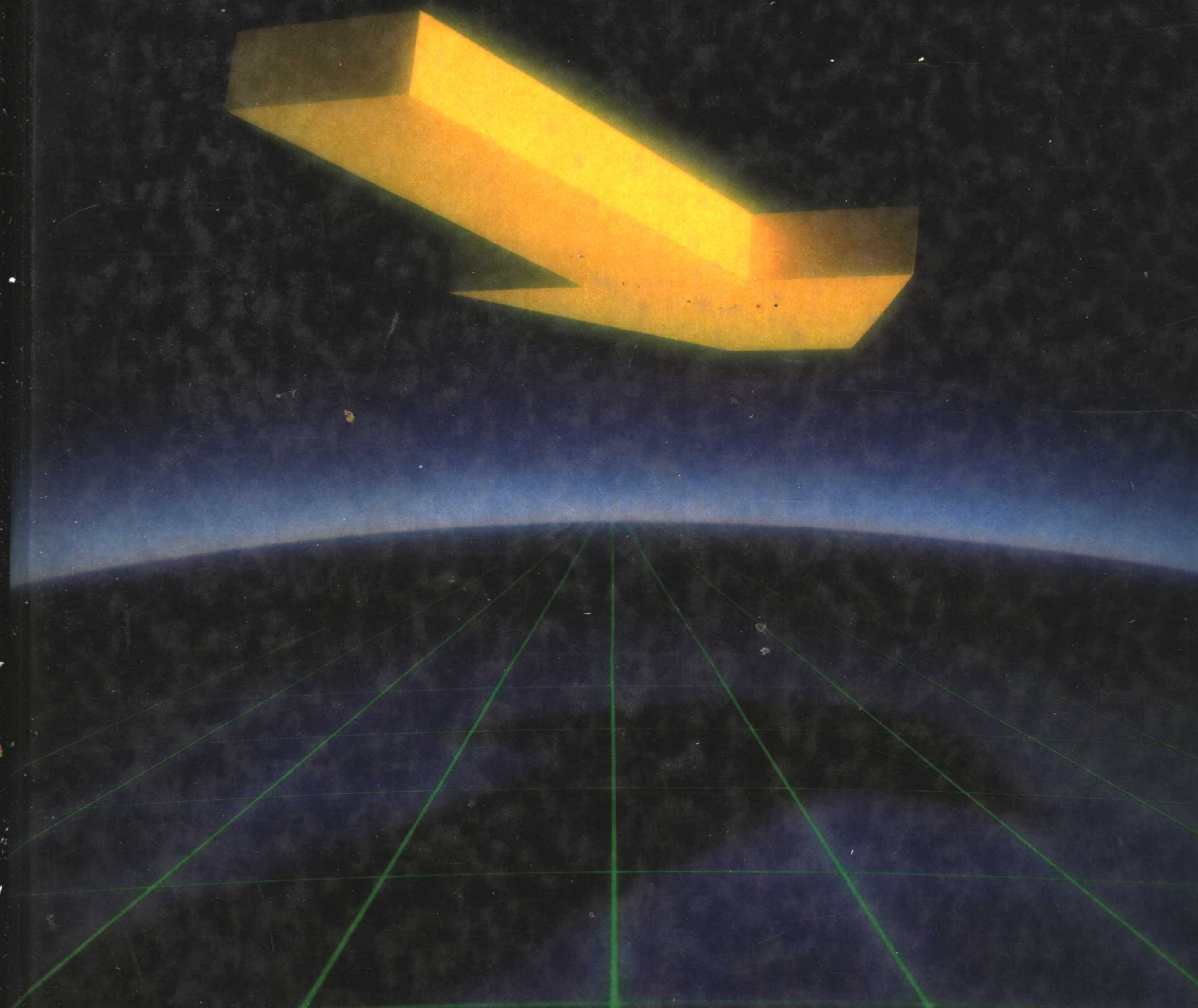
Second Edition

PRINCIPLES OF FINANCIAL MANAGEMENT



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PRINCIPLES OF FINANCIAL MANAGEMENT

Second Edition

by

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Preface

Principles of Financial Management is intended primarily for the introductory undergraduate core course in business finance (financial management or corporate finance). While it provides a sound base for advanced study of finance, this text is relevant to all students of business administration. *Principles of Financial Management* also may be used in MBA programs, for students whose undergraduate work did not include a finance course, or in conjunction with case-method instruction. Although the text easily can be understood without formal prerequisite instruction, a course in financial accounting is a highly desirable preparation.

Principles of Financial Management is designed to provide an understanding of the financial considerations, analyses, and decisions pertinent to management of a business firm. Since financial management is inseparably related to the other areas of business management and not an isolated function, we emphasize such interrelationships throughout. The general philosophy of the text is pragmatic and practical. Substantial examination of financial theory is incorporated, but abstractions are limited and practical application of theory to managerial problems is emphasized.

Our goal is to present the concepts, theories, analytical tools, and techniques of financial management in a clear and understandable fashion. The writing style emphasizes readability, but never at the sacrifice of factual soundness. Great care is exercised to define key terms, spell out the logic of each model, and walk the reader through realistic examples illustrating the use of each model or analytical tool.

CHANGES IN THE SECOND EDITION

The second edition of *Principles of Financial Management* is far more than just a routine updating. We consider it something between a major revision and a new textbook. There are two reasons for the magnitude of the change. First is the contribution of coauthor Richard F. DeMong, of the University of Virginia; he strengthens the knowledge base, particularly in financial markets, risk, return, and valuation. Second, most introductory business finance courses have shifted from a balance-sheet format to a valuation format. Thus the second edition of *Principles of Financial Management* establishes valuation concepts relatively early, followed immediately by the long-term topics, capital investment decisions, capital structure, and dividend policy.

The sequence of topics in the second edition has significant advantages. Part 1, Financial Management and Its Environment, covers the necessary background material during the early sessions of the class. Chapter 3 is new. It introduces the financial markets and the factors that influence interest rates and securities prices—material students need to understand how markets value a firm's securities. Part 2 deals with accounting-based financial analysis, beginning the students' analytical work on the familiar ground of the usual prerequisite accounting course. This bridges the gap between accounting and finance and provides a sound grasp of financial analysis and planning.

Part 3, Fundamental Financial Management Concepts, provides the core of the valuation approach. The time value of money, formerly treated in Chapter 11, has been advanced to Chapter 7 and considerably expanded. Chapters 8 and 9 are new to this edition, bringing together at this relatively early stage material on risk, return, and valuation that had been scattered about several later parts of the first edition. Capital investment decisions and cost of capital (Part 4), and capital structure and dividend policy (Part 5) now immediately follow risk, return, and valuation, and thus provide immediate practical application of these fundamental concepts.

Working capital management now falls later in the text (Part 7) but the thorough treatment of this subject is not diminished. We consider working capital very important, for two reasons: (1) a large portion of financial management activity is devoted to controlling and financing it, and (2) many graduates find their first jobs in this area, either in credit management or in banks and other institutions that provide short-term financing.

Tax Law Revision

The most sweeping overhaul of the federal income tax code since its inception in 1914 was brought about by the Tax Reform Act of 1986. This law, fully effective in 1988, has a profound impact on financial analysis and decision making. The portion of Chapter 2 dealing with the tax environment has been completely revised to take into account the major changes that affect financial management: individual and corporate tax rates, the greatly modified accelerated cost recovery system (modified ACRS), changed treatement of capital gains, elimination of investment tax credits, limited deductions, and changed minimum tax provisions. Also, appropriate examples and end-of-chapter problems throughout the text have been revised to correspond with the new law as it applies in 1988.

Other Changes

All chapters in *Principles of Financial Management* have been updated to reflect changes in financial market conditions, laws, interest rates, and other institutional and environmental developments. Portions of the first edition that were retained have been polished to improve exposition and to incorporate helpful suggestions from users, both professors and students.

In addition to the major organizational changes already mentioned, specific changes include:

1. Chapter 1 has been condensed, and the section dealing with the firm's goal has been clarified.
2. Chapter 3 of the first edition, Operating and Financial Overview, has been eliminated. Some of the margin and turnover analysis is now included in Chapter 5, Financial Statement Analysis, and all material dealing with operating and financial leverage is now brought together in Chapter 13, Business and Financial Risk.
3. Part 2 begins with the new Chapter 4, a review of financial statements. It is included primarily for those students who require a brief review, and may be omitted by students with strong accounting backgrounds.
4. Treatment of ratio analysis in Chapter 5 has been condensed and a complete summary table showing the formula and calculation of each ratio has been added.
5. Both short-term and long-term (strategic) planning are now treated in Chapter 6.
6. Treatment of the time value of money in Chapter 7 has been expanded to include additional material on future value; loan amortization and accumulation of a future sum are illustrated. Appendix tables now include future value interest factors of a sum (FVIF) and future value interest factors of an annuity (FVIFA), as well as present value tables.
7. The new Chapter 8, Risk and Return, discusses the nature and types of risk, the relationship between risk and required return, probability distribution analysis, portfolio theory, the capital asset pricing model (CAPM), and beta as a measure of risk of an asset in a portfolio context.
8. The new Chapter 9, Valuation, introduces the general equilibrium valuation model, bond valuation and yield to maturity, preferred stock valuation, and common stock valuation, both under various future dividend valuation models and under the CAPM.
9. The new Chapter 11, in Part 3, Capital Investment Decisions, combines material from two earlier chapters: one on estimating relevant cash flows, and one treating risk differentials and strategic considerations. We have added sections on sensitivity analysis, computer simulation, and limited use of the CAPM in measuring project risk. The certainty equivalent method of incorporating project risk into capital investment decision making has been moved to a Chapter 11 appendix.
10. Valuation of bonds, preferred stock, and common stock, thoroughly discussed in the new Chapter 9, now forms the basis for determining the cost of each in Chapter 12. This enhances the clarity of Chapter 12. The section dealing with the weighted marginal cost of capital also has been expanded.

11. Part 5 of the first edition has been reorganized. A new chapter (Chapter 13) treats in depth the concepts of business and financial risk and related analysis of operating and financial leverage. Chapter 14 then introduces modern capital structure theory and examines the practical aspects of capital structure decision making. This is followed by the repositioned Chapter 15, on dividend policy and retained earnings. The result is both a more cohesive treatment of capital structure theory and policy and a more logical tie-in of dividend policy and capital structure.
12. The new Part 6, Sources of Long-Term Financing, begins with the repositioned and somewhat condensed Chapter 16 on raising funds in the capital markets. The two chapters of the first edition that dealt with long-term debt and leasing have been contracted and combined into Chapter 17. Coverage of long-term debt instruments now includes unconventional bonds, such as deep discount, zero coupon, and floating rate bonds, as well as conventional bonds and term loans. A section on pure options has been added to Chapter 19, Convertible Securities and Warrants.
13. In Part 7, Working Capital Management, treatment of inventory management has been modified: description of computerized inventory control systems is expanded, and methods of inventory control now include the ABC system, out-sourcing, and the just-in-time system, as well as the traditional EOQ approach. Management of accounts receivable and inventory now precedes cash management, so that cash management can draw on the inventory control model.
14. Discussion of short-term financing has been reduced from two chapters to one, largely by condensing the materials dealing with spontaneous credit and secured loan arrangements.
15. In Chapter 24, Mergers and Acquisitions, discussion of techniques used to prevent hostile takeovers has been expanded and leveraged buyouts has been added.
16. The use of newly developed instruments to hedge foreign exchange risk, including currency futures, currency options and futures options, has been added to Chapter 26, International Financial Management.

KEY FEATURES

The strongest pedagogical feature a basic textbook can provide is clear, correct, and readily understood presentation of the concepts, theories, analytical tools and techniques of the field. We believe that users—both professors and students—will find this true for *Principles of Financial Management.* We do not believe that a text should be cluttered with frequent "pedagogical aids," often superfluous and distracting.

We have included useful features that will help students to learn and professors to teach:

1. **Key Terms.** Each key term is printed in **boldface** and defined when it is first introduced. At the end of each chapter, the key terms are listed so the student can self-check understanding. All key terms plus other terms used in the text are defined in the glossary.

2. **Examples.** Each concept, model, or analytical tool is immediately followed by one or more examples illustrating its use.

3. **Questions.** End-of-chapter questions help discussion, review, and reinforcement of subject matter.

4. **Problems.** End-of-chapter problems are in two groups, Series A and Series B. This arrangement facilitates assignment of problems for alternate terms or semesters. The total number of problems has been increased.

5. **Flexible Sequence.** Although we recommend that the text be read in sequence, almost any part, and some chapters, may be repositioned without disturbing continuity. For example, professors wishing to treat working capital management earlier in the course may shift Part 7 to follow Part 2, and the dividend policy chapter may be moved to several possible positions. Most one-term or one-semester courses will not include all chapters: they might conclude anywhere from the end of Part 5 to the end of Part 7.

SUPPLEMENTARY AIDS

A number of supplementary materials are available to aid students and professors.

1. **Study Guide.** An excellent study guide by Duncan J. Kretovich and Susan E. Moeller of Northeastern University is available. It includes discussion of each chapter, practice problems and questions, and minicases.

2. **Instructor's Manual.** An instructor's manual, prepared by the text authors, includes teaching notes for each chapter, complete answers to chapter-end questions, and fully developed solutions to all problems. In addition, we provided handout masters of solutions to selected end-of-chapter problems for distribution at the instructor's discretion, present value tables for use in examinations, and transparency masters of key illustrations.

3. **Transparencies Kit.** A comprehensive set of transparency acetates for overhead projection of all key illustrations is available to adopting instructors.

4. **Test Bank.** A test bank of more than 1,000 objective questions classified by type and degree of difficulty is available to instructors in printed form, on our computer diskette, "Computest II," and "Teletest."

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NOTE TO THE STUDENT

Financial management should be studied with a pencil in one hand and the text in the other. Just reading the text is not enough. As each concept, analytical tool, or technique is explained, carefully follow the example and "put the pencil to it" to make sure you understand the material. Then, solve the appropriate end-of-chapter problems to reinforce what you have learned. Practice makes perfect. The *Study Guide* for *Principles of Financial Management* gives you additional problems, exercises, and study material and will help you learn finance.

It is particularly important that you master the fundamental financial management concepts in Part 3—time value of money, risk, return, and valuation—because much of the rest of the text will employ and expand on these concepts.

Financial management is relevant to almost all business managers and relates to all activities of a business organization. We believe your study of financial management will contribute significantly to your education and your subsequent career. Good luck!

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Richard F. DeMong

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PART 1

Financial Management and Its Environment