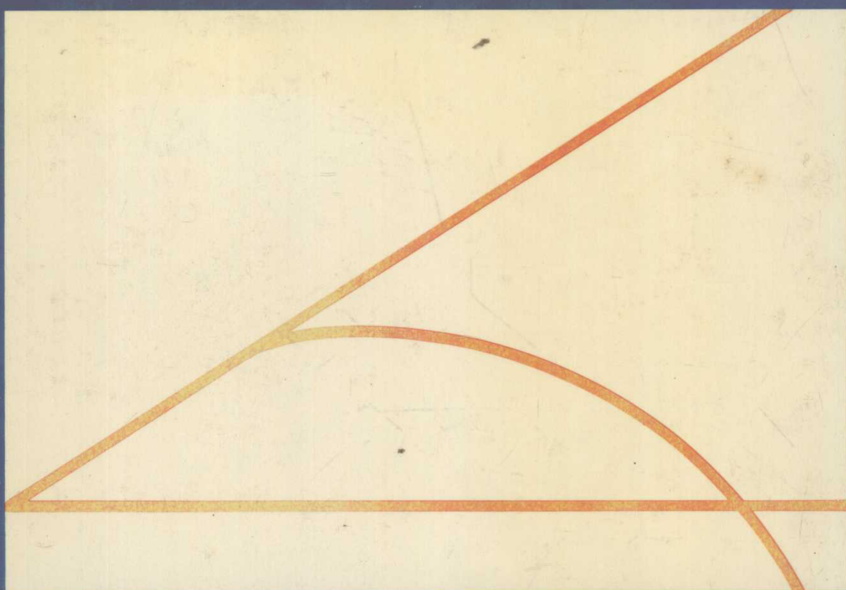
FINANCIAL MANAGEMENT

THEORY AND PRACTICE

Fifth Edition



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Preface

Financial management has changed significantly since 1984, when we last updated this text. The strong inflationary pressures that pushed interest rates to unprecedented heights have abated, at least for now, and the stock market has hit a new all-time high. However, all the financial markets have become increasingly volatile. Furthermore, distinctions among financial institutions are becoming increasingly blurred, and the rapid development of new markets and securities has continued. Academic researchers have also been busy developing new theory, business practitioners have made increasing use of financial theory, and feedback from the "real world" has led to modifications and improvements in academic financial theory. Finally, computers, especially personal computers, are being used with increasing effectiveness to analyze financial decisions, and this usage makes it more important than ever that finance students understand how to structure problems in a form suitable for quantitative analysis. To a large extent, these trends have dictated the revisions made in this edition.

The book begins with basic concepts, focusing on security markets and the valuation process, and then goes on to show how specific techniques and decision rules can be used to help maximize the value of a firm. This organization has three important advantages:

1. Explaining early in the book how financial markets operate, and how security prices are determined within these markets, lays the groundwork for explaining how financial management can affect the value of the firm. Also, this organization gives students an early exposure to discounted cash flow techniques, to valuation concepts, and to methods of risk analysis, which in turn permits us to use and reinforce these key concepts throughout the book.
2. Structuring the book around markets and valuation concepts provides a unifying theme that is missing in many texts. Some finance texts develop a series of topics in modular form, then attempt to integrate them in later chapters. The organization used in *Financial Management* gives students a better and more comprehensive understanding of how the topics interact with one another.
3. Students — even those who do not plan to major in finance — generally enjoy working with stock and bond valuation models, rates of return, and the like. Since people's ability to learn a subject is a function of their interest and motivation, and since *Financial Management* begins with a discussion of security prices and markets, the book's organization is sound from a pedagogic standpoint.

INTENDED MARKET AND USE

Financial Management is designed primarily for use as an introductory MBA text. However, it can be used as an undergraduate introductory text either with exceptionally good students or where the introductory course is taught over two terms. In the past, the book has also been used in the second corporate finance course, following the use of a lower-level book in the first course. *Financial Management* can still be used in this manner, but our more advanced book, *Intermediate Financial Management,* is generally preferable for the second corporate finance course.

There is too much material in the text to cover everything thoroughly in one term, and it is certainly not possible to go over everything in class. However, most students, and especially MBA students, can read on their own and understand reasonably well all but the most technical sections, so classroom coverage of everything is not necessary. In our introductory MBA course, we have taken two somewhat different approaches. At times, we have covered only the material in Chapters 1–15 plus Chapters 21 and 22, or 17 chapters in total. At other times, we have covered the entire text. Obviously, we cover things in greater depth when we assign less material, but in both situations, we expect students to learn much of the assigned materials by reading the book, and we concentrate on the more difficult concepts in class.

We have also made a special effort to make the text useful as a reference book. It is important that students have materials available for use in subsequent case courses and for on-the-job application after graduation. Based on reviewer comments, on a study of the leading casebooks, on our own experience in consulting assignments, on our work with executive development programs, and on discussions with numerous financial executives, we have tried to put into the book those materials that students will need to deal with most real-world financial decisions.

MAJOR CHANGES IN THE FIFTH EDITION

Based on student comments, on reviewers' suggestions, and on economic developments such as the recent change in tax laws, we have made a number of substantial changes in the fifth edition as summarized below:

Updates

We updated the entire book to reflect recent changes in tax laws, interest rates, financial markets, takeovers, and the like. The biggest update, by far, is in the tax area. This edition and all its ancillary materials incorporate fully the provisions of the Tax Reform Act of 1986, including (1) new personal and corporate rates, (2) elimination of the capital gains differential, (3) elimination of the investment tax credit, and (4) new depreciation rates. These changes have significant implications for dividend policy, capital structure policy, capital budgeting analysis, and lease analysis, and we have specifically addressed the impact of the new law in relevant chapters.

Size

Although we wanted the book to be useful as a reference source, the sheer bulk of the fourth edition intimidated many students. Thus, we have reduced the size of the book by more than 200 pages, primarily by streamlining some discussions and by eliminating certain technical materials not generally covered in most introductory courses, especially materials that are covered in advanced courses normally taken by finance majors. However, where we deleted material, we added references to journal articles and to other books, especially *Intermediate Financial Management.* Over the years, we added discussions of both interesting nuances and technical issues that are not of concern to most MBAs. To streamline the book, we deleted a number of these items, but we provided a reference to where they were covered in *Intermediate* for use by students who might be doing a special report on a given topic.

Introductory Examples

Each chapter begins with a real-world example that highlights the key issues in the chapter. These examples both motivate students to read the chapter and help them see where it is headed. The examples were updated to reflect current developments in finance.

Financial Calculators and Microcomputers

In the third edition, published in 1982, we took the traditional approach to time value of money — we used tables. In the fourth edition, we included footnotes to show how financial calculators could be used to solve most compound interest problems. Today, calculator costs have come down, and their power has gone up, to the point where a business student should purchase a financial calculator. Thus, in the fifth edition, we focus on calculator, rather than tabular, solutions. We still discuss the traditional approach, but primarily as an aid to understanding the mathematical concepts which underlie discounted cash flow analysis rather than as a way to actually solve problems.

Also, rapid advances in computer hardware and software are revolutionizing financial management. Powerful personal computers are now available to any business that can afford to hire a business student, and new software makes it easy to do things that were simply not feasible a few years ago. Today, a business that does not use microcomputers in its financial planning process is about as competitive as a student who tries to take a finance exam without a financial calculator. Therefore, wherever possible, we have included a discussion of how PCs are being used to help make better financial decisions. This orients students toward the kind of business environment they will face upon graduation.

Obviously, some students do not have access to a computer, so the text is written so that it can be covered without ever going near one. However, for those institutions whose students do have access to a PC and *Lotus 1-2-3®,* we have provided models for both selected end-of-chapter problems and for some cases, as discussed on the following pages.

Computer-Oriented Problems

Computer-oriented problems, along with models written in *Lotus 1-2-3,* were added to most chapters, and a diskette containing the models is available to adopting instructors. There are 35 of these problems, and they are identified by a diskette logo below the problem number. (For example, see Problem 2-5 on Page 52.) The computerized problems are designed to show students how computers and spreadsheet programs can assist in financial analyses, especially in the key areas of sensitivity and scenario analysis, which are used today in virtually all types of financial planning and decision processes. Essentially, very little knowledge of computers or of *Lotus 1-2-3* is required to use the models, but when students see how powerful these models can be, they are often motivated to learn more about *Lotus 1-2-3* and computer modeling in general. This is a great help — and rightly so — when students go into the job market.

Organization and Content

We made a number of changes in the organization and content of the book. The following are the most important ones:

1. Major works on asymmetric information and signaling theory have appeared in recent years. We have incorporated this material into relevant sections of the book, especially in the areas of capital structure and dividend policy.

2. Much current research is also being conducted on mergers, divestitures, and, more generally, the battle for corporate control. We have placed more emphasis on the research in this area, especially in the corporate restructuring chapter.

3. Our discussion of cash management has been updated to focus on current practices rather than decades-old academic models that have limited relevance to modern corporate decision making.

4. The bankruptcy material was condensed and placed as an appendix to the long-term debt chapter. In conjunction with this change, multiple discriminant analysis is now covered as an appendix to the financial analysis chapter.

5. International finance concepts have been integrated throughout the book in sections entitled "Multinational Finance."

6. The difference between accounting income and cash flows is now discussed earlier in the text (in Chapter 2) and given greater emphasis.

7. The concept of modified IRR (IRR*), which assumes reinvestment at the cost of capital out to a terminal date, was added to the discussion of capital budgeting decision rules.

8. Our coverage of risk analysis in capital budgeting was reformulated to emphasize the differences between a project's stand-alone, within-firm, and market risk.

9. The discussion of option pricing was expanded to include the binomial model.

10. Our coverage of working capital was condensed from four to three chapters.

11. Chapters 21 and 22 (Financial Statement Analysis and Financial Planning and Control) were modified to make it easier to cover them either late in the course, where they are used as a course capstone, or early in the course, where they can be used to introduce (or review) basic accounting concepts. The two orderings both work well, so instructors can choose the sequence which best fits their particular needs. We suggest covering Chapters 21 and 22 after Chapter 3 if cases that deal with financial analysis are to be used early in the course. Otherwise, students seem to get more out of this material toward the end of the course, when it can be used to tie earlier materials together.

ANCILLARY MATERIALS

The package of ancillary materials which accompanies *Financial Management* is perhaps the most complete available with any finance text. The following items are available free of charge to adopting instructors:

1. **Instructor's Manual.** A comprehensive, 400-page manual is available to instructors who adopt the book. The manual contains (1) a suggested course outline, (2) extensive lecture notes that focus on topics students find most difficult, (3) seven cases, one for each major section, with solutions, and (4) answers to all text questions and problems.

2. **Transparencies.** A set of transparency acetates, designed to highlight key materials in each chapter and keyed to the lecture notes in the *Instructor's Manual,* is available from The Dryden Press. In addition, the manual is designed to make it easy to xerox transparencies of end-of-chapter problem solutions.

3. **Cases.** The *Instructor's Manual* contains seven cases and solutions that can be used in the introductory MBA course. These cases are all modeled with *Lotus 1-2-3,* although they can be worked without a computer. They cover the following topics: (1) capital budgeting, (2) capital structure analysis, (3) bond refunding, (4) lease analysis, (5) cash budgeting, (6) financial analysis, and (7) financial forecasting.

4. **Problem Diskette.** This diskette contains the *Lotus 1-2-3* models that accompany selected end-of-chapter problems.

5. **Case Diskette.** This diskette contains the *1-2-3* models for the seven cases included in the *Instructor's Manual.*

6. **Test Bank.** A test bank with more than 600 class-tested questions and problems in objective format is available both in hardcopy form and on computer diskettes. The test bank questions are, in general, more challenging than those in most test banks, and they are well suited for exams. (Most other test banks are more suitable for quizzes than for midterm and final exams.)

A number of other items are available for purchase by students:

1. **Study Guide.** This supplement outlines the key sections of each chapter, gives some self-test questions for each chapter, and provides a set of solved problems similar to those in the test bank.

2. **Casebooks.** A tax update edition of *Cases in Managerial Finance,* Sixth Edition (Dryden Press, 1986), by Roy L. Crum and Eugene F. Brigham, is well suited

for use with this text. In addition, a collection of Harvard-type cases by Diana Harrington, *Case Studies in Financial Decision Making,* also coordinated with this text, is available (Dryden Press, 1985). Note that both of these casebooks have *Lotus 1-2-3* models available which can be used in conjunction with the cases.

3. Readings Books. A new readings book, *Issues and Readings in Managerial Finance,* Third Edition (Dryden Press, 1987), edited by Ramon E. Johnson, provides an excellent mix of theoretical and practical articles which can be used to supplement the text.

4. Computer Books. A new Dryden book, *Finance With Lotus 1-2-3: Text, Cases, and Models,* by Eugene F. Brigham and Dana Aberwald, is available to teach students how to use *Lotus 1-2-3* and to explain how commonly encountered problems in financial management can be analyzed using this powerful software. For individuals or schools that do not have access to *Lotus 1-2-3,* a powerful new Lotus workalike, *Joe Spreadsheet,* by Goldstein Software Inc., is available from Dryden.

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ERRORS IN THE TEXT

At this point in the preface, authors of most books say something like this: "We appreciate all the help we received from the people listed above, but any remaining errors are, of course, our own responsibility." And in many books there are plenty of remaining errors. Having experienced difficulties with errors ourselves, both as students and as instructors, we resolved to avoid this problem in *Financial Management.* As a result of the error detection procedures used, we are convinced that it is virtually free of mistakes.

Some of our colleagues suggested that if we are so confident about the book's accuracy, we should offer a reward to people who find errors. With this in mind, but primarily because we want to detect any remaining errors and correct them in subsequent printings, we hereby offer a reward of $7.50 per error (misspelled word, arithmetic mistake, and the like) to the first person who reports it to us. (Any error that has follow-through effects is counted as two errors only.) Two accounting students have set up a foolproof audit system to make sure we pay off. Accounting students tend to be skeptics!

CONCLUSION

Finance is, in a real sense, the cornerstone of the enterprise system, so good financial management is vitally important to the economic health of business firms, and hence to the nation and the world. Because of its importance, finance should be widely and thoroughly understood, but this is easier said than done. The field is relatively complex, and it is undergoing constant change in response to shifts in economic conditions. All of this makes finance stimulating and exciting, but also challenging and sometimes perplexing. We sincerely hope that *Financial Management* will meet its own challenge by contributing to a better understanding of the financial system.

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October 1987

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Contents in Brief

Part I Foundations of Financial Management *1*

Chapter 1 An Overview of Financial Management *3*
Chapter 2 Financial Statements, Taxes, and Cash Flows *27*
Chapter 3 Financial Markets, Institutions, and Interest Rates *55*

Part II Valuation and the Cost of Capital *87*

Chapter 4 Discounted Cash Flow Analysis *89*
Chapter 5 Valuation Models *125*
Chapter 6 Risk and Rates of Return *169*
Chapter 7 The Cost of Capital *219*

Part III Capital Budgeting *253*

Chapter 8 The Basics of Capital Budgeting *255*
Chapter 9 Cash Flow Estimation and Other Topics in Capital Budgeting *287*
Chapter 10 Risk Analysis and the Optimal Capital Budget *321*
Appendix 10A: Capital Rationing *361*

Part IV Capital Structure and Dividend Policy *367*

Chapter 11 Capital Structure Theory *369*
Chapter 12 Capital Structure Policy *407*
Chapter 13 Dividend Policy *457*

Part V Long-Term Financing Decisions *493*

Chapter 14 Common Stock, Preferred Stock, and the Investment Banking Process *495*
Chapter 15 Long-Term Debt *533*
Appendix 15A: Bankruptcy and Reorganization *565*
Appendix 15B: Refunding Operations *573*
Chapter 16 Lease Financing *581*
Chapter 17 Options, Warrants, Convertibles, and Futures *605*

Part VI **Working Capital Management** *641*

Chapter 18 Working Capital Policy and Financing *643*

Chapter 19 Accounts Receivable and Inventory *677*

Chapter 20 Cash and Marketable Securities *721*

Part VII **Financial Analysis and Planning** *755*

Chapter 21 Financial Statement Analysis *757*

Appendix 21A: Multiple Discriminant Analysis *800*

Chapter 22 Financial Planning and Control *807*

Chapter 23 Corporate Restructuring: Mergers, Divestitures, and Holding Companies *841*

Appendix A Mathematical Tables *871*

Appendix B Solutions to Selected End-of-Chapter Problems *881*

Contents

Part I **Foundations of Financial Management** *1*

Chapter 1 **An Overview of Financial Management** *3*

Increasing Importance of Financial Management *5* Alternative Forms of Business Organization *7* The Place of Finance in a Business Organization *10* The Goals of the Firm *11* Agency Relationships *13* Managerial Actions to Maximize Stockholder Wealth *18* The Economic Environment *20* Organization of the Book *20* Summary *21* Multinational Finance *22*

Chapter 2 **Financial Statements, Taxes, and Cash Flows** *27*

Financial Statements and Securities *28* The Federal Income Tax System *31* Depreciation *40* Cash Flow Versus Accounting Income *44* Effects of Depreciation Methods on Taxes, Net Income, and Cash Flows *45* Summary *49*

Chapter 3 **Financial Markets, Institutions, and Interest Rates** *55*

The Financial Markets *56* Financial Institutions *57* The Stock Market *61* The Cost of Money *63* Interest Rate Levels *65* The Determinants of Market Interest Rates *68* The Term Structure of Interest Rates *72* Other Factors That Influence Interest Rate Levels *76* Interest Rate Levels and Stock Prices *78* Interest Rates and Business Decisions *78* Summary *80*

Part II **Valuation and the Cost of Capital** *87*

Chapter 4 **Discounted Cash Flow Analysis** *89*

Future Value *90* Present Value *94* Future Value Versus Present Value *95* Future Value of an Annuity *96* Present Value of an Annuity *99* Perpetuities *102* Uneven Payment Streams *103* Determining Interest Rates *104* Semiannual and Other Compounding Periods *106* Continuous Compounding and Discounting *109* Amortized Loans *110* Summary *112*

Chapter 5 **Valuation Models** *125*

Bond Values *126* Preferred Stock Valuation *140* Common Stock Valuation *141* Summary *157*

Chapter 6 **Risk and Rates of Return** *169*

Defining and Measuring Risk *170* Expected Rate of Return *172* Portfolio Risk and the Capital Asset Pricing Model *180* The Relationship Between Risk and Rates of Return *194* Security Market Equilibrium *200* Physical Assets Versus Securities *204* A Word of Caution *205* Arbitrage Pricing Theory *205* Summary *207* Multinational Finance *208*

Chapter 7 **The Cost of Capital** *219*

Capital Components and Costs *220* Cost of Debt *221* Cost of Preferred Stock *222* Cost of Common Equity *223* Cost of Retained Earnings *224* The CAPM Approach *224* The DCF Approach *229* Bond Yield Plus Risk Premium Approach *231* Comparison of the CAPM, DCF, and Risk Premium Methods *232* Cost of Newly Issued Common Equity *233* Weighted Average Cost of Capital *235* The Cost of Depreciation-Generated Funds *241* Summary *242*

Part III **Capital Budgeting** ***253***

Chapter 8 **The Basics of Capital Budgeting** *255*

Project Proposals and Classifications *256* Similarities Between Capital Budgeting and Security Valuation *258* Capital Budgeting Decision Rules *259* Evaluation of the Decision Rules *266* Comparison of the NPV and IRR Methods *266* The Reinvestment Rate (Opportunity Cost) Assumption *270* Modified Internal Rate of Return (IRR*) *272* Comparison of the NPV and PI Methods *274* Present Value of Future Costs *274* Multiple IRRs *275* The Post-Audit *277* Summary *278*

Chapter 9 **Cash Flow Estimation and Other Topics in Capital Budgeting** *287*

Cash Flow Estimation *288* Identifying the Relevant Cash Flows *289* Tax Effects *292* Salvage Value *292* Investment in Net Working Capital *293* An Example of Cash Flow Estimation *293* Replacement Analysis *299* Evaluating Projects with Unequal Lives *302* Abandonment Value *305* Adjusting for Inflation *307* Summary *310*

Chapter 10 **Risk Analysis and the Optimal Capital Budget** *321*

Introduction to Risk Assessment *322* Techniques for Measuring Stand-Alone Risk *323* The Impact of Abandonment on NPV and Project Risk *333* Market Risk *335* Techniques for Measuring Market Risk *337* Problems with Project Risk Assessment *338* Incorporating Project Risk and Capital Structure into Capital Budgeting Decisions *339* Risky Cash Outflows *340* The Optimal Capital Budget *343* Capital Rationing *348* Establishing the Optimal Capital Budget in Practice *348* Summary *349* Multinational Finance *350* **10A:** Capital Rationing *361*

Part IV **Capital Structure and Dividend Policy** ***367***

Chapter 11 **Capital Structure Theory** *369*

Key Terms and Equations *370* Early Theories of Capital Structure *373* The Modigliani-Miller Models *375* The Miller Model *382* Financial Distress and Agency Costs *386* Review of the Tradeoff Models *391* Asymmetric Information Theory *392* Our View of Capital Structure Theory *396* Summary *398*

Chapter 12 **Capital Structure Policy** *407*

Business and Financial Risk: Total Risk Perspective *408* Business and Financial Risk: Market Risk Perspective *417* Estimating the Target Capital