BASIC FINANCIAL MANAGEMENT

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FIFTH EDITION

5th Edition

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The fifth edition of
Basic Financial Management
is dedicated to
Sally, Donna, Barbara, and Peggy

PREFACE

Historical circumstances are a driving force underlying the development and practice of financial management. For example, in the 1970s volatile energy prices, interest rates, and exchange rates dominated both the financial press and the economic environment within which financial decisions were made. These factors led to the development of new commodity and financial futures markets in which firms could hedge their risk exposure and speculate on the directions of anticipated price movements. Similarly, in the 1980s corporate control contests have resulted in the restructuring of corporate America. This unprecedented wave of transactions has included corporate divestitures, leveraged buyouts, joint ventures, spin-offs, split-ups, employee stock option plans (ESOPs), partial public offerings, project financings, and a host of other types of transactions which have filled the financial press during the 1980s.

Some have characterized this latest wave of corporate control contests simply as evidence of the continual tug-of-war between the capital market and corporate managments for control over financial resources. If this be true, then it would appear that the 1980s have been a time of unprecedented victory for the capital markets. Many of the largest corporations have fallen victim to the "bust-up merger" as they have been bought up and their assets sold to the highest bidder. This, in turn, means that the investment and financing decisions of even the very largest firms are subject to an unprecedented level of scrutiny by the capital markets.

Some practicing financial managers have cried foul, saying that investors in the capital markets are too short-term oriented or myopic. This, they argue, has placed undue pressure on the corporate manager to produce short-term profits to the exclusion of making long-term commitments. The evidence from the academic community, however, has not supported this contention. Furthermore, as the pressures of international competition continue unabated, serious consideration must be given to the impact the capital markets have on the firm's competitiveness in world markets through its influence on the firm's investment and financing choices. Consequently, it is our belief that the events of the 1980s have *heightened* the importance of corporate finance in the overall formula for corporate competitiveness and success.

In this text we have endeavored to provide the introduction to financial decision making, which is rooted in both the current state of our understanding of financial theory and in current world economic conditions. This focus is evident in a number of ways in the fifth edition of *Basic Financial Management*. The most obvious is the rearrangement of the chapter sequence, which is designed to place an increased prominence on the capital market's influence on corporate financial decisions. We have moved our discussion of the concepts of valuation and the related notion of opportunity costs forward in the text presentation. We would hasten to add that we have not eliminated any of our previous discussions of managerial issues such as short-term forecasting, planning, and budgeting. The new chapter sequence is consistent with what we feel to be the increasingly more prominent role of the capital markets in the making of corporate financial decisions.

Pedagogy and Target Audience

Basic Financial Management provides the reader with an overview of financial management as intended for an introductory course in the subject. Such a course might be taught in one semester or two quarters. The orientation continues to be managerial with an emphasis on the identification and solution of the financial problems confronting the business enterprise. Decision making within an enterprise valuation framework is stressed throughout the text, and thereby, provides a unifying theme across all discussions. In the preparation of the manuscript, three primary standards were used. First, we have made a strong effort to offer *completeness* in the treatment of each topic. Second, we have given *readability* a high priority. We have taken extra care to use a clear and concise writing style, especially in the treatment of concepts requiring the use of mathematics. Third, complete, *step-by-step* examples are frequently used to increase clarity and to crystallize the critical issues in the student's mind. In summary, the pedagogical approach taken, particularly for the more difficult topics, progresses from an intuitive presentation of the problem to the introduction and illustration of the appropriate decision-making framework.

The Fifth Edition

A number of other changes have been made in the fifth edition. In addition to the revised chapter sequence, whereby valuation and related concepts are moved up, thereby placing emphasis on the role of the capital markets in corporate financial decision making, we have also made a number of significant changes throughout the text which might not be so obvious.

1. We have worked to add life to the presentations by increasing the number of *Basic Financial Management in Practice* inserts. Because these practical application inserts proved to be a very popular feature of the fourth edition, we have expanded them in this edition.
2. A new feature, which we refer to as *Readings in Financial Managment*, has been added. In these readings we provide more in-depth discussion of key topics. We have sampled readings from a wide range of academic and popular press sources with an eye toward bringing the subject matter to life.
3. Also, given the continued ethical questions being addressed in the press, we have, on several occasions, offered the student value orientations we believe will be helpful. The basic notion of what constitutes ethical behavior is not clear-cut. However, we have tried to provide some definitions, which will provide a fundamental starting point for considering the issues as they relate to financial decision making.

We believe these additions will add value to the students' learning and reduce the chance that the student will perceive the presentation as sterile.

Significant changes have also been made in the individual chapters. The following list includes ten major additions that are new to *Basic Financial Management* in the fifth edition:

1. Chapter 1 incorporates consideration for business ethics through the use of an article by Milton Friedman. In addition, we discuss stockholder–manager conflicts and arbitrage in an efficient market.
2. In Chapter 2, we have added an introductory section on the capital markets. This material provides background information needed to help

the student better understand the valuation process used throughout the text. Also, we updated the section on taxes to reflect the most current tax provisions at the time of the revision. Here we also added an international dimension by comparing some of the basic differences in taxes across foreign borders. Lastly, we developed a more complete introduction into the legal forms of organization by providing an overview of the significance of the respective forms before evaluating each type of organization.

3. In Chapter 4, when dealing with systematic risk and beta, we thought the student's understanding would be improved by observing firsthand, through an example, how beta is actually computed. Also, given the importance of the growth factor in valuing common stock, we expanded the explanation of what is meant by the term "growth" in a valuation context. Finally, we added a section to clarify the relationship between value and earnings, which is often times misunderstood.
4. The introduction to capital budgeting found in Chapter 5 has been expanded to include a new section titled "Competitive Markets and Profitable Projects—Where Do Profitable Projects Exist in Competitive Markets?" In addition, we have incorporated a number of readings which enhance the realism of the treatment of the capital-budgeting decision. Finally, we include a brief case-study reading of the ethical issues that arose out of Beech-Nut's selling sugar water for apple juice.
5. In Chapter 6 we have added a section which discusses the alternative methods that can be used to estimate a project's systematic risk. We discuss the use of accounting data as well as the proxy or pure play method.
6. In Chapter 7 the presentation of the weighted cost of capital has been simplified so that the student is not required to spend an inordinate amount of time on computational detail. Also, a major section has been incorporated into the chapter to develop the concept of the required rate of return for individual projects, as opposed to a company-wide cost of capital.
7. In coming to understand the importance or relevance of a firm's dividend policy in Chapter 10, we are required to look carefully at the empirical evidence available to us. In this edition, we have expanded this evidence to include both (1) surveys of management opinions about dividend policy, and (2) the latest empirics regarding the link between stock price and dividend policy.
8. We updated the discussion of the capital markets in Chapter 19 to include discussions of junk bonds, Eurobonds, and dual-class recapitalizations.
9. In Chapter 21 we look at the restructuring of firms, which has become a predominant issue in the media. To bring the chapter up to date, we have added a section on why mergers and acquisitions might create value, an important question with no easy answer for those managers contemplating such a decision. We also look at the more recent approaches used in valuing a firm, which include what we refer to as the *chop-shop* approach and the free-cash flow valuation model.
10. We made two major revisions in Chapter 24. A section was added on the relevance of capital budgeting techniques for the owner-manager of the small firm. Small firms have been criticized for not joining the bandwagon of the discounted cash flow models. Maybe there is a rationale for such actions on the part of the small-firm managements. This issue is now addressed in the chapter. Second, the discussion of the valuation of the small firm, whose stock is not publicly traded, was expanded. This latter topic is of considerable interest to small-firm owners.

This list does not completely describe even the major changes made to the fifth edition. However, it highlights the types of changes we have committed ourselves to making in order that *Basic Financial Management* will reflect the very best thinking that financial scholars have to offer.

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J.D.M
J.W.P
A.J.K
D.F.S

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