FRONTIERS OF FINANCIAL MANAGEMENT

FOURTH EDITION

SERRAINO · SINGHVI · SOLDOFSKY

F28 SOUTH-WESTERN

FRONTIERS OF FINANCIAL MANAGEMENT

FOURTH EDITION
SELECTED READINGS

William J. Serraino
Professor of Finance
Miami University
Oxford, Ohio

Surendra S. Singhvi
General Manager, Financial
Planning and Analysis
Armco Inc.
Middletown, Ohio
and
Adjunct Professor of Finance
Miami University
Oxford, Ohio

Robert M. Soldofsky
Professor of Finance
University of Iowa
Iowa City, Iowa

Published by
F28 **SOUTH-WESTERN PUBLISHING CO.**
CINCINNATI WEST CHICAGO, IL DALLAS PELHAM MANOR, NY PALO ALTO, CA

ISBN: 0-538-06280-0

Library of Congress Catalog Card Number: 84-50117

2 3 4 5 D 8 7 6 5

Printed in the United States of America

PREFACE

In assembling the 36 articles selected for the fourth edition of these collected readings in financial management, the editors continued to use the three major criteria that guided the selection of articles in the prior editions. These criteria are a managerial viewpoint; a concern for real and relevant problems that financial and other top-level managers confront; and a judicious introduction of new approaches to subjects including models, simulations, and alternative formulations of the firm's goals. Two articles in Part I provide explicit statements of the major new conceptual frameworks in finance. Another article in this section elaborates alternative ways of viewing the goals of business firms. These goals have been gaining operational acceptance and increasing academic respectability, but are seldom discussed in finance textbooks or other materials to which business students are exposed.

Even though most of the articles discuss theories, problems, and changing institutional developments that are at the very frontiers of financial management, not one of them requires a knowledge of mathematics or statistics that is beyond the level of training received by the overwhelming majority of undergraduate business school students. The problems, practices, theories, and institutional developments discussed in this collection should be very useful to the readers in the latter part of the 1980s, the 1990s, and even into the twenty-first century.

This revised collection includes 19 items from the 1981 edition, only four of which remain from the 1976 edition and two from the 1971 edition. Users were consulted both about articles they would like to see continued from the prior edition and about suggestions for new articles. The continuing emergence of new problems, new techniques, new institutional arrangements, new laws, and new theoretical developments necessarily leads to changes in any collection of articles that hopes to be both current and at the frontiers of its field.

The articles may be classified in many different ways, such as according to the experience or position of the authors; the uses of models, surveys of practices, or case histories; and the sources from which the articles are drawn. Many of the articles do not fit neatly into any one single classification. Most of the authors who work outside of a university setting have advanced academic degrees. Among these nonacademic authors are investment bankers such as Henry Kaufman of Salomon Brothers and Allen Seed, III, senior consultant at Arthur D. Little. Others include four senior officers of major banks, six senior officers of business corporations, professional journalists, and two members of "Big Eight" accounting firms.

The collection has been gathered from 18 different journals and four different conferences. The paper by Dr. Henry Kaufman was given at a Congressional hearing on monetary and fiscal policy. Four of the articles appeared originally in the *Harvard Business Review* and another four in *Financial Management*. Three of the papers were published in the *Financial Executive* and two were published in each of the following journals: *California Management Review, Management Accounting*, and *Managerial Planning*.

W. J. S.

S. S. S.

R. M. S.

ABOUT THE AUTHORS*

S. K. Bhattacharyya—Professor of Accounting and Control, Indian Institute of Management, Ahmedabad.

Eugene F. Brigham—Professor of Finance and Director of Public Utility Research Center, University of Florida.

Robert A. Bullington—Assistant Secretary, Irving Trust Company.

Robert Cobbaut—Professor of Finance, Catholic University of Louvain, Belgium.

Eugene E. Comiskey—Callaway Professor of Accounting, Georgia Institute of Technology.

Patrick J. Davey—Senior Research Associate, The Conference Board.

Ralph E. Drtina—Assistant Professor of Accounting, Lehigh University.

A. F. Ehrbar—Associate Editor, *FORTUNE Magazine*.

Peter C. Eisemann—Assistant Professor of Finance, Georgia State University.

Ted D. Englebrecht—Associate Professor of Accounting, University of Oklahoma.

M. Chapman Findlay, III—Professor of Finance and Chairman, Department of Finance and Business Economics, University of Southern California.

George M. Frankfurter—Professor of Finance, Syracuse University.

James A. Gentry—Professor of Finance and Associate Dean, College of Commerce and Business Administration, University of Illinois, Urbana-Champaign.

Charles H. Gibson—Professor of Accounting, University of Toledo.

Lawrence J. Gitman—Professor of Finance, Wright State University.

Sara L. Gordon—Associate Professor of Economics and Finance, St. John's University.

*The positions of some of the authors have changed since the date of their article. Present positions are given when known to the editors.

David D. Harrison—Manager, Accounting Services, Borg-Warner Chemicals, Inc.

K. Larry Hastie—Assistant Treasurer, The Bendix Corporation.

Donald A. Heckerman—Manager, Financial Modeling Coordination, Mead Corporation.

James A. Hendricks—Professor of Accounting, Northern Illinois University.

William H. Hernandez—Business Manager, ABS Polymers.

Henry Kaufman—Managing Director and Member of the Executive Committee, Salomon Brothers Inc.

Steven W. Kohlhagen—Assistant Professor of International Business and Applied Economics, University of California, Berkeley.

Francis A. Lees—Chairman, Department of Economics and Finance, St. John's University.

Cathy H. Leeson—Tax Accountant, Deloitte Haskins & Sells.

Dileep R. Mehta—Professor of Finance, Georgia State University.

Vincent A. Mercurio—Manager of Corporate Accounting, Oak Communications, Inc.

Merton H. Miller—Edward Eagle Brown Professor of Finance and Economics, Graduate School of Business, University of Chicago.

Edward A. Moses—Associate Professor of Finance, University of Tulsa.

Daniel Orr—Professor of Economics, University of California, La Jolla.

George M. Parks—Dean, School of Business Administration, Emory University.

Alfred Rappaport—The Leonard Spacek Professor of Accounting and Information Systems and Director of the Accounting Research Center, Graduate School of Management, Northwestern University.

Russ Ray—Assistant Professor of Finance, Central Michigan University.

Raymond R. Reilly—Professor of Finance, University of Michigan.

Michael S. Rozeff—Professor of Finance, The University of Iowa.

Jean-Louis Scaringella—Professor of Finance, Centre d'Enseignement, Superieur des Affairs, H.E.C., Paris, France.

Allen H. Seed, III—Senior Consultant, Arthur D. Little, Inc.

Surendra S. Singhvi—General Manager, Financial Planning and Analysis, Armco Inc.; and Adjunct Professor of Finance, Miami University.

Robert M. Soldofsky—Professor of Finance, The University of Iowa.

Dennis S. Soter—Vice President of Chase Financial Policy, a unit of The Chase Manhattan Bank, N.A.

James McNeill Stancill—Associate Professor of Finance, University of Southern California.

Meir Statman—Assistant Professor of Finance, University of Santa Clara.

Dev Strischek—Vice President, Commercial Loan Administration, Southeast Bank, N.A., Fort Lauderdale, Florida.

Barry Sullivan—Executive Vice President, The Chase Manhattan Bank, N.A.

J. Fred Weston—Cordner Professor of Money and Finance of Markets, University of California, Los Angeles.

G. A. Whitmore—Professor of Statistics, McGill University.

Allan E. Young—Professor of Finance, Syracuse University.

CONTENTS

PART IX FINANCIAL IMPACT OF ACCOUNTING AND TAXATION

PART X FINANCING SMALL BUSINESS

PART XI INTERNATIONAL FINANCIAL MANAGEMENT

Part I PERSPECTIVES IN FINANCIAL MANAGEMENT

Both the academic definition and the practical applications of financial management have changed since it emerged as a separate branch of economics at about the beginning of the twentieth century. Historically, it was preoccupied with the procurement of funds, but it has moved toward the analysis of the allocation of funds within the firm. The most recent developments stress the analysis of risk and uncertainty, and their relationships to the market value of a firm's common stock. The problems that were emphasized in each era reflected the political, economic, and social preoccupations of that period. An increasing use of computer, mathematical, and statistical analysis is apparent. The techniques of financial analysis are used not only in profit-seeking businesses but also in nonprofit organizations and in government at all levels. The underlying movements in financial management stem from profound changes in society that are related to high technology, improving education, theoretical breakthroughs, the period of high inflation that ended in 1981, and our changing international position. The four articles in this section provide a perspective on these developments.

The first article, which was published by J. Fred Weston in 1974, summarizes the new themes in finance that had developed during the prior fifteen years.[1] Weston, whose own contributions to financial management go back to the 1940s, stresses these new developments for their own sake. The second article, "Financial Theory: Its Message to the Accountant," was published in 1983 by Frankfurter and Young. It stresses the practical significance of the theoretical developments that have taken place during the past twenty-five years. Additional analytical devices and concepts have developed and become popular in the ten years since Weston's "New Themes."

The third article is by Henry Kaufman of Salomon Brothers Inc. Kaufman was called "Doctor Doom" by some until he announced in July 1982 that the economy would soon start to recover and interest rates would fall, to which the stock market responded almost immediately by starting a prolonged rally. His testimony in a Congressional hearing, "The Urgency to End Our Economic and Financial Turbulence," reviews developments in the financial markets, the financial posture of corporations and their financial requirements, monetary policy, and fiscal policy from a twenty-five year perspective. This review is combined with his analysis of past events and recommendations for future policies. The fourth article, which was written in 1974 by Findlay and Whitmore, incorporates vital developments in the behavioral theory of the firm which are almost totally neglected in the most popular financial-management textbooks.

Professor J. Fred Weston organized more recent developments in finance around a framework of five new themes. He cited a highly selective list of works to

---

[1]For a review of the developments in financial management starting with the 1920s, see Ezra Solomon, "Recent Trends and Developments in Academic and Professional Thinking on the Subject of Financial Management," published in the 3d edition of this book (Article 1, pages 4-11).

support his position. His acute observations in 1974 pointed to trends that are continuing today.

First, overly aggressive—nearly predatory—means were used to bolster the growth of corporate assets and earnings. Professor Weston hoped that more planned and controlled methods would gain the upper hand. However, as the corporate "take-over" binge built up in 1978 and 1979, it was doubtful which approach was winning. (See Article 23, "Strategic Analysis for More Profitable Acquisitions.")

Secondly, the systems approach to financial management appeared and grew rapidly under the name of corporate modeling. Many corporations felt they must develop a corporate model and maintain a model builder on their staff to keep up. The third theme was the continued developments in financial theory that were being brought into both textbooks and corporate practices. The most important among these were (1) the formal measurement of uncertainty, and (2) the developments in portfolio theory. The use of these methods was helpful in the reorganization of thinking about capital budgeting. (For a more detailed review of these developments, see Article 6 by James Gentry and the editors' introduction on pages 72–76 of the third edition of this book.)

The fourth of Weston's themes stressed changes in the economic and financial environment. Rising inflation and fluctuating interest rates continue to occupy a good deal of attention and the growth of international business continues. Finally, the techniques and developments in financial management are being applied to nonprofit business and even to some government operations. A challenge here is to develop single and multiple goals and measures of financial efficiency.

Professors Frankfurter and Young stress that they are writing for the practicing accountant who may be a member of a corporation, a CPA firm, or a management consulting firm. No matter where this accounting advisor works, he must have a firm grasp of the developments in financial research which is now stressing value-maximization models and value-measurement models. This erudite statistical and mathematical research is summarized without mathematical notation and with the use of only one simple diagram. They list twelve different themes or topics around which their discussion is organized, and they are able to condense these topics into two major sections because of the way the themes are interrelated.

Two of the major theoretical developments, the capital-asset-pricing model (CAPM) and the Modigliani-Miller (MM) theory of valuation, had their origins in the late 1950s. Seven of the specific theoretical topics which are developed are: risk-free assets, beta, systematic risk, nonsystematic risk, risk premium, the security market line, and market efficiency. These topics are largely related to developments in CAPM research. Frankfurter and Young stress the limitations of applying these research results to financial management because the underlying assumptions fit the financial markets rather well but generally do not fit with the managerial environment.

Three of the topics—arbitrage and pricing theory, informational asymmetry, and agency costs—are largely new since 1974. Findlay and Whitmore wrote in 1974 about some of the analytical insights that would now fall under the term "agency costs," a theory pioneered by Jensen and Meckling in 1978. Michael Rozeff's article, which is number 14 in this collection, also uses the agency-cost terminology to further his analysis of dividend policy.

In Article 3, Henry Kaufman, who has been a Federal Reserve economist and who holds a Ph.D. in banking from New York University, reviews interest rates, fiscal and monetary policies, and suggests policy alternatives designed to overcome our past economic and financial turbulence. He observes that government, business, and household debt has increased more then sevenfold in a little more than twenty years. The quality of that debt has deteriorated as evidenced by a review of the changes in both Standard & Poor's and Moody's ratings on corporate bonds. Both nominal and real interest rates have grown much higher and fluctuated much more widely, especially since the October 1979 change in monetary policy. These high interest rates and negative yield curves are an obstacle to economic recovery and sustained economic growth.

Dr. Kaufman believes that our fiscal policy is more likely to keep private savings as a percentage of the GNP from growing as much as the administration in power in Washington, D.C., would like. The major underlying cause of these smaller real savings and high interest rates is the extremely large federal deficit. The federal budget may be taking as much as 31 percent to 35 percent of the Gross National Product (GNP) in 1983-1984. Sometime during the recovery that started in November 1982, the combination of the high federal deficit and the rising demand for credit to finance the expansion of plant and equipment will result in higher interest rates that are likely to bring an end to the current recovery.

From November 1978 to March 1892 the definition of money changed four times and money defined as both M_1 and M_2 continues to decline relative to the GNP. The continuing changes in the definition of money and financial innovations complicate monetary policy. Monetarism—the position that the control of the money supply will dampen economic fluctuations—has been shown to have numerous detrimental consequences. The combination of monetarism and deregulation of financial institutions is likely to lead to increasing concentration in this field.

Dr. Kaufman takes the position that reform in monetary policy is needed to prevent failures in the financial system. He makes several recommendations to strengthen commercial banks and recommends that the Federal Reserve be given power to regulate margin requirements in the financial futures and options markets. The federal deficit and large off-budget demands for funds urgently need to be reduced. The latter problems relate to the nation's broad military, social, and political policies.

In their article, "Beyond Shareholder Wealth Maximization," Professors Findlay and Whitmore point out that Harvard cases are based on a behavioral model of the firm and that shareholder wealth maximization (SWM) is a modern version of the profit maximization goal of neoclassical economic theory. Two other respected models of the firm are pointed out: (1) managerial welfare maximization (MWM), which is elaborated in the work of such writers as Williamson and Marris, and (2) the behavioral theory of the firm, which is identified with Cyert and March.

Since the perfect markets of neoclassical economic theory do not exist in the "real world," the authors ask which of the models of the firm has greater predictive validity in positive or descriptive finance. They proceed to compare the predicted results of SWM and MWM with the outcomes of decisions and the decisions rules of financial managers in the areas of capital structure, dividend policy, capital budgeting, research and development expenditures, earnings-determination, and earnings growth. They also review how firms both do and should respond to risk according to each of the SWM and MWM theories of the firm. The authors display evidence from a number of areas to bolster their position that managers do have enough control over enterprises to maximize their own wealth. Federal legislation, and the drive for further disclosure by the Securities and Exchange Commission are designed to reduce the limits of managerial discretion. Such private groups as the New York Stock Exchange and the American Institute of Certified Public Accountants have also put forth rules limiting managerial discretion, a position that would not exist under pure and perfect competition without endangering the very existence of the firm itself.

Finance teachers should be clear about the differences between SWM, MWM, and behavioral models of the firm. Much of the marginal analysis leads to the same policy decisions under these alternative theories of the firm. Other policy areas could be discussed in textbooks from several viewpoints. More research needs to be conducted and valuated on the basis of the positive MWM model. The SWM model and its normative, value-free assumptions may even mislead shareholders and increase managerial power.

1. NEW THEMES IN FINANCE*

J. FRED WESTON†

Stirred by new controversial issues and social potentials, both the theory and practice of finance have experienced heightened intellectual ferment. The purpose of this essay is to attempt to place these developments in perspective, indicating their broad implications. Five themes are treated: (1) the gunslinger versus planning and control processes, (2) the systems approach, (3) the theory of capital markets, (4) some new dimensions of financial environments and (5) the broader requirements of open systems models. This review and analysis will demonstrate that even greater challenges and opportunities for the finance field lie ahead.

I. GUNSLINGING VS. PLANNING AND CONTROLLING

The late sixties produced a crop of finance men who became known as gunslingers. They were calling the shots in investment companies, principally the "performance funds." Their counterparts in business firms were the financial managers who rose quickly to top executive positions. They were able to say to the executive committee or board of directors of the company, "Tell us what rate of growth in earnings per share you wish to promise to financial analysts. Fifteen per cent? Fine! How much of that growth can you achieve through operations? Three to five per cent? Fine! We will make up the difference through the new magic of finance." Thus instant growth took its place alongside instant breakfasts, instant knowledge, and instant nirvana in the new society.

The highly publicized merger activity utilized differential price earnings ratios, dirty pooling, puffing purchases and other financial stratagems to inflate reported growth in earnings per share. Leasing, land development, franchising, finance companies, among others, engaged in practices of deferring expenses and/or accelerating income recorded to present favorable earnings reports. Less widely recognized was how more traditional methods of financing could achieve the same or even more exaggerated results than the various forms of accounting and merger machinations. It can readily be demonstrated how increased use of leverage and the appropriate timing of equity issues (or under different circumstances share repurchase) can do as much as or more than merger practices to levitate earnings per share. The traditional financial methods were further enlarged by the imaginative use of warrants, converts, other option combinations, complex forms of executive compensation schemes—all of which

*From *The Journal of Finance* (March, 1974), pp. 237–243. Reprinted by permission.
†University of California, Los Angeles. My thanks for suggestions from Y. Imai, C. G. Krouse and J. P. Shelton. This paper was developed from a presentation to the Financial Management Association on October 14, 1972.

interacted with powerful wealth motivations in the new financial managers and their associates.

But the criticisms have been as exaggerated as were the individual financial practices. The publicized excesses were not the essence, but an excrescence (which Webster defines as "an abnormal outgrowth as a wart"). For example, the area in which financial trickery was supposed to be at its worst was in conglomerate merger activity. Empirical measurement of the performance of conglomerates (using measures relatively free from the effects of pooling or purchasing accounting methods employed) reveal some basis for the claims of efficiencies in asset or managerial redeployment and in effective use of new managerial technologies.[1] As a group, conglomerates are found to have had earnings on total assets less than the manufacturing average at the beginning of the late 1950's, but to have increased the effective economic utilization of resources under their responsibility to average levels by the end of the 1960's [21]. But within these overall results are wide extremes. A number of conglomerates, particularly some latecomers attracted by earlier successes, had no sound basic business conception and are doomed to the inexorable verdict of the marketplace.

Fortunately, individuals constituting only a small segment of the business and financial community were involved in the highly publicized gunslinging activities. To claim otherwise is to argue by anecdote rather than by systematic empirical studies. The more general proposition, exemplified by the vast majority of American enterprise, is that financial management does have a fundamental contribution to make to growth in earnings per share and the effective performance of business firms. By effective interaction with the basic planning, administrative and operating activities of the firm, financial management can help enhance performance in functional areas as well as discharge its own responsibilities with effectiveness. This takes us to another set of key issues.

II. THE SYSTEMS APPROACH AND THE FINANCE FUNCTION

We have now reached another bridgehead. The traditional financial emphasis on funds flow can be viewed in a narrow and mechanical way or as a creative interacting process. This newer emphasis has been variously characterized as planning and control for profit (P & C), management by objectives (MBO) and management information systems (MIS). Whatever its designation, the essence is to give a "systems approach" to the role of finance. Here some clarifications are needed. In their 1967

[1]There is by no means a consensus on these findings. A divergence of views is found in a growing literature on the subject.