR is in partnership with the Environmental Defense Fund, which helps the private equity fund build their Green Portfolio.

**Questions for Critical Thinking**

1. **“Today’s institutional investors want their dollars to create both financial returns and environmental and social value,” says the Fund. Why is this so?**

*This is because today’s society is more environmentally concerned, which means that consumers appreciate conducting business with companies who practice sustainability efforts.*

1. **A KKR manager was “encouraged by the enthusiasm which our portfolio companies have shown for the Green Portfolio Program.” What accounts for their enthusiasm?**

*Companies are satisfied with KKR’s Green Portfolio Program because it indicates to their customers that the companies are eco-friendly, and the companies increase their profit through sustainability efforts.*

Assessment Check Answers

**6.1 What is the most common type of security sold privately?**

*Corporate debt securities are the most common type of security sold privately.*

**6.2 Explain venture capital.**

*Venture capitalists are important sources of funding, especially for new companies. Venture capitalists invest in these companies by taking an ownership position. If the business succeeds, venture capitalists can earn substantial profits.*

**6.3 What is a sovereign wealth fund?**

*A sovereign wealth fund is a government-owned investment company. These companies make investments in a variety of financial and real assets, such as real estate. Although most investments are based on the best risk-return trade-off, political, social, and strategic considerations play roles as well.*

**Learning Objective 7: Describe mergers, acquisitions, buyouts, and divestitures.**

*A merger is a combination of two or more firms into one company. An acquisition is a transaction in which one company buys another. Even in a merger, there is a buyer and a seller (called the* target*). The buyer offers cash, securities, or a combination of the two in return for the target’s shares. Mergers and acquisitions should be evaluated as any large investment is, by comparing the costs with the benefits.* Synergy *is the term used to describe the benefits a merger or acquisition is expected to produce. A leveraged buyout (LBO) is a transaction in which shares are purchased from public shareholders, and the company reverts to private status. Usually LBOs are financed with substantial amounts of borrowed funds. Private equity companies are often major financers of LBOs. Divestitures are the opposite of mergers, in which companies sell assets such as subsidiaries, product lines, or production facilities. A sell-off is a divestiture in which assets are sold to another firm. In a spin-off, a new firm is created from the assets divested. Shareholders of the divesting firm become shareholders of the new firm as well.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **MERGERS, ACQUISITIONS, BUYOUTS, AND DIVESTITURES** | PowerPoint Slide 17 |
| 1. Mergers and acquisitions |  |
| * 1. A merger is a transaction where two or more firms combine into one company. | *Lecture Enhancer: Give an example of a recent merger and discuss the potential benefits to both companies.* |
| * 1. In an acquisition, one firm buys the assets and assumes the obligations of another firm. |  |
| * + 1. Classifications of mergers and acquisitions: vertical, horizontal, and conglomerate. |  |
| * + 1. Transactions involve large sums of money. |  |
| * + 1. The seller is called the *target*. |  |
| * + 1. Financial managers evaluate a merger or acquisition by comparing costs and benefits. |  |
| * + 1. A *tender offer* is made by a buyer for the target’s shares and specifies a price and the form of payment. |  |
| * + 1. Shareholders of both the buyer and target must vote to approve a merger. |  |
| * + 1. The financial manager estimates the benefits of a proposed merger. |  |
| * 1. *Synergy* is the notion that the combined firm is worth more than the buyer and target are individually. |  |
| 2. Leveraged buyouts (LBOs) |  |
| 1. In a *leveraged buyout* *(LBO)*, public shareholders are bought out, and the firm reverts to private status. |  |
| 1. *Leverage* means that many of these transactions are financed with high degrees of debt. |  |
| 1. Private equity companies and hedge funds provide equity and debt financing for many LBOs. |  |
| 1. LBO activity decreased sharply with the recent economic downturn, but it has begun to increase again as the economy recovers. |  |
| 3. Divestitures | Case 17.1: ConocoPhillips Divests to Return to Its Core |

|  |  |
| --- | --- |
| a. In a *divesture*, a company sells assets such as subsidiaries, product lines, or production facilities. |  |
| i. In a *sell-off,* assets are sold by one firm to another. |  |
| ii. In a *spin-off,* the sold assets form a new firm. |  |
| b. Reasons for divestitures |  |
| * + 1. Divestitures result from prior acquisitions that didn’t work out. | *Lecture Enhancer: Can you provide an example of a recent divestiture that resulted from an unsuccessful acquisition?* |
| * + 1. A firm concentrates on core businesses and divests anything else. |  |
| * + 1. Due to antitrust issues, the government may require divestitures of certain assets as a condition for approving a merger. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Assessment Check Answers

**7.1 Define *synergy.***

Synergy *is the term used to describe the benefits produced by a merger or acquisition. It is the notion that the combined firm is worth more than the buyer and the target are individually.*

**7.2 What is an LBO?**

*An LBO—leveraged buyout—is a transaction whereby public shareholders are bought out, and the firm reverts to private status. LBOs are usually financed with large amounts of borrowed money.*

**7.3 What are the two types of divestitures?**

*A sell-off is a divestiture in which assets are sold to another firm. In a spin-off, a new firm is created from the assets divested. Shareholders of the divesting firm become shareholders of the new firm as well.*

**Answers to Review Questions**

**1. Explain the risk-return trade-off and give two examples.**

*Risk-return trade-off refers to the balance between the risk—the uncertainty of gain or loss—with expected return—the gain or loss resulting from investments over time, with the goal of maximizing shareholder wealth. Financial professionals continually seek to balance risks with expected financial returns.*

*For example, Airbus faced the decision of whether to begin development and production of the giant A380 jetliner. The development costs for the aircraft were estimated at more than $10 billion. Financial managers weighed the potential profits against the risk that the profits would not materialize.*

*Likewise, auto manufacturer BMW announced a $750 million expansion of its production facility in South Carolina, bringing its total investment in the state to more than $5.4 billion. Financial managers weighed the potential profits against the risk that the profits would not materialize.*

**2. Describe the financial planning process. How does asset intensity affect a financial plan?**

*Three steps are involved in the financial planning process: forecasting sales over a future period of time, estimating the expected level of profits over the planning period, and determining the additional assets needed to support additional sales.*

*Depending on the nature of the industry, some businesses need more assets than others to support the same amount of sales. The technical term for this requirement is asset intensity. Asset intensity affects the financial plan because the planner must estimate how many additional assets the firm will need to support projected sales.*

**3. What are the principal considerations in determining an overall credit policy? How do the actions of competitors affect a firm’s credit policy?**

*Formulating a credit policy involves deciding whether the firm will offer credit and, if so, on what terms. Will a discount be offered to customers who pay in cash? Often, the overall credit policy is dictated by competitive pressures or general industry practices. If competitors offer customers credit, a firm will likely have to as well. The other aspect of a credit policy is deciding which customers will be offered credit. Managers must consider the importance of the customer as well as its financial health and repayment history.*

**4. Why do exchange rates pose a challenge for financial managers of companies with international operations?**

*An exchange rate is the rate at which one currency can be exchanged for another. Exchange rates can vary substantially from year to year, creating a problem for any company with international assets. For example, a U.S. firm has a subsidiary in the United Kingdom that earns an annual profit of £750 million. Over the past five years, the exchange rate between the U.S. dollar and the British pound has varied between 1.74 (dollars per pound) and 2.09. This means the dollar value of the UK profits ranged from less than $1.3 billion to almost $1.6 billion.*

**5. Discuss the concept of leverage. Use a numerical example to illustrate the effect of leverage.**

Leverage *is the principle of increasing the rate of return on funds invested by borrowing funds. The key to managing leverage is to ensure that a company’s earnings remain larger than its interest payments, which increases the leverage on the rate of return on shareholders’ investment.*

*For example, Leverage Company obtains 50 percent of its funds from lenders who purchase company bonds. Leverage Company pays 10 percent interest on its bonds. Equity Company raises all of its funds through sales of company stock. If earnings double, from say $10 million to $20 million, returns to shareholders of Equity Company also double—from 10 percent to 20 percent. But returns to shareholders of Leverage Company more than double—from 10 percent to 30 percent. However, leverage works in the opposite direction as well. If earnings fall from $10 million to $5 million, a decline of 50 percent, returns to shareholders of Equity Company also fall by 50 percent—from 10 percent to 5 percent. By contrast, returns to shareholders of Leverage Company fall from 10 percent to zero. Thus, leverage increases potential returns to shareholders but also increases risk.*

**6. What are the advantages and disadvantages of both debt and equity financing?**

*Raising needed cash by borrowing allows a firm to benefit from the principle of leverage, increasing the rate of return on funds invested by borrowing funds. The advantage of leverage is that it increases potential returns to shareholders. Another advantage is that a firm can deduct interest payments on debt, reducing its taxable income and tax bill.*

*A disadvantage of debt financing is that it also increases risk. Another problem with borrowing money is that an overreliance on borrowed funds may reduce management’s flexibility in future financing decisions.*

*The advantage of equity financing is that it is less risky than debt financing*. *For example, if earnings fall from $10 million to $5 million, a decline of 50 percent, returns to shareholders of Equity Company also fall by 50 percent—from 10 percent to 5 percent. By contrast, returns to shareholders of Leverage Company fall from 10 percent to zero.*

*A disadvantage of equity capital is that shareholders have the right to vote on major company issues and elect the board of directors. Whenever new equity is sold, the control of existing shareholders is diluted, and the outcome of these votes could potentially change. Another disadvantage of equity capital is that it is more expensive than debt capital. Also, dividends paid to shareholders are not tax deductible.*

**7. Compare and contrast the three sources of short-term financing.**

*The three major sources of short-term funds include trade credit, short-term loans, and commercial paper.*

* + *Trade credit: Suppliers routinely ship billions of dollars of merchandise to retailers each day and are paid at a later date. Without trade credit, the retailing sector would have fewer selections. The advantage of trade credit is its easy availability since credit sales are common in many industries. The main drawback to trade credit is that the amount a company can borrow is limited to the amount it purchases. If suppliers do not offer a cash discount, trade credit is effectively free.*
  + *Loans are used to finance inventory and accounts receivable.* *A line of credit specifies the maximum amount the firm can borrow over a period of time, usually a year, whereas a revolving credit agreement is a guaranteed line of credit—the funds will be available when needed. The cost of short-term loans depends not only on the interest rate but also on the fees charged by the lender. Some lenders require compensating balances—5 to 20 percent of the outstanding loan amount—in a checking account. Compensating balances increase the cost of a loan since the borrower doesn’t have full use of the amount borrowed.*
  + *Commercial paper is a short-term IOU sold by a company, sold in multiples of $100,000 to $1 million with a maturity that ranges from one to 270 days. Most commercial paper is unsecured. It is an attractive source of financing because large amounts of money can be raised at rates that are typically 1 to 2 percent less that those charged by banks. While commercial paper is an attractive short-term financing alternative, only a small percentage of businesses can issue it. Access to the commercial paper market has traditionally been restricted to large, financially strong corporations*.

**8. Define *venture capitalist,* *private equity fund,* *sovereign* *wealth* *fund,* and *hedge fund*. Which of these four sources of funds invests the most money in start-up companies?**

* 1. *Venture capitalists raise money from wealthy individuals and institutional investors and invest these funds in promising firms.*
  2. *Private equity funds are investment companies that raise funds from wealthy individuals and institutional investors and use those funds to make large investments in both public and privately held companies.*
  3. *Sovereign wealth funds are owned by governments and invest in a variety of financial and real assets, such as real estate.*
  4. *Hedge funds are private investment companies open only to qualified, large investors.*

*Venture capitalists invest the most money in start-up companies.*

**9. Briefly describe the mechanics of a merger or acquisition.**

*A merger is a transaction where two or more firms combine into one company. In an acquisition, one firm buys the assets and assumes the obligations of another firm. The classifications of mergers and acquisitions include: vertical, horizontal, and conglomerate. These transactions involve large sums of money.*

*Financial managers evaluate a proposed merger or acquisition by comparing the costs and benefits. These benefits could take the form of cost-savings from economies of scale or reduced workforces or the buyer getting a bargain price for the target’s assets. Sometimes, a buyer finds that the most cost-effective method of entering a new market is simply to buy an existing company. To acquire another company, the buying firm typically has to offer a premium for the target’s shares—in other words, a higher price than the current market price.*

**10. Why do firms divest assets?**

*Sometimes divestitures result from prior acquisitions that didn’t work out as well as expected. In other cases, a firm makes a strategic decision to concentrate on its core businesses and decides to divest anything that falls outside this core. Still another explanation relates to antitrust issues. Government authorities occasionally require divestitures of certain assets as a condition for approving a merger*.

**Projects and Teamwork Applications**

1. Students will share their financial plans. Assume you would like to start a business. They will address the financial planning questions. What funds will the firm require during the planning period? When will it need additional funds? Where will it obtain the necessary funds?

2. Working with a partner, students will prepare a memo outlining the advantages and disadvantages of debt and equity financing. Using the numbers provided, they will prepare a numerical illustration of leverage similar to the one earlier in the chapter.

3. Students can discuss the advantages and disadvantages of venture capitalists. They can share their decisions on whether they would be willing to take the money but lose control over their business.

4. Students will share their findings on three publicly traded companies gathered by visiting each firm’s Web site. They will discuss each firm’s dividend policy and see if the company is currently repurchasing shares.

5. In small groups or pairs, students will collect at least five years’ worth of balance sheet data on three publicly traded companies operating in different industries. They will determine whether each company has become more leveraged in recent years. Some firms appear to rely more on debt than others. Students will explain why this is the case.

Web Assignments

1. **Jobs in financial management.** Visit the Web site listed here to explore careers in finance. How many people currently work as financial managers? What is the projected increase in employment over the next 10 to 20 years? What is the average level of compensation?  
   <http://www.bls.gov/oco/ocos010.htm>
2. **Capital structure.** Go to the Web site here to access recent financial statements for the retailer Costco-Wholesale Corporation. Click on “balance sheet.” What is the firm’s current capital structure (the breakdown between debt and equity)? Has it changed significantly over the past five years? Why would a firm such as Costco choose to become more or less levered?  
   <http://moneycentral.msn.com/investor/invsub/results/statemnt.aspx?symbol=cost>
3. **Mergers and acquisitions.** Using a news source, such as Google News (<http://news.google.com>) or Yahoo! News (<http://news.yahoo.com>), search for a recent merger or acquisition announcement. An example would be Facebook’s acquisition of Instagram. (A link is shown here.) Print out the articles and bring them to class.

http://newsroom.fb.com/Announcements/Facebook-to-Acquire-Instagram-141.aspx

*Note: Internet Web addresses change frequently. If you don’t find the exact sites listed, you may need to access the organization’s home page and search from there or use a search engine such as Bing or Google.*

Case 17.1

ConocoPhillips Divests to Return to Its Core

**Answers to Questions for Critical Thinking:**

**1. Why is it important for ConocoPhillips to increase the value of its shares for its investors?**

*Investors can earn a return by either receiving dividends or by appreciation in the price of the shares (capital gain). Additionally, many older investors need and depend on dividend income for their fixed obligations.*

**2. Research ConocoPhillips. How close has it come to raising the desired $10 billion?**

*The following excerpt from Seeking Alpha (http://seekingalpha.com/article/217210-conocophillips-q2-2010-earnings-call-transcript), which provided the Conoco Phillips Second Quarter 2010 Earnings Call transcript on July 29, 2010, indicates that Conoco has made significant progress, but has not yet met the $10 billion goal: “At our 2010 Analyst Meeting, we detailed our plans to enhance returns and strengthen our financial position. From 2010 to 2013, we expect to grow our production per share by approximately 3% per year on a compound annual growth rate basis, and we're on target to deliver this. Another part of the plan was to sell $10 billion in assets over the next two years. We've made significant progress with the completion of the sale of Syncrude, our CFJ interest and other miscellaneous assets. The data rooms for North America asset disposition packages have been open since June, and we’ve seen significant amounts of interest from potential buyers. Our expectation is to receive bids during this quarter and begin closing on our E&P North America asset sometime in the fourth quarter of 2010.*

*“We’ve engaged an adviser for the sale of our 25% interest in the REX pipeline, and marketing efforts are progressing. Total cash proceeds year-to-date are in excess of $5.8 billion, and we expect to reach between $7 billion and $8 billion for asset dispositions, excluding LUKOIL by the end of the year.”*

Case 17.2

Top Hedge Fund Managers Earn Record Paychecks

**Answers to Questions for Critical Thinking:**

**1. Compare hedge funds with mutual funds.**

*Hedge funds are elite, private investment companies that are open only to highly qualified, large investors. Unlike mutual funds, hedge funds are not regulated by the Securities and Exchange Commission.*

**2. Do you agree that the top hedge fund managers deserve their high salaries? Why or why not?**

*Answers will vary by student. This is a controversial and timely topic. Many hedge fund managers were intimately involved and profited greatly from their investments and sales of derivative securities. Many of these were either fraudulent or clients were not clearly told of the underlying risks. An argument can also be made that hedge fund managers and investment bankers profited from their own greed while many with 401(k) retirement plans and pensions lost trillions of dollars. Therefore, the question is whether any real added value is attributable to them for relatively passive investment vehicles compared to companies involved in the production of services and goods that employ people and grow the economy. At a minimum, the level of their compensation is greatly disproportionate to that of other executives.*

**CHAPTER 17: COLLABORATIVE LEARNING EXERCISES**

# **1 - NYSE**

Learning Objective: 6

Purpose:

To offer interesting background on the New York Stock Exchange

Background:

Virtually every student has heard of the New York Stock Exchange, but few are familiar with its fascinating past, which stretches back to near the founding of the United States. This exercise is designed to engage student interest in the NYSE by sharing its fascinating history and milestones in a verbal quiz format.

Relationship to Text:

Learning Objective 6 – Buying and Selling Securities

Estimated Class Time:

Less than 10 minutes

Preparation/Materials:

None needed

Exercise:

Offer this information as a quick verbal quiz. For maximum impact and fun, solicit the full range of responses before you share the answers.

1. In what year was the NYSE founded? (1792…only 16 years after the Declaration of Independence)
2. What is the longest-listed company on the NYSE? (Con Edison, listed in 1824)
3. What is the oldest-listed company on the NYSE? (Browne & Company, founded in 1775, listed 1999)
4. What is the highest price paid for a seat on the NYSE? ($2,650,000 in 1999) The lowest price paid? ($4,000 in 1876 and 1878)
5. When did the Dow Jones Industrial reach its peak? (On the last day of the last millennium, 12/31/1999, the Dow closed at 11,497.)
6. How many seats are available on the NYSE? (1,366)
7. When was the last increase in the number of seats? (1953)
8. What is the most “delicious” company to move in 2003 from NASDAQ to NYSE? (Krispy Kreme moved on May 17, 2003, NYSE’s 209th birthday)

Source: The New York Stock Exchange, at <http://www.nyse.com>.

**2 - Fairy Godmother Investments, Inc.**

Learning Objective: 6

Purpose:

To highlight the relationship between investment objectives and research strategy

Background:

Most successful investors attribute their positive, long-term results to thoughtful, thorough research. But the specific research approach for any investor clearly depends on the investment objectives. This exercise is designed to illustrate the range of research sources, and the crucial link between the research approach and the investment objectives.

Relationship to Text:

Learning Objective 6 – Buying and Selling Securities

Estimated Class Time:

About 25 minutes

Preparation/Materials:

None required

Exercise:

Divide your class into groups of 3 to 5 students, and announce that each group has just received $100,000 in fantasy money that it must invest in common stock by tomorrow morning. Direct them to begin by establishing investment objectives. Key questions: What do you want to gain from your investment (e.g., aggressive growth, dividend income)? How much risk are you willing to accept? What is your timeframe? (This should take a bit less than five minutes.)

Once the groups have clear objectives, instruct them to develop an investment research strategy. The goal is not to actually choose companies, but rather to determine how to make the best decision. (Example: If your group follows the high-risk strategy of seeking maximum portfolio value by year-end, you could start by finding the 10 companies with highest YTD growth. Then you could review the financials of each company. Then you could search for recent articles on each company.)

Ask the groups to share their results with the class—encourage them to cite the specific information that they would seek from each source. As they report, develop a list of research sources on the board. Follow-up discussion: How do your objectives impact your research strategy? Which information would be most helpful in making a decision? Why?

Just for fun, you might want to share with your class Mark Twain’s perspective on the stock market: There are two times in a man’s life when he should not speculate: when he can’t afford it and when he can. Remind them that the difference between speculation and wise investment can be defined in one word: research! And the quality of their research is definitely within their control.

# **3 - Stock Market Fluctuations**

Learning Objective: 6

Purpose:

To underscore the fluctuating nature of the stock market

Background:

Many investment experts such as Warren Buffet recommend buying and holding the stock of top quality companies, but weathering the daily stock fluctuations can be a scary challenge, especially for the smaller investor. This exercise is designed to prompt discussion about the continual changes and the reasons behind them.

Relationship to Text:

Learning Objective 6 – Buying and Selling Securities

Estimated Class Time:

About 10 minutes

Preparation/Materials:

None needed

Exercise:

Divide your class into groups of 3 to 5 students, and announce that each group represents an investment advice team for a major brokerage house. Just yesterday, each group advised an important client to buy 5,000 shares in a high-profile company with a strong endorsement from your firm and an excellent reputation in the marketplace. Today, the price of the stock has plunged, along with the overall market. Your client has lost $3.25 per share, or $16,250. You know that he will call you any moment, furious that your advice has caused him to lose money.

The challenge: How will you handle that call? Why would a strong stock drop so much in one day? What alternatives might you offer your client (e.g., clench your teeth and bear it, consider switching to a mutual fund, establish a limit order, etc.)?

Ask for several volunteers to role-play the phone call for your class (it typically works best if you play the angry client). Follow-up discussion: How long should you “buy and hold” in a down market? What factors would influence your choice? Are some personalities simply unsuited for investment in the stock market? Why or why not?

# **4 - Stock Indices**

Learning Objective: 6

Purpose:

To familiarize students with the Dow Jones Industrial Average

Background:

While the Dow represents a small number of companies, the specific firms are chosen to represent the industries that drive our economy. This quick discussion exercise is designed to introduce students to those firms in a historical context.

Relationship to Text:

Learning Objective 6 – Buying and Selling Securities

Estimated Class Time:

Less than 10 minutes

Preparation/Materials:

None needed

Exercise:

Share with your class the 12 companies on the original Dow Jones Industrial Average, initially published in 1896:

* American Cotton Oil
* American Sugar
* American Tobacco
* Chicago Gas
* Distilling and Cattle Feeding
* General Electric
* Laclede Gas
* National Lead
* The North American Company
* Tennessee Coal and Iron
* U.S. Leather
* U.S. Rubber

Ask your students to comment. They will almost certainly notice the heavy emphasis on commodities, agriculture, and utilities, which defined the economy of the late 1800s. They may also notice the nationalistic nature of the company names. Pre-globalization, a name that included “American” or “U.S.” would have seemed expansive, while in today’s economy it seems limiting.

Now share a sampling from a current list of Dow Jones Industrials, and ask your students to identify the changes. The current index clearly reflects the dominant role of technology, communications, retail, consumer products, finance, and entertainment in today’s economy. Here is the company list:

* Alcoa Inc
* Altria Group
* American Express
* AT&T
* Boeing
* Caterpillar
* Citigroup
* Coca-Cola
* DuPont
* Eastman Kodak
* Exxon-Mobil
* General Electric
* General Motors
* Hewlett-Packard
* Home Depot
* Honeywell International
* Intel
* IBM
* International Paper
* JP Morgan Chase
* Johnson & Johnson
* McDonald’s
* Merck
* Microsoft
* 3M
* Procter & Gamble
* SBC Communications
* United Technologies
* Walt Disney
* Wal-Mart Stores