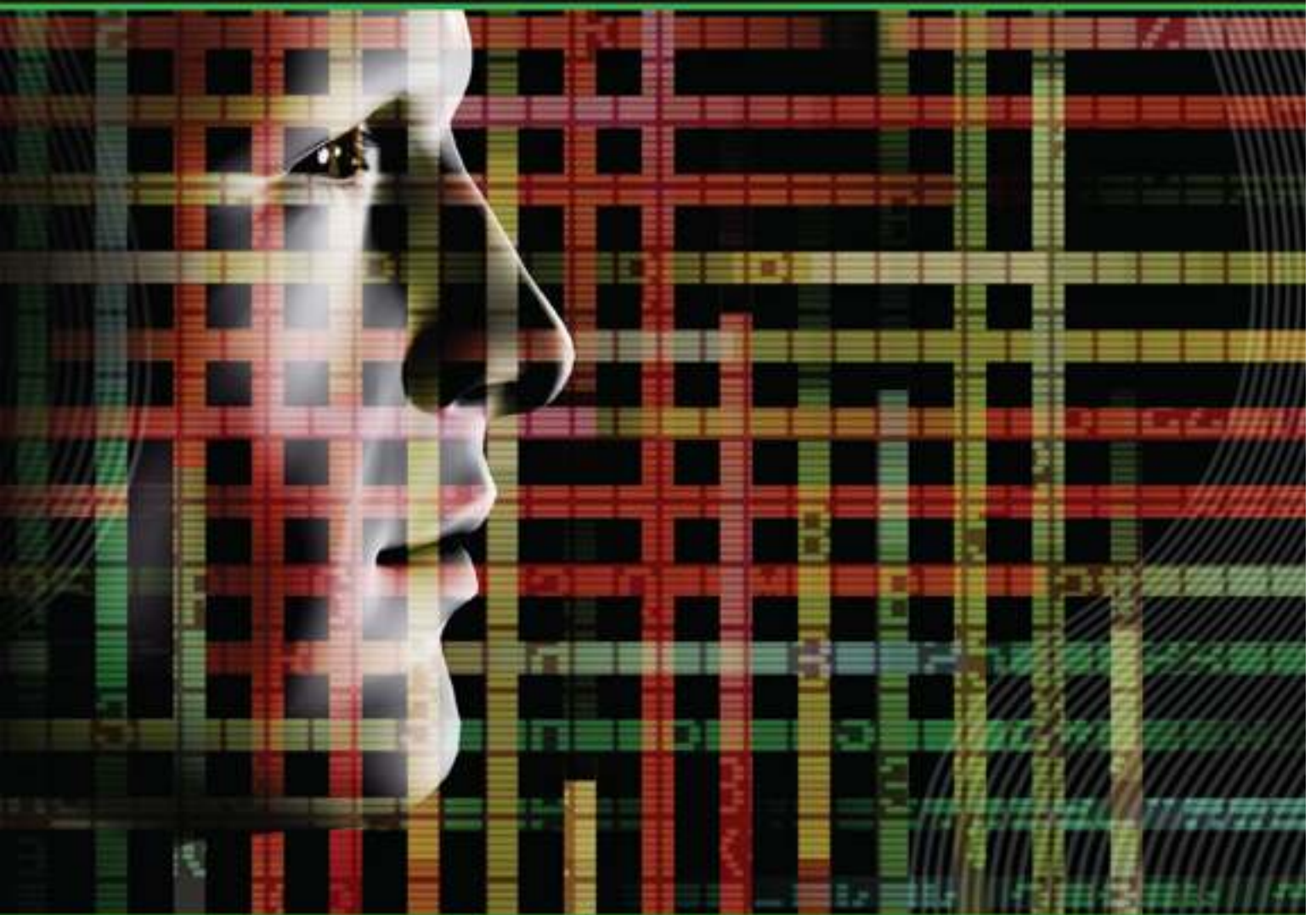


12E

Intermediate Financial Management



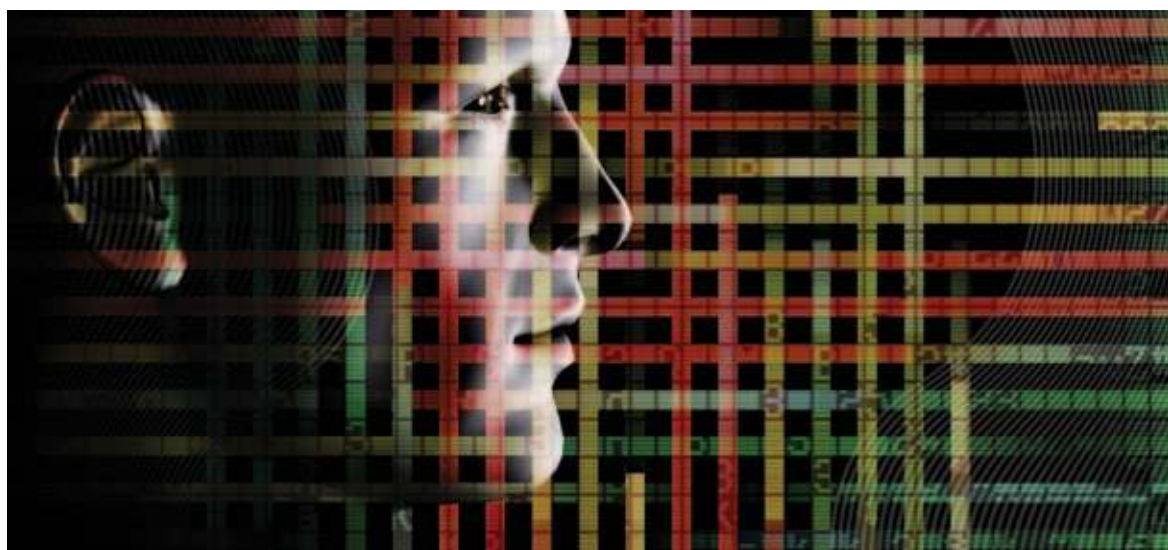
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EUGENE F. BRIGHAM
University of Florida

PHILLIP R. DAVES
University of Tennessee



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12th Edition****Eugene F. Brigham and Phillip R. Daves**

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Preface

Much has happened in finance recently. Years ago, when the body of knowledge was smaller, the fundamental principles could be covered in a one-term lecture course and then reinforced in a subsequent case course. This approach is no longer feasible. There is simply too much material to cover in one lecture course.

As the body of knowledge expanded, we and other instructors experienced increasing difficulties. Eventually, we reached these conclusions:

- 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 cover key concepts but avoid confusing students by going beyond basic principles.
- Finance majors need a second course that provides not only greater depth on the core issues of valuation, 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.
- This second course should also utilize cases that show how finance theory is used in practice to help make better financial decisions.

When we began teaching under the two-course structure, we tried two types of existing books, but neither worked well. First, there were books that emphasized theory, but they 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 deal with cases. Second, there were books designed primarily for the introductory MBA course that contained the required 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, and that led to the creation of *Intermediate Financial Management*, or *IFM* for short.

The Next Level: *Intermediate Financial Management*

In your introductory finance course you learned a number of terms and concepts. However, an intro course cannot make you “operational” in the sense of actually “doing” financial management. For one thing, introductory courses necessarily focus on individual chapters and even sections of chapters, and first-course exams generally consist of relatively simple problems plus short-answer questions. As a result, it is hard to get a good sense of how the various parts of financial management interact with one another. Second, there is not enough time in the intro course to allow students to set up and work out realistic problems, nor is there time to delve into actual cases that illustrate how finance theory is applied in practice.

Now it is time to move on. In *Intermediate Financial Management*, we first review materials that were covered in the introductory course, then take up new material. The review is absolutely essential, because no one can remember everything

WEB

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Instructors: Access the *Intermediate Financial Management 12e* companion site and instructor resources by going to **www.cengage.com/login**, logging in with your faculty account username and password, and using ISBN 9781285850030 to reach the site through your account “Bookshelf.”

that was covered in the first course, yet all of the introductory material is essential for a good understanding of the more advanced material. Accordingly, we revisit topics such as the net present value (NPV) and internal rate of return (IRR) methods, but now we delve into them more deeply, considering how to streamline and automate the calculations, how to obtain the necessary data, and how errors in the data might affect the outcome. We also relate the topics covered in different chapters to one another, showing, for example, how cost of capital, capital structure, dividend policy, and capital budgeting combine forces to affect the firm's value.

Also, because spreadsheets such as *Excel*, not financial calculators, are used for most real-world calculations, students need to be proficient with spreadsheets so that they will be more marketable after graduation. Therefore, we explain how to do various types of financial analysis with *Excel*. Working with *Excel* actually has two important benefits: (1) a knowledge of *Excel* is important in the workplace and the job market, and (2) setting up spreadsheet models and analyzing the results also provide useful insights into the implications of financial decisions.

Corporate Valuation as a Unifying Theme

Management's goal is to maximize firm value. Job candidates who understand the theoretical underpinning for value maximization and have the practical skills to analyze business decisions within this context make better, more valuable employees. Our goal is to provide you with both this theoretical underpinning and a practical skill set. To this end, we have developed several integrating features that will help you keep the big picture of value maximization in mind while you are honing your analytical skills:

- Every chapter starts off with a series of integrating *Beginning-of-Chapter Questions* that will help you place the material in the broader context of financial management.
- Most chapters have a valuation graphic and description that show exactly how the material relates to corporate valuation.
- Each chapter has a *Mini Case* that provides a business context for the material.
- Each chapter has an *Excel* spreadsheet *Tool Kit* that steps through all of the calculations in the chapter.
- Each chapter has a spreadsheet *Build-a-Model* that steps you through constructing an *Excel* model to work problems. We've designed these features and tools so that you'll finish your course with the skills to analyze business decisions and the understanding of how these decisions impact corporate value.

Design of the Book

Based on more than 30 years working on *Intermediate Financial Management* and teaching the advanced undergraduate financial management course, we have concluded that the book should include the following features:

- *Completeness*. Because *IFM* is designed for finance majors, it should be self-contained and suitable for reference purposes. Therefore, we specifically and purposely included: (a) some material that overlaps with introductory finance texts and (b) more material than can realistically be covered in a single course. We included in Chapters 2 through 5 some fundamental materials borrowed

directly from other Cengage Learning texts. If an instructor chooses to cover this material, or if an individual student feels a need to cover it on his or her own, it is available. In other chapters, we included relatively brief reviews of first-course topics. This was necessary both to put *IFM* on a stand-alone basis and to help students who have a delay between their introductory and second financial management courses get up to speed before tackling new material. This review is particularly important for working capital management and such “special topics” as mergers, lease analysis, and convertibles—all of which are often either touched on only lightly or skipped in the introductory course. Thus, the variety of topics covered in the text provides adopters with a choice of materials for the second course, and students can use materials that were not covered for reference purposes. We note, though, that instructors must be careful not to bite off more than their students can chew.

- *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 theory can lead to better decisions. The combination of theory and applications also makes the text more usable as a reference for case courses as well as for real-world decision making.
- *Computer orientation.* Today, a business that does not use computers in its financial planning is about as competitive as a student who tries to take a finance exam without a financial calculator. Throughout the text, we provide computer spreadsheet examples for the calculations and spreadsheet problems for the students to work. This emphasis on spreadsheets both orients students to the business environment they will face upon graduation and helps them understand key financial concepts better.
- *Global perspective.* Successful businesses know that the world’s economies are rapidly converging, that business is becoming globalized, and that it is difficult to remain competitive without being a global player. Even purely domestic firms cannot escape the influence of the global economy, because international events have a significant effect 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 this end, *IFM* also contains an entire chapter on multinational financial management. In addition, to help students “think global,” we provide examples throughout the text that focus on the types of global problems companies face. Of course, we cannot make multinational finance experts out of students in a conventional corporate finance course, but we can help them recognize that insular decision making is insufficient in today’s world.

Beginning-of-Chapter Questions

We start each chapter with several Beginning-of-Chapter (BOC) questions. You will be able to answer some of the questions before you even read the chapter, and you will be able to give better answers after you have read it. Other questions are harder, and you won’t feel truly comfortable answering them until after they have been discussed in class. We considered putting the questions at the ends of the chapters, but

we concluded that they would best serve our purposes if placed at the beginning. Here is a summary of our thinking as we wrote the questions:

- The questions indicate to you the key issues covered in the chapter and the things you should know when you complete the chapter.
- Some of the questions were designed to help you remember terms and concepts that were covered in the introductory course. Others indicate where we will be going beyond the intro course.
- You need to be able to relate different parts of financial management to one another, so some of the BOC questions were designed to get you to think about how the various chapters are related to one another. These questions tend to be harder, and they can be answered more completely after a classroom discussion.
- You also need to think about how financial concepts are applied in the real world, so some of the BOC questions focus on the application of theories to the decision process. Again, complete answers to these questions require a good bit of thought and discussion.
- Some of the BOC questions are designed to help you see how *Excel* can be used to make better financial decisions. These questions have accompanying models that provide tutorials on *Excel* functions and commands. The completed models are available on the textbook's Web site. Going through them will help you learn how to use *Excel* as well as give you valuable insights into the financial issues covered in the chapter. We have also provided an "*Excel* Tool Locator," which is an index of all of the *Excel* skills that the BOC models go over. This index is in the *Excel* file, *Excel Locations.xls*. Because recruiters like students who are good with *Excel*, this will also help you as you look for a good job. It will also help you succeed once you are in the workplace.

We personally have used the BOC questions in several different ways:

- In some classes we simply told students to use the BOC questions or not, as they wished. Some students did study them and retrieve the *Excel* models from the Web, but many just ignored them.
- We have also assigned selected BOC questions and then used them, along with the related *Excel* models, as the basis for some of our lectures.
- Most recently, we literally built our course around the BOC questions.¹ Here we informed students on day one that we would start each class by calling on them randomly and grading them on their answers.² We also informed them that our exams would be taken verbatim from the BOC questions. They complained a bit about the quizzes, but the students' course evaluations stated that the quizzes should be continued because without them they would have come to class less well prepared and hence would have learned much less than they did.
- The best way to prepare for the course as we taught it was by first reading the questions, then reading the chapter, and then writing out notes outlining

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1. Actually, we broke our course into two segments, one where we covered selected text chapters and another where we covered cases that were related to and illustrated the text chapters. For the case portion of the course, students made presentations and discussed the cases. All of the cases required them to use *Excel*.
 2. Most of our students were graduating seniors who were interviewing for jobs. We excused them from class (and the quizzes) if they informed us by e-mail before class that they were interviewing.

answers to the questions in preparation for the oral quiz. We expected students to give complete answers to “easy” questions, but we gave them good grades if they could say enough about the harder questions to demonstrate that they had thought about how to answer them. We would then discuss the harder questions in lieu of a straight lecture, going into the related *Excel* models both to explain *Excel* features and to provide insights into different issues.

- Our midterm and final exams consisted of five of the harder BOC questions, of which three had to be answered in 2 hours in an essay format. It took a much more complete answer to earn a good grade than would have been required on the oral quizzes. We also allowed students to use a four-page “cheat sheet” on the exams.³ That reduced time spent trying to memorize things as opposed to understanding them. Also, students told us that making up the cheat sheets was a great way to study.

Major Changes in the Twelfth Edition

As in every revision, we updated and clarified sections throughout the text. Specifically, we also made the following changes in content:

References to, implications of, and explanations for the global economic crisis. Last edition we began using the global economic crisis to illustrate important learning points, and we have continued that in this edition with new examples and tie-ins to the chapters’ topics.

Additional integration of the textbook and the accompanying Excel Tool Kit spreadsheet models for each chapter. Many figures in the textbook come directly from the chapter’s *Excel Tool Kit* model. This serves two purposes. First, it makes the analysis more transparent to the student; the student or instructor can go to the *Tool Kit* and see exactly how all of the numbers in a figure were calculated. Second, it provides an additional resource for students and instructors to use in learning *Excel*.

Improvements in the MicroDrive Examples. For many editions, we have used a hypothetical company, MicroDrive, as a running example. This provides continuity in the examples from chapter to chapter and helps students apply the material more quickly. We have improved the integration in this edition and have made some changes to the financial statements to accommodate our changes. First, the financial statement values are now all integers and in most cases end with a zero, which simplifies calculations. Second, we have separated operating costs into three categories: cost of goods sold (excluding depreciation), other operating costs, and depreciation. This allows for added flexibility when defining ratios and forecasting financial statements. Third, we have modified the financial statements to allow MicroDrive to be the illustrative company for more chapters and more topics than in previous editions. This has been especially important in the systematic risk topic and the free cash flow valuation topic.

3. We did require that students make up their own “cheat sheets,” and we required them to turn their sheets in with their exams so we could check for independence.

Significant Changes in Selected Chapters

We made many small improvements within each chapter; some of the more notable ones are discussed below.

Chapter 1: An Overview of Financial Management and the Financial Environment We added a box on high-frequency trading—“Life in the Fast Lane: High-Frequency Trading!”—and a box on mortgage-backed securities, “Anatomy of a Toxic Asset.” We also increased our coverage of the global economic crisis to reflect changes in the past 3 years, including a section on the Dodd-Frank Act.

Chapter 2: Risk and Return: Part I As a part of our effort to integrate the illustrative company MicroDrive throughout the book, we made significant changes in this chapter. We begin with a discussion of discrete probability distributions involving different market scenarios and then segue into continuous distributions and estimating means and standard deviations using historical data for MicroDrive. We discuss two-stock portfolios and the impact of diversification by using data for MicroDrive and another company. This sets the stage for a discussion of market risk versus diversifiable risk and the appropriate measure of market risk, beta. We then describe the risk-return relationship defined by the CAPM and the basic concept of market equilibrium. This provides a natural transition into the efficient market hypothesis. We also added optional sections covering the Fama-French three-factor model and behavioral finance. These optional sections can be omitted without loss of continuity, or they can be covered to provide more depth on the topic of market efficiency and asset pricing. This new organization consolidates our treatment of risk and return and also illustrates these concepts with MicroDrive, providing a more effective learning experience for students.

Chapter 4: Bond Valuation We updated the box “Betting With or Against the U.S. Government: The Case of Treasury Bond Credit Default Swaps” to reflect the debt-ceiling crisis of July 2011. We added another new box describing the handful of AAA-rated companies, “The Few, the Proud, the.... AAA-Rated Companies!” We revised another box, “Fear and Rationality,” to include the TED spread as well as the Hi-Yield bond spread. We also added a brief discussion of duration and its use as a measure of risk. MicroDrive is the company used as a running example throughout the book. We changed its example bond offering to be consistent with MicroDrive’s revised financial statements.

Chapter 6: Accounting for Financial Management We reorganized and better integrated the sections on the statement of cash flows, operating cash flow, and free cash flow. We now have a single section focusing on the use of free cash flow and its components as performance measures. We added two new boxes. “Filling in the GAAP” describes the planned convergence of GAAP and IFRS; “When It Comes to Taxes, History Repeats and Repeats Itself!” discusses the actual taxes (or lack thereof) paid by many corporations. MicroDrive is the company used as a running example throughout the book. We changed its financial statements so that MicroDrive would provide additional learning points when we cover valuation and forecasting in Chapters 8 and 9.

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