

The background of the book cover features a sepia-toned photograph of classical architectural columns. A dark red horizontal bar is positioned at the top right, and a dark purple horizontal bar is located below the title. The authors' names are printed at the bottom in a serif font.

Financial Management

An Introduction to Principles and Practice

Lewellen ■ Halloran ■ Lanser

Financial Management:

An Introduction to Principles and Practice

Wilbur G. Lewellen

Purdue University

John A. Halloran

University of Notre Dame

Howard P. Lanser

University of Notre Dame



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To Karen, Ellen, Howard and Anne, and Alison *Howard Lanser*

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Preface

The intent of *Financial Management: An Introduction to Principles and Practice* is to expose the student taking a first course in finance to the terminology, theory, and analytical techniques of corporate financial management. The *terminology* of finance is clearly labeled throughout the text and defined in margin notes as well as in a comprehensive glossary at the end of the book. The treatment of financial *theory* is organized around the unifying theme of seeking to maximize the value of the firm to its owners—that is, to its common stockholders. The first eight chapters are devoted to the development of what we term the **Investment Valuation Model (IVM)**, which defines the impact of investing and financing decisions on firm value. Reference throughout is made to the discipline which the external capital market imposes on those decisions. The *analytical techniques* employed by financial managers are covered in the subsequent sixteen chapters. These describe the application of the IVM to specific types of investing and financing decisions. This progression from financial theory to its application is designed to develop in the student a firm sense of the conceptual foundation of contemporary financial management practices. Additionally, the format of the text allows the course instructor to select which application areas he or she would like to emphasize, without forgoing the coverage of the underlying theoretical framework.

Since the book is targeted for the first course in finance, it is designed to meet the needs of a broad range of business students, not only those who concentrate on finance. As a reflection of that objective, the text examines theory at a level that will be tractable for courses in which it may be the students' last as well as their first exposure to financial management. Thus, while concepts are strongly emphasized, the student is not immersed in mathematics or in abstract proofs. We believe that extensive mathematical treatment diminishes rather than enhances student understanding in an introductory course, particularly if part of the objective is to encourage students to proceed to follow-on courses in finance. Our approach has been to make the book *analytical* throughout, but only mathematical to the extent necessary to deliver the key messages. As a result, we have opted for conceptual discussions of difficult topics which summarize, rather than enumerate, the theoretical steps which lead to the final conclusion. In instances where we feel a more detailed treatment is appropriate, we have located it in an appendix which does not interfere with the flow of the materials in the chapter.

For the same reason, only *one* approach will be described when presenting the application of the IVM to the analysis of particular investing and financing decisions. This approach represents what we believe to be a reasonable consensus of current academic doctrine. When important alternative frameworks exist, they are discussed in chapter appendices. An insistence on comprehensiveness in an introductory text, while intellectually appealing, we believe serves mainly to confuse the student and create pedagogical difficulties for the instructor. Thus, the text materials are solidly grounded in contemporary theory but are also direct and focused on the *uses* of theory.

AUDIENCE

The primary audience is expected to be in introductory courses in undergraduate business programs. The text stands alone as a resource for such courses, and can

serve either in a full semester or a two-quarter course format. The text can also be used for the introductory finance course in an MBA program. It is comprehensive in its treatment of the topics which are commonly covered in that course; it provides the necessary valuation paradigm; and it emphasizes applications. Finally, given the style of the text as described below, an additional logical use would be in Executive MBA programs where readability, focus, and an applications orientation are especially important.

CONTENT

We have endeavored to make the text distinctive in several respects: (1) a concentration on the student user of the text; (2) a real rather than merely a claimed organization around the theme of valuation; and (3) a substantive and integrated treatment of the international aspects of financial decision-making.

The materials in the text have been use-tested on students in a variety of courses. We have attempted throughout the book to address each of the topics covered by asking the following simple question: As we remember back to seeing these materials for the first time, how could they have been presented to us with maximum effectiveness? A consistent effort, therefore, has been made to look at the materials from the student's perspective and to stress logic, intuition, and readability. Our experience is that not only do students respond well to that approach, but most importantly, by their own admission, they also learn something.

Most financial management texts profess to be organized around the concept of shareholder wealth maximization. Nonetheless, the theme is seldom carried through consistently in a unified fashion. After establishing the notion that a discounted cash flow model captures the market valuation process, the application of the model typically stops with the analysis of capital expenditure decisions and the estimation of a company's cost of capital. The concept is rarely applied to working capital management, financial budgeting and planning, or to international financing and investing activities. Thus, the message to the reader is that these topics are somehow different, and that a value maximization approach either cannot or need not be used in all aspects of financial decision-making.

In this text, the label "Investment Valuation Model" is used to refer to the discounted cash flow paradigm. It serves as the focal point both for the discussion of financial theory and for procedures for the implementation of that theory throughout the text. The chapters proceed from an introduction, formal development, and quantitative estimation of the IVM in the first portion of the book, to a series of specific applications of the model in the remainder of the text. Not only are decisions about capital budgeting and capital structure treated explicitly in this framework, but the choices among alternative short-term financing arrangements, cash and receivables management, inventory management, sustainable corporate growth, the resolution of financial distress, and corporate restructurings are as well. The result is a more coherent story and a more solid foundation for decision-making.

We believe many texts often fail to present, systematically and carefully, material on the investing and financing decisions of multinational firms. Despite the AACSB mandate to integrate international dimensions, the discussion of international financial management is often relegated to a single final chapter where it can conveniently be ignored or takes the superficial form of boxed inserts or appendices clearly segregated from the main body of the discussion.

This text is differentiated by a substantive treatment of international financial decision-making as part of the core of the managerial process. The IVM is applied

to such decisions, and the parallels are drawn between them and domestic (single-currency) financial decisions. Among the messages is that there are more similarities than differences between the two. The strategy adopted is to include at the end of each of three major sections of the book a full chapter that explicitly addresses the application and extension of the materials to the international context. Thus, a chapter on the international financial marketplace immediately follows the chapter on the domestic money and capital markets in the first section of the text. A chapter on international financial valuation finishes the section on Valuation Principles that lays out the IVM. And a chapter on international investing and financing decisions concludes the text.

The materials in the international chapters require that only the other chapters in those sections be covered first, not necessarily the entire book. The advantage of this approach is that international finance can be treated seamlessly and in discrete doses as the course proceeds, if the instructor so wishes. Alternatively, the international chapters in each section can be bypassed and international finance included as the finishing segment of the course with assurance of a parallel and integrated treatment. The further advantage is that the international materials do not artificially intrude on the *basic* topics to be covered, by breaking into the discussions in the standard chapters. An implicit final advantage is that the book can thereby also stand alone as a domestic finance text if the international chapters are omitted.

The overall topical coverage is generally comparable to that of existing texts. This reflects our emphasis on *how* the materials can most effectively be conveyed, rather than *what* should be taught. The major exception is the material on international financial management, which is much more extensive and, we believe, better designed and located than in most other texts. This method of coverage is a response both to AACSB concerns and to the evident growing commitment of corporate resources in practice to international operations.

Some other differences are worth noting. The chapter on Capital Expenditure Decision Rules (Chapter 9) contains a discussion of the link between ex ante valuation estimates and ex post measured performance results at the business unit level, which is absent in many texts. Chapter 10 on Capital Investment Cash Flows provides a treatment of the administrative setting of capital budgeting, which is also commonly not covered. In Chapter 16, we offer a resolution of the “dividend controversy” in the context of developing a strategic financing plan in practice. We believe the result is a reasonable distillation of the messages from the literature in an area in which there has been considerable controversy. The discussion also provides a good opportunity to tie together the material in the section on capital structure and cost of capital.

As we indicated above, the IVM is applied consistently to working capital decisions in Chapters 17 through 20, in order to imbed those decisions in an underlying value maximization framework. In Chapter 21 on Financial Planning, we devote above-average attention to the concept of sustainable corporate growth. We believe this analysis provides a very effective synthesizing vehicle for enhancing the student’s understanding of the interrelationships among investing, financing, and operating decisions. By linking that framework to the IVM, we further illustrate how the characteristics of the firm which are within the control of management can—separately and in combination—contribute to shareholder wealth maximization. This reinforces the materials in a number of prior chapters and can be a useful late-course review. Chapter 23 emphasizes valuation tests for the choice of the form of the firm’s response to financial distress, rather than the legal aspects alone.

The chapter topics are, perhaps not surprisingly, designed to be covered in the sequence in which they appear. Nonetheless, we have been careful in developing concepts and defining terms to allow for alternative sequencing according to instructor preferences.

For example, after Chapters 1 and 2, which establish the setting and identify the financial statement context of the firm, an instructor could assign Chapter 17 and the first half of Chapter 21. These chapters provide an overview of working capital management and describe cash budgets and pro forma statements, without requiring a formal valuation framework at that stage. The course could then turn to a series of case analyses on financial ratios and short-term cash forecasting as a way to review accounting, reinforce the accounting/finance link, and examine the cash flow implications of corporate operating decisions. This is a common tactic and may be especially useful for undergraduate students. The course would then move on to Chapters 3 through 8, which lay out valuation and the IVM, then proceed to capital budgeting.

In similar fashion, after covering Chapters 3 through 7, the instructor could pass over Section III on capital budgeting and deal first with Section IV on long-term financing and capital structure, returning thereafter to the examination of investing decisions. The content of the chapters makes this possible.

A note about footnotes. Footnotes are confined to important supplemental insights or to references to key related discussions elsewhere in the book. The footnotes contain no citations to the academic literature, nor is that literature cited in the body of the text as the materials are developed. We feel this style is best suited to the needs and interests of students in an introductory course having an applied orientation, because it minimizes distractions from the messages to be delivered. It also fits with the text's philosophy to *get* to the point rather than to chronicle all the thinking that allows us to *arrive* at the point.

FEATURES

This text has employed a number of pedagogical features to enhance student learning and to facilitate teaching.

Overview

Each part begins with an overview of the material to be covered in that part and in the individual chapters. These are designed to establish the context of, and motivation for, the upcoming discussions.

Decision Problems

Each chapter begins with a list of practical decision problems to be addressed in the chapter which is intended to stimulate the students' interest in real-world questions with which they may identify.

IVM

IVM margin icons highlight the valuation emphasis throughout the text. These are placed at the beginning of discussions that reflect the valuation theme and before end-of-chapter questions related to the valuation model.

Issues Boxes

- **Financial ISSUES** featured throughout the text highlight important financial management issues from the popular press, from finance journals and research, and from the authors' own experiences.

- **Valuation ISSUES** highlight issues related to the valuation orientation of the text and offer additional information and insight about the topic.
- **Ethics ISSUES** emphasize the importance of ethical behavior in business and finance.
- **International ISSUES** extend the discussion of chapter topics to the operations of international firms and markets.

Internet Materials

Internet addresses in the margins direct students to Web sites of particular interest and relevance to the topics being discussed. End-of-chapter Internet exercises are also provided.

Margin Definitions

Terms and concepts are highlighted and defined in the margins at their first occurrence as well as included in a comprehensive glossary at the end of the text.

Graphs and Tables

Liberal use is made of charts and graphs to illustrate the components and logical sequence of the decision-making processes subsequently described.

Chapter Equation Summary and Summary Figures

A summary listing of chapter equations is provided in the Summary section of each chapter.

Key concepts, terms, and procedures are succinctly outlined in summary figures located throughout individual chapters.

Self-Study Quiz and Concept Questions

In addition to detailed solutions for examples discussed within each chapter, a Self-Study Quiz with additional problems is provided for each chapter, with answers in an appendix at the end of the text.

Each chapter contains both Content Questions that require the student to recall basic terminology and theory, and Concept Questions that call for more in-depth and conceptual analysis of chapter topics.

Financial Calculator Appendix

An appendix at the end of the text provides help for using financial calculators. In addition, the text contains a quick-reference card to assist students with the keystrokes for the most frequently used problems, using the HP-10B and TI BAII Plus financial calculators.

SUPPLEMENTS

The following supplements are available with this text:

Study Guide

A study guide, prepared by Richard Gendreau of Bemidji State University, contains chapter outlines, reviews of key equations, multiple choice, true/false, and fill-in questions, as well as problems and Internet exercises. Answers are provided at the end of each chapter.

Web Site

The text Web site, at <http://lewellen.swcollege.com>, contains Teaching and Learning Resources, updates for the Internet sites listed in the text, topical updates, the PowerPoint slide package, links to relevant financial Web sites, including Thomson Investors Network, and other valuable features.

PowerPoint Package

PowerPoint slides, prepared by Emery A. Trahan of Northeastern University, are available on the text Web site at <http://lewellen.swcollege.com> and can be downloaded for use by students as an aid to note-taking and by instructors as a lecture enhancement.

Instructor's Manual

An instructor's manual by the text authors explains each chapter's design and contains solutions to end-of-chapter problems and questions.

Transparency Masters

A set of over 100 transparency masters of important figures and tables from the text is available to adopting instructors.

Test Bank

A test bank of over 3,000 questions, compiled and prepared by Allen D. Morton of Western Connecticut State University, is available to adopting instructors.

Thomson World Class Test

The *Thomson World Class Testing Tools™* computerized testing program contains all of the questions in the printed test bank. *Thomson World Class Testing Tools* is an easy-to-use test-creation software compatible with Microsoft Windows. Instructors can add or edit questions, instructions, and answers, and select questions—randomly or by number—by previewing them on the screen. Instructors can also create and administer quizzes online, whether over the Internet, a local area network (LAN), or a wide area network (WAN).

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Bowling Green State University

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Nicholls State College

Jeong W. Lee
University of North Dakota

Lee McClain
Western Washington University

James A. Miles
The Pennsylvania State University

Allen D. Morton
Western Connecticut State
University

David L. Schalow
California State University—San
Bernardino

Elliott P. Smith
Boston College

Robert A. Taggart
Boston College

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Wilbur G. Lewellen

John A. Halloran

Howard P. Lanser

About the Authors

Wilbur G. Lewellen

Wilbur Lewellen is the Herman C. Krannert Distinguished Professor of Management at the Krannert Graduate School of Management at Purdue University. He is also Director of the School's Executive Education Programs.

Dr. Lewellen's primary area of professional specialization is corporate finance. He has been on the Purdue faculty since 1964, was acting Dean of the Krannert School during the 1978-79 academic year, and has had visiting faculty appointments at the Harvard Business School, MIT, and Duke University. He holds a B.S. degree in Aeronautical Engineering from Penn State and M.S. and Ph.D. degrees from MIT. Dr. Lewellen is the author of three previous books and has published over 90 papers in professional academic journals including the *Journal of Finance*, the *Journal of Financial Economics*, the *Journal of Financial and Quantitative Analysis*, the *Journal of Accounting and Economics*, and *Financial Management*. He has served on the editorial boards of seven journals and his biography is listed in *Who's Who in America* and *Who's Who in Finance and Industry*. On four occasions, he received the Salgo-Noren Award as the Outstanding Teacher in the Master's Program in Management at Purdue, served on the Board of Directors of USF&G Corporation from 1992 to 1998, and was awarded an honorary Doctorate in Economics by the faculty of the Budapest University of Economic Sciences in 1996.

John A. Halloran

John A. Halloran is an Associate Professor of Finance and Director of the Center for Research in Banking at the University of Notre Dame. He received a Bs.C. in Finance from St. Louis University and his M.B.A. and Ph.D. from Washington University in St. Louis. His

areas of teaching and research interest include capital investment analysis, working capital theory, commercial bank management, and the operation of financial markets. Professor Halloran has extensive experience in teaching his specialties to both full-time students and executive development participants. He has conducted numerous seminars on corporate finance for firms such as Arthur Andersen and the Bayer Corporation. A former member of the educational consulting staff of the Bank Administration Institute, he has received several fellowships in the field of banking. Professor Halloran has published research on issues such as working capital management, the cost of capital, and the role of financial intermediaries in the operation of financial markets.

Howard P. Lanser

Dr. Lanser is currently an Associate Professor of Finance at the University of Notre Dame. He joined the University of Notre Dame upon earning a Ph.D. from Purdue University's Krannert Graduate School of Management. He also holds a B.S. degree in Electrical Engineering from Notre Dame and a M.S.I.A. from Purdue University. He served seven years as Chairman of the University of Notre Dame's Department of Finance and Business Economics and has been deeply involved in curricular and strategic planning. In addition, Professor Lanser's international experience includes serving as director of Notre Dame's undergraduate program in Fremantle, Australia and its M.B.A. program in Santiago, Chile. He has extensive experience teaching both the graduate and undergraduate levels of corporate finance. Professor Lanser has experience and has been published in areas such as executive compensation, capital budgeting, the cost of capital, working capital management, and the valuation of privately held companies.

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