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Intermediate Financial Management

SIXTH EDITION

INTERMEDIATE FINANCIAL MANAGEMENT

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Preface

A great deal has happened in finance in recent years. Some time ago, when the body of knowledge was smaller, the fundamental principles could be covered in a one-term lecture course, then reinforced in a second-term case course. This approach is no longer feasible. The field has expanded far beyond what can be covered in one term, so most schools now require finance majors to take two financial management courses.

As the body of knowledge expanded, we experienced increasing difficulties in structuring the financial management curriculum. Eventually, we reached these conclusions: (1) The introductory course should be designed for all business students, not just for finance majors, and it should provide a broad overview of finance. Therefore, a text designed for the first course should concentrate on key concepts and avoid going beyond basic principles. (2) Finance majors need a second course that provides not only greater depth on the core issues of capital budgeting, capital structure, cost of capital, and working capital management but also covers such special topics as mergers, multinational finance, leasing, risk management, and bankruptcy. (3) This second course should include cases that show how finance theory is used in practice to help make better financial decisions.

When we went to the two-course structure, we tried two types of existing books but neither worked well. First, books that emphasized theory were unsatisfactory because students had difficulty seeing the usefulness of the theory and consequently were not motivated to learn it. Moreover, these books were of limited value in helping students work cases. Second, books designed primarily for the introductory MBA course contained useful material, but they also contained too much introductory material. We eventually concluded that a new text was needed, one designed specifically for the second financial management course. That led to the creation of *Intermediate Financial Management*, or *IFM* for short.

People familiar with past editions will note that a new coauthor, Phillip Daves of the University of Tennessee, has come aboard. Phillip brings a wealth of experience as a teacher, as a financial researcher, and as a consultant with various business firms. His contributions are reflected throughout the text.

WAYS THE BOOK CAN BE USED

The second corporate finance course can be taught in different ways, depending on various schools' curriculum structures. Therefore, we designed the book so that it can be used in several alternative ways.

1. **How We Generally Use the Book.** At many schools, including Florida and Tennessee, students take the introductory finance course, then two courses that deal with investments and capital markets, and finally a second corporate finance course in which this book is used. If students have had an introductory finance course plus courses in financial markets and investments, they should have a reasonably good foundation in the basic concepts.

Therefore, the primary function of the second corporate finance course should be to extend students' knowledge about how financial decisions should be made. This is the situation at Florida and Tennessee, so in our classes, we use Chapter 1 as an introduction to the course, then spend about two hours on the new Chapter 2, which reviews the time value of money, risk analysis, and stock and bond valuation. Then we go through Chapters 3 through 17, illustrating the text material with cases. Finally, we conclude with as many of Chapters 18 through 24 as we can fit into the schedule, with the selected chapters depending on our interests at the time and current events in the economy.

Our lectures are based on the Mini Cases for each chapter. (See the section entitled "The Instructional Package" later in this preface for a discussion of lecture aids available from The Dryden Press.) We encourage questions and class discussion, and the Mini Case format stimulates both. Generally, it takes us about two hours to go through each Mini Case, so we allocate that much time. We use the *PowerPoint* slide show, which Dryden provides, and students have a printout of the slides that they bring to class to make it easier to take good notes. (See the later section in the preface which deals with the *Blueprints* ancillary.)

We also assign about ten cases from the Dryden case bank, and we have teams of students present their findings in class. We, as instructors, play the role of company CEO or CFO, the presenters play the role of consultants, and the nonpresenting students play the role of the firm's financial staff. Both the instructors and the nonpresenters ask questions of the presenters/consultants. Moreover, we call on students and grade them on class participation, and our exams are patterned closely after the material in the cases. Therefore, nonpresenting students have an incentive to study and understand the cases, and to participate when the cases are discussed in class. This format has worked well—we and others have obtained excellent results with a relatively small amount of preparation time. Indeed, some of our PhD students with no previous teaching experience have taught the course entirely on their own, following our outline and format, and also obtained excellent results.

2. **Other Approaches.** There are many alternative course structures. Here are two that we have used in the past:
 - If students have not gained a thorough understanding of the basic concepts in earlier finance courses, instructors may want to place more emphasis on basic concepts and thus cover Chapters 25 through 28 in detail rather than simply use Chapter 2 as a review. Then, Chapters 1 and 3 through 12 can be covered in detail, and any remaining time can be used to cover a selection of the other chapters. This approach will give students a sound background on the core of financial management, but there will not be time to cover a number of interesting and important topics. Still, since the book is written in modular format, their familiarity with the fundamental core topics should enable students to cover the remaining chapters on their own, if and when the need arises.
 - At the other extreme, where students have an exceptionally good background, hence do not need to review topics covered in the basic finance course, instructors may cover less of the material in early chapters and concentrate on advanced topics. When we take this approach, we assign cases that deal with the topics covered in the early chapters and tell

students to review the relevant chapters on their own to the extent necessary to work the cases. This frees up class time for more of the advanced material. This approach works best with relatively mature students, including evening students with a good deal of business experience.

DESIGN OF THE BOOK

We have spent 20 years working on *IFM* and teaching the advanced financial management course. Throughout this span, we have concluded that the book should include the following features:

1. **Completeness.** Because *IFM* is designed for finance majors, it should be both self-contained and suitable for reference purposes. Therefore, we specifically and purposefully included (a) some material that overlaps with introductory finance texts and (b) more material than can generally be covered in a single course. We included in Chapters 25 through 28 some fundamental materials borrowed directly from other Dryden texts. If instructors choose to cover this material, or if individual students feel that they need to cover it on their own, it is there for them in complete form. In addition, we included relatively brief reviews of most first-course topics. This was necessary to put *IFM* on a stand-alone basis, and many students experience a delay between the introductory course and the second financial management course, so they need to get up to speed before tackling new materials. This is particularly true of “special topics” such as mergers, lease analysis, convertibles, and aspects of working capital management—all of which are often either touched on only lightly or skipped entirely in the introductory course because of time pressures. Thus, we tried to develop a text that covers a wide variety of topics so as to provide adopters with a choice of materials for the second course, plus other material that students can use for reference purposes. We note, though, that instructors must be careful not to bite off more than their students can chew.
2. **Theory and Applications.** Financial theory is useful to financial decision makers, both for the insights it provides and for direct application in several important decision areas. However, theory can seem sterile and pointless unless its usefulness is made clear. Therefore, in *IFM* we present theory in a decision-making context, which motivates students by showing them how a knowledge of theory can lead to better decisions. The combination of theory and applications also makes the text more usable as a reference for case courses and real-world decision making.
3. **Computer Orientation.** Rapid advances in computer technology are revolutionizing financial management. Powerful microcomputers are affordable to all businesses, and new software makes it easy to do things that were not feasible several years ago. Today, a business that does not use microcomputers in its financial planning is about as competitive as a student who tries to take a finance exam without a financial calculator. Therefore, we provide many examples of how computers can be used to help make better financial decisions. This orients students to the business environment they will face upon graduation. Also, students can often understand key financial concepts better after they work through a computer model of the problem.

Because finance majors should be computer literate, especially with regard to spreadsheets, this edition of *IFM* includes a diskette with completed

spreadsheet models for selected end-of-chapter problems. In addition, instructors can obtain completed models for many of the Mini Cases. Obviously, not every student has access to a personal computer, but for those who do, the models diskette will be quite useful.

4. **Global Perspective.** Successful businesses know that the economy is rapidly becoming globalized, and that it is difficult to remain competitive without being a global player. New technological advancements have led to increasingly complex products and services, hence to higher development costs. These high development costs have forced many companies to merge or to enter into joint agreements across national borders so that costs can be shared and sales volumes increased to cover development. Moreover, communications and transportation improvements permit firms to produce goods and services at locations far removed from the country of sale, and global competition has forced firms to move production to low-cost areas. Thus, Toyota, Honda, BMW, and Mercedes-Benz now produce autos in the United States, and many U.S. software companies provide technical support by phone to users from India and Ireland. Even purely domestic firms cannot escape the influence of the global economy, because international events have a significant impact on domestic interest rates and economic activity. All of this means that today's finance students—who are tomorrow's financial executives—must develop a global perspective. To help students “think global,” we provide throughout the text examples that focus on the types of global problems companies face.

In addition, *IFM* contains an entire chapter on multinational financial management. Of course, we cannot make multinational finance experts out of students in a conventional corporate finance course, but we can help students recognize that insular decision making is insufficient in today's world.

RELATIONSHIPS WITH OTHER DRYDEN BOOKS

The relationship between this text and others in the Dryden series deserves special comment. Because *IFM* is often used by students who also used one of the other Dryden texts in their introductory course, we were concerned about two potential problems: (1) There might be excessive overlap in certain areas, and (2) students might not be exposed to alternative points of view on controversial topics. Regarding overlap, both the reviewers and the authors looked for *undesirable* duplication and then removed it. We should note that some duplication is desirable, for students report that they find it helpful to have some material repeated—they need the review. Students also like the fact that the style and notation in *IFM* are consistent with that in Dryden's introductory texts, which makes learning easier. Regarding alternative points of view, we have made every effort to take a moderate, middle-of-the-road approach, and where serious controversy exists, we have tried to present alternative points of view. Reviewers were asked to consider this point, and their comments helped us avoid biases.

MAJOR CHANGES IN THE SIXTH EDITION

The entire book has been reviewed for completeness and clarity, and to ensure that it is up to date. We also made some major structural changes, along with hundreds of small changes. Some examples of changes include the following.

1. **Identification of Core Material.** Over the years, financial researchers have developed new theories. In addition, the financial markets have spawned new types of securities, consulting firms have developed new and useful ways of thinking about financial practices, computers have facilitated new and better ways of analyzing decisions, and business has become increasingly global. All of this has led to the danger that textbooks and instructors will overwhelm students with more material than they can digest. New material must be added to the text because without it students' knowledge would be obsolete even before they graduate. However, if we try to cover too much, students will not learn much about anything.

With this in mind, we reviewed every chapter to identify (a) core topics that are essential to finance majors, (b) topics that are important but not essential, and (c) topics that no longer warrant coverage. The core topics are now covered in the basic chapters, while important but nonessential material is covered in appendix-like sections called **Extensions**. This breakdown makes it easier for instructors to customize the package of material assigned so as to meet the specific needs of their students and to ensure the best fit of the second financial management course into the overall business and finance curricula. Of course, what is a review for some students will be new material for others, and what we believe to be an extension might be regarded as core by others. Therefore, we were careful to write the book in a modular format that makes it possible for instructors to cover chapters in alternative sequences.

2. **Review Material.** We wrote a new Chapter 2 that reviews the time value of money, risk analysis, and stock and bond valuation. Most finance majors need a review, but only a brief one, because they have already been exposed to these topics in several previous courses. Thus, the new Chapter 2 permits us to move on to advanced topics more quickly. However, we included complete chapters on risk and valuation as Chapters 25 through 28 for instructors whose students need a more detailed explanation of risk and security valuation than we provide in Chapter 2.
3. **Shift of Financial Statement Material.** We moved financial statement analysis from Chapter 18 to Chapter 3, and we put more emphasis on the use of projected statements to help estimate the effects of current financial decisions on future statements and stock prices. However, instructors can choose to delay covering this material until later in the course, and then use financial statement analysis to tie things together in a "capstone" sense.
4. **Free Cash Flow Valuation Models.** In the fifth edition, we presented only the discounted dividend model for valuing corporations. That model is appropriate in many situations. However, it is inadequate (a) when dealing with companies that do not pay dividends, (b) when divisions, as opposed to entire companies, are being analyzed, (c) when privately owned firms are being evaluated, and (d) when potential mergers are being analyzed and the acquirer plans to make structural changes in the target's operations. To fill this void, we added Chapter 4, which discusses free cash flow valuation techniques, and we extend this discussion in the chapters on capital budgeting, long-term financial planning, mergers, and bankruptcy.
5. **Revised Discussion of the Cost of Capital.** We significantly reworked and simplified Chapter 5, which covers the cost of capital. Our earlier discussion was unnecessarily complicated — we spent too much time on stock

flotation costs and the resulting break points even though established firms rarely issue new stock. We now emphasize the need to adjust the corporate cost of capital to account for differential project risk, and we show how firms make these risk adjustments.

6. **Increased Coverage of Multinational Financial Management.** We made several changes in this edition to strengthen our international coverage. First, we revised the multinational financial management chapter to incorporate the key topics of interest rate and purchasing power parity. Second, we expanded our coverage of international capital structures and capital budgeting, and we included new material on the European monetary system and the proposed common currency. And third, as noted earlier, to better integrate international material with regular domestic financial management, we added new multinational illustrations throughout the book. Andy Naranjo, an international financial expert at the University of Florida, and Subu Venkataraman, who deals with international issues at Morgan Stanley, gave us many suggestions, and they also helped us integrate international topics throughout the text.
7. **Real Options and Decision Trees.** Chapter 8 now contains additional material on real, or strategic, options, as well as an expanded section on decision trees and their use in evaluating real options. We also streamlined and shortened the discussion of the optimal capital budget to reflect changes made in Chapter 5.
8. **Long-Term Financial Planning.** We rewrote Chapter 9, and we moved it forward from Chapter 19. It now presents a simplified and improved way to analyze the effects of alternative operating policies on a firm's value, and it also serves as a bridge from capital budgeting to long-term financing decisions.
9. **Working Capital Management.** We streamlined our treatment of working capital management, covering the topic in two basic chapters (one on current assets and one on current liabilities) plus an Extensions section that goes into technical details on working capital management.

THE INSTRUCTIONAL PACKAGE: AN INTEGRATED APPROACH TO LEARNING

IFM includes a broad range of ancillary materials designed both to enhance students' learning and to make it easier for instructors to prepare for and conduct classes. The ancillaries are described here:

1. **Instructor's Manual.** This comprehensive manual contains answers to all text questions and problems, plus detailed solutions to the integrated cases. It also contains an instructor's diskette with all the spreadsheet applications for the instructor. If a computerized version of the IM would help in class preparation, instructors can contact The Dryden Press for a copy.
2. **PowerPoint Lecture Presentation.** This ancillary, prepared in *Microsoft PowerPoint*, covers all the essential issues presented in each chapter. Graphs, tables, lists, and calculations are developed sequentially, much as one might develop them on a blackboard. However, the slides are crisper and clearer, and color coding is used to tie elements of a given slide

together. The new slide show is more polished than anything previously available. Based on our end-of-course evaluations, students overwhelmingly like the slides and recommend that we continue using them as an integral part of our lectures.

When we first began using the slide show, we were concerned that we might lack flexibility in the classroom because, while one can navigate easily from slide to slide, one cannot modify the slides themselves in the classroom. Our fears were unfounded. First, because we had spent a great deal of time designing the slides, our examples and materials turned out to be appropriate in most lecture situations. Second, when we used the slides in class, we found that we could easily depart from them by going to the blackboard, which also added variety and spontaneity. Now the slides provide the backbone of our lectures, and we spice them up by going to the blackboard to address current events, to present alternative examples, and to help answer questions.

3. **Blueprints.** As technological advances led lectures away from the blackboard, it became increasingly important to provide students with a hard copy of the lecture materials. Students must have hard copies if they are to focus on the lecture yet still develop a complete and useful set of notes. With this in mind, we concluded that *Blueprints* would be most useful if it actually consisted of copies of the slides. So, each chapter of *Blueprints* begins with the case itself and is then followed by copies of each slide, along with space for notes and comments.

Blueprints has several other advantages. First, it offers flexibility for presenting alternative examples and discussing current events. Because *Blueprints* provides students with an almost complete set of notes, it is less necessary for instructors to lecture on every single topic in class. Second, space for notes is provided alongside each slide, and because our discussion in class is tied directly to the slides, students can place their notes next to (or on) the relevant slide. This enables students to develop a better set of notes.

When teaching this course, we use a "course pack" that consists of our syllabus, a 10- to 12-page calculator tutorial (taken from the *Technology Supplement* described below), some old exams, and *Blueprints*. Such a package can be provided by The Dryden Press; for further information, contact your local Dryden Press sales representative.

4. **Test Bank.** Although some instructors do not like multiple-choice questions, such questions do provide a useful means for testing students in many situations. If they are used, it is critically important that questions be both unambiguous and consistent with the lectures and assigned readings. To meet this need, we developed a large *Test Bank* containing hundreds of class-tested questions and problems. It is available both in book form and on diskettes. A number of new and thoroughly class-tested conceptual questions and problems, which vary in level of difficulty, have been added to *Intermediate Financial Management's Test Bank*. Information regarding the topics, degree of difficulty, and the correct answers, along with complete solutions for all numerical problems, is provided with each question.

The *Test Bank* is available in book form and in Dryden's computerized test bank form (EXAMaster+). This software has many features that make test preparation, scoring, and grade recording easy. EXAMaster+ allows automatic conversion of multiple-choice questions and problems into

free-response questions. The sequence of test questions can be altered to make different versions of a given test, and the software makes it easy to add to or edit the existing test items, or to compile a test which covers specific topics.

5. **Student Spreadsheet Applications Disk.** A diskette containing *Excel* spreadsheet models for the computer-related end-of-chapter problems is packaged with the textbook.
6. **Transparencies.** A set of more than 200 transparency acetates, designed to accompany the Mini Cases for use as lecture illustrations, is available from The Dryden Press.
7. **Cases in Financial Management: Dryden Request.** More than 80 cases written by Eugene F. Brigham, Louis C. Gapenski, and Linda Klein are now available via the World Wide Web, with new cases to be added every year. The *Cases in Financial Management: Dryden Request* series is a customized case database that allows instructors to select cases and create their own customized casebooks. These cases can be used as supplements to illustrate the various topics covered in the textbook. Many of the cases come with accompanying spreadsheet models that are available on The Dryden Press web site. The models are not essential for working the cases, but they do reduce number crunching and thus leave more time for students to consider conceptual issues. The models also show students quite clearly the usefulness of computers for helping to make better financial decisions. Cases that we have found particularly useful for the different chapters are listed in the end-of-chapter references.

All of the cases can be previewed and downloaded from the Dryden Press Finance Case web site <http://www.dryden.com/finance/fincase> with proper access. Case solutions and spreadsheet models can also be downloaded. For professorial access, contact your Dryden Press sales representative.

8. **Data Files.** We have put together a set of financial data from several actual companies, along with a set of key economic statistics, including interest rates and stock market indexes, and have made it available on Dryden's web site to adopting professors.
9. **Technology Supplement.** The *Technology Supplement* contains tutorials for five commonly used financial calculators and for *Microsoft Excel*, *Lotus 1-2-3*, and *PowerPoint*. The calculator tutorials cover everything a student needs to know about calculators to work the problems in the text, and we provide them as a part of our course pack. These tutorials are generally about 12 typewritten pages. Some students are intimidated by the rather large manuals that accompany the calculators, and they find our brief, course-specific tutorials far easier to use. The spreadsheet tutorials are useful if students are asked to work cases, and the *PowerPoint* tutorial is useful to students who must make presentations or to instructors who want to make slides for their lectures.
10. **Finance NewsWire.** One of the problems inherent in textbooks is keeping them current in a constantly changing world. When Orange County goes bankrupt or Baring Bank collapses or Procter & Gamble loses \$200 million, it would be useful to relate these events to the textbook. Fortunately, the advent of the World Wide Web can help us keep up to date. Adopters of *Intermediate Financial Management* will have access to a portion of the

Dryden Press web site, where they will be provided with summaries of recent articles in *The Wall Street Journal*, *Business Week*, or some other major business publication, along with discussion questions and references to the text. This will facilitate incorporating late-breaking news into classroom discussions. Instructors can also use the accompanying questions for quizzes and/or exams.

11. **Study Guide.** This supplement, which can be purchased by students, outlines the key sections of each chapter and provides students with a set of questions and problems similar to those in the text and in the *Test Bank*, but with worked-out solutions. Instructors seldom use the *Study Guide* themselves, but students find it extremely useful, so we recommend that instructors ask their bookstore to have copies available. Our bookstore generally has to reorder the *Study Guide*, which attests to its popularity with students.

The Dryden Press will provide complimentary supplements or supplement packages to those adopters qualified under Dryden's adoption policy. Please contact your sales representative to learn how you may qualify. If, as an adopter or potential user, you receive supplements you do not need, please return them to your sales representative or send them to the following address: Attn: Returns Department, Troy Warehouse, 465 South Lincoln Drive, Troy, MO 63379.

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ERRORS IN THE TEXT

At this point, authors generally 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 *Intermediate Financial*

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Partly because of our confidence that few such errors remain, but primarily because we want very much to detect those errors that may have slipped by so we can correct them in subsequent printings, we decided to offer a reward of \$10 per error to the first person who reports it to us. For purposes of this reward, errors are defined as misspelled words, nonrounding numerical errors, incorrect statements, and any other error that inhibits comprehension. Typesetting problems, such as irregular spacing and differences in opinion regarding grammatical or punctuation conventions, do not qualify for this reward. Given the ever-changing nature of the World Wide Web, changes in web addresses also do not qualify as errors. Finally, any qualifying error that has follow-through effects is counted as two errors only. Please report any errors to Phillip Daves at the address given below.

CONCLUSION

Finance is, in a real sense, the cornerstone of the free enterprise system. Good financial management is therefore vitally important to the economic health of business firms, hence to the nation and the world. Because of its importance, financial management should be 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 financial management stimulating and exciting, but also challenging and sometimes perplexing. We sincerely hope that the sixth edition of *Intermediate Financial Management* will help you understand the financial problems faced by businesses today, as well as the best ways to solve those problems.

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