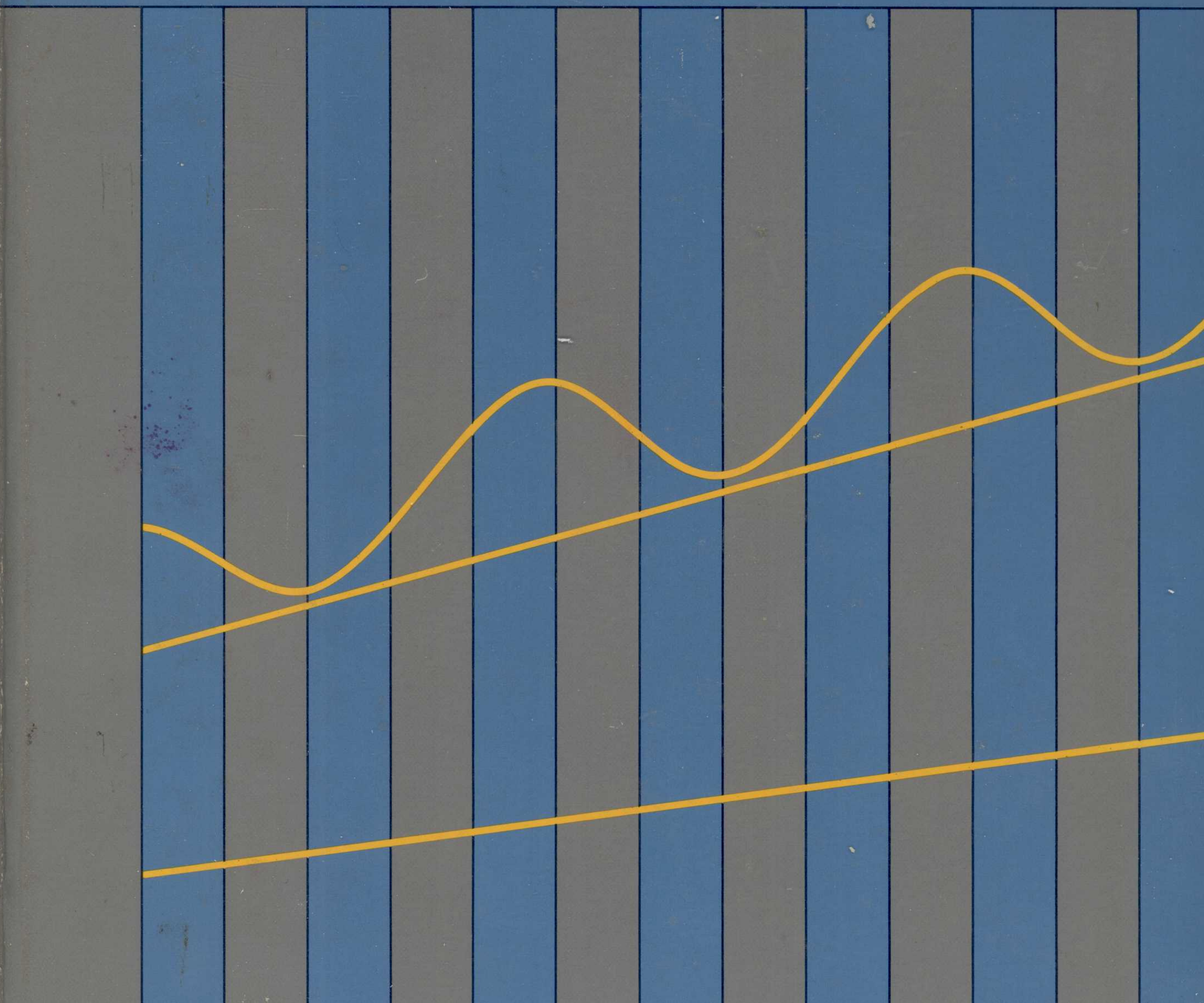
Financial Management
Theory and Practice

Fourth Edition

Eugene F. Brigham



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Fourth Edition

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Preface

Financial management has changed greatly in recent years Strong inflationary pressures have pushed interest rates to unprecedented heights, and the resulting high and volatile cost of capital has led to profound changes in corporate financial policies and practices. Academic researchers have made a number of significant theoretical advances. At the same time, business practitioners are making 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 increasingly and effectively to analyze financial decisions. This usage has made it more important than ever that financial problems be set up in a form suitable for quantitative analysis. To a large extent, these trends have dictated the revisions made in the fourth edition of *Financial Management Theory and Practice.*

The book begins with basic concepts, focusing on security markets and the valuation process, and then goes on to show how the principles of financial management 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, gives students a basic appreciation of how financial management can affect the value of the firm. Also, this organization gives students an early familiarity with the time value of money, valuation, and risk analysis, which in turn permits us to use and reinforce these key concepts throughout the book.
2. Structuring the book around market 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

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3. Students—even those who do not plan to major in finance—generally find the study of investments interesting. They enjoy working with stock and bond values, rates of return, and the like. Because people's ability to learn a subject is a function of their interest and motivation, and because *Financial Management* begins with a discussion of security prices and markets, the book's organization is good from a pedagogic standpoint.

Intended Market and Use

Financial Management is designed primarily for use as an introductory MBA text, although 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 undergraduate corporate finance course, following the use of an easier book in the first course. *Financial Management* can still be used in this manner, but our new book, *Intermediate Financial Management*, is preferable for the second undergraduate 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, we have tried to write the book in a manner that permits students, especially MBAs, to read on their own and understand those parts that are not covered in class. 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 18–23, or 21 chapters in total. At other times, we have covered the entire text. Obviously, the depth of coverage is less when we cover more material, but in both situations, we expect students to learn most of the assigned materials by reading the book, and we concentrate on the more difficult materials 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 that they can use in subsequent case courses and apply in on-the-job situations after graduation. Based on a study of the leading casebooks, plus our own experience in consulting assignments, in work with executive development programs, and in discussions with numerous financial executives, we have tried to put into the book what students need to know to deal with most real-world financial decisions.

Major Changes in the Fourth Edition

Updates. We updated the entire book to reflect recent changes in tax laws, interest rates, bankruptcy proceedings, takeovers, and the like. The biggest update, by far, is in the tax area, especially depreciation allowances. We changed most examples and end-of-chapter problems to reflect ACRS depreciation schedules.

Introductory Examples. A real-world example that highlights the key issues in each chapter is presented at the beginning of the chapter. These examples both motivate students to read the chapters and help them see, as they go through each of the chapters, where we are headed.

End-of-Chapter Problems. Most end-of-chapter problems have been revised and extended. Also, the first question at the end of each chapter now lists the key terms in the chapter This serves both as a quick self-test for students and as a speedy summary/review of the chapter's basic coverage. Further, a set of fairly difficult self-test problems, with detailed solutions, is given at the end of the more quantitative chapters. These problems serve (1) to test students' ability to set up problems for solution and (2) to explain the solution setup for those who need help.

Level. Both the breadth and depth of coverage have been extended. Therefore, the fourth edition of *Financial Management (FM)* is a somewhat "higher level" book than the third edition. However, because of our efforts to clarify our explanations of the more difficult concepts, the fourth edition is not necessarily more difficult than the previous one.

If you felt that the last edition of *FM* was challenging enough for your students and are concerned that this new, more rigorous edition may be too difficult, we urge you to consider using the third edition of *Fundamentals of Financial Management* (1983, Dryden Press). *Fundamentals* is close in level to the basic chapters in the third edition of *FM*, but quite a bit easier than the fourth edition. One of the reasons for *FM*'s revision was to differentiate it further from *Fundamentals,* so that they present clear alternatives

Organization. We made some significant changes in the organization of the book to improve its flow Here is the new structure:

I. **Introduction.** The introduction, which was expanded from two to three chapters, now includes a discussion of agency theory, as well as more material on types of securities, capital markets, and the economic environment. The new materials on securities and security price changes over time in Chapters 2 and 3 provide a better lead-in to the valuation and risk chapters that follow.
II. **Valuation and the Cost of Capital.** This section contains four chapters which progress from time value, to valuation models, to risk/return relationships, to the cost of capital. The major change here is the shift in the cost of capital chapter from Chapter 15 to Chapter 7.
III. **Capital Budgeting.** This important subject is expanded from two to three chapters. Also, having covered cost of capital earlier in the book, we now discuss the effects of capital budgeting on the

cost of capital in the capital budgeting section. Note also that microcomputer models are introduced in an appendix in this section

IV. **Capital Structure and Dividend Policy.** Here we discuss strategic policy decisions regarding how the firm is to be financed. We stress how the target capital structure and the target dividend payout ratio are established.

V. **Types of Long-Term Capital.** Part V moves on from strategic long-term financing policies to implementation. Investment banking, common and preferred stock, long-term debt, leasing, and options-related securities, including a discussion of the Black-Scholes model, are presented in this section. Because these chapters now follow cost of capital and capital structure, their level has been raised somewhat.

VI. **Working Capital Management.** This material has been moved from Chapters 8–10 to Chapters 18–21. The new placement greatly improves the flow of the book by permitting us to complete our strategic, long-run analysis before moving into tactical, operational decision analysis, which is what working capital management is all about. Note also that this section has been expanded from three to four chapters, and greater emphasis is now given to overall working capital policy

VII. **Financial Analysis and Planning.** In the last edition, this material was presented in Chapters 6 and 7. However, such early placement made it difficult for students to appreciate why ratios were targeted at specific levels, and to understand the intricacies of financial planning. With the topics' new placement, following all the asset and liability management chapters, students can better understand the logic of ratio analysis and grasp the forecasting/planning models. Also, by placing planning and analysis later in the book, we can use it to tie together earlier parts of the course.

VIII. **Special Topics.** Mergers, bankruptcy/reorganizations, multinational finance, and pension fund management are presented in this section. Executive reviewers of the third edition of *Financial Management* suggested that the most glaring omission was a chapter on pension fund management, which today has become one of the most critical areas of financial management. We rectified that and also greatly strengthened the other chapters in this section.

Financial Calculators and Microcomputers. In the third edition, we offered only the traditional approach to time value of money. In this edition, we have expanded that discussion to show how financial calculators can be used to solve most compound interest 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 programs make it easy to do things that were 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 examples of how computers can be used to help make better financial decisions. This orients students toward the kind of business environment they will face upon graduation; moreover, students can often understand the underlying financial theory better after working through a computer model of the problem than they could using the older methods.

Obviously, everyone does not have access to a personal computer or a mainframe terminal; therefore, (1) the text is written so that it requires no computer orientation whatever, and (2) it does not include any problems that require computer solutions. However, we do provide an appendix which introduces electronic spreadsheets (*VisiCalc* and *Lotus 1-2-3*) Additionally, we include both spreadsheet and *IFPS* models in the Instructor's Manual, along with diskettes, on the following subjects: (1) capital budgeting, (2) capital structure, (3) debt refunding, (4) leasing, (5) cash budgeting, and (6) financial forecasting/analysis.

Ancillary Materials

The package of ancillary materials which accompanies *Financial Management* is the most complete one available with any finance text. The additional items available to aid both students and instructors include the following:

1. **Study Guide.** This supplement outlines the key sections of the text, gives some self-test questions for each chapter, and provides a set of solved problems similar to those in the text. The Study Guide for the third edition was designed for use with both *FM* and *Fundamentals*. The new one is designed specifically for *FM*

2. **Casebooks.** A revised edition of *Cases in Managerial Finance,* fifth edition (1983, Dryden Press), by Eugene F. Brigham and Roy L. Crum, is well suited for use with this text. In addition, a new collection of Harvard-type cases by Diana Harrington, *Case Studies in Financial Decision Making,* also coordinated with this text, is available from The Dryden Press.

3. **Readings Books.** A number of readings books, including *Issues in Managerial Finance*, second edition (1980, Dryden Press), edited by Eugene F. Brigham and Ramon E. Johnson, can be used as supplements to *FM*.

4. **Test Bank.** A Test Bank with more than 600 class-tested questions/problems in objective format is now available both in book form and on computer diskettes (Apple II and IBM PC). The Computerized Test Bank is also available on magnetic tape. The Test Bank questions are, in gen-

eral, 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.)

5. **Transparencies.** A comprehensive set of acetate transparencies, designed to highlight key materials in each chapter and keyed to extensive lecture notes in the Instructor's Manual, is available from The Dryden Press to instructors who adopt the text.

6. **Instructor's Manual.** A complete, 300-page manual is available to instructors who adopt the book. The manual contains (1) answers to all text questions, (2) solutions to all text problems, (3) extensive lecture notes that focus on more difficult topics and are keyed to the transparency acetates, and (4) several write-ups of personal computer solutions (or "template models") to key financial problems in a form suitable for reproduction.

7. **Diskette with Models.** A diskette with actual programs for computer solutions is available to instructors These models work with *VisiCalc*, *Lotus 1-2-3*, and *IFPS/Personal*, and they correspond to the text examples and appendices provided in the Instructor's Manual.

8. **Financial Management with *Lotus 1-2-3* (CBS College Publishing).** The *Lotus 1-2-3* spreadsheet program is currently the best-selling financial analysis package available for use with personal computers. Paul D. Cretien, Susan E Ball, and Eugene F. Brigham are writing a supplemental book that explains how many commonly encountered problems in financial management can be analyzed with electronic spreadsheets. The supplement will also provide a series of "template models" that address most types of decision areas in finance.

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We would like to thank the 14 professors who reviewed the third edition of *FM* and who provided us with detailed comments and suggestions for this revision: Keith Boles, Severin Carlson, William Damon, Sankar De, Samuel Hadaway, Joseph Kiernan, Joan Lamm, Edward Lawrence, D. J. Masson, John Settle, Stephen Smith, Sue Visscher, Jonathan Welch, and Dennis Zocco. In addition, we appreciate the marketing feedback on the draft manuscript provided by Roger Miller, William Nelson, and Jaye Smith A great many people helped with the book during its first three editions, and we would like to thank them here:

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Last, but certainly not least, we owe a special debt to Fred Weston, both for teaching us much of what we know about finance and for permitting us to draw from our coauthored texts.

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 in order to correct them in subsequent printings, we hereby offer a reward of $5 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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