Preface

This book describes the theory and practice of corporate finance. We hardly need to explain why financial managers have to master the practical aspects of their job, but we should spell out why down-to-earth managers need to bother with theory.

Managers learn from experience how to cope with routine problems. But the best managers are also able to respond to change. To do so you need more than time-honored rules of thumb; you must understand *why* companies and financial markets behave the way they do. In other words, you need a *theory* of finance.

Does that sound intimidating? It shouldn't. Good theory helps you to grasp what is going on in the world around you. It helps you to ask the right questions when times change and new problems need to be analyzed. It also tells you which things you do *not* need to worry about. Throughout this book we show how managers use financial theory to solve practical problems.

Of course, the theory presented in this book is not perfect and complete—no theory is. There are some famous controversies where financial economists cannot agree. We have not glossed over these disagreements. We set out the arguments for each side and tell you where we stand.

Much of this book is concerned with understanding what financial managers do and why. But we also say what financial managers *should* do to increase company value. Where theory suggests that financial managers are making mistakes, we say so, while admitting that there may be hidden reasons for their actions. In brief, we have tried to be fair but to pull no punches.

This book may be your first view of the world of modern finance theory. If so, you will read first for new ideas, for an understanding of how finance theory translates into practice, and occasionally, we hope, for entertainment. But eventually you will be in a position to make financial decisions, not just study them. At that point you can turn to this book as a reference and guide.

Changes in the Second Edition

We are proud of the success of the first edition of *Principles,* and we have done our best to make the second edition even better.

What is new in the second edition? First, we have rewritten and refreshed several basic chapters. Content remains much the same, but we think that the revised chapters are simpler and flow better. These chapters also contain more **real-world examples**.

- **Chapter 1** is now titled "Goals and Governance of the Firm." We introduce financial management by recent examples of capital investment and financing decisions by several well-known corporations. We explain why value maximization makes sense as a financial objective. Finally, we look at why good governance and incentive systems are needed to encourage managers and employees to work together to increase firm value and to behave ethically.
- **Chapter 2** combines Chapters 2 and 3 from the first edition. It goes directly into how present values are calculated. We think that it is better organized and easier to understand in its new presentation.
- **Chapter 3** introduces bond valuation. The material here has been reordered and simplified. The chapter focuses on default-free bonds, but also includes an introduction to corporate debt and default risk.
- Short-term and long-term financial planning are now combined in **Chapter 19**. We decided that covering financial planning in two chapters was awkward and inefficient. We have also added an Appendix that covers bank loans and other short-term debt, and the possible parking places for any surplus cash.
- **Chapter 18** is now devoted entirely to financial analysis, which should be more convenient to instructors who wish to assign this topic early in their courses. We explain how the financial statements and ratios help to reveal the value, profitability, efficiency, and financial strength of a real company (Lowe's).

The **credit crisis** that started in 2007 dramatically demonstrated the importance of a well-functioning financial system and the problems that occur when it ceases to function properly. Some have suggested that the crisis disproved the lessons of modern finance. On the contrary, we believe that it was a wake-up call—a call to remember basic principles, including the importance of good systems of governance, proper management incentives, sensible capital structures, and effective risk management.

We have added **examples and discussion of the crisis throughout the book**, starting in Chapter 1 with a discussion of agency costs and the importance of good governance. Other chapters have required significant revision as a result of the crisis. These include **Chapter 11**, where the review of market efficiency includes an expanded discussion of asset price bubbles, and the Appendix to **Chapter 19** where we note the effect of the crisis on money-market mutual funds.

The first edition of the comprehensive version of this book appeared in 1981. Basic principles are the same now as then, but the last three decades have also generated important changes in theory and practice. Research in finance has focused less on what financial managers should do, and more on understanding and interpreting what they do in practice. In other words, finance has become more positive and less normative. For example, we now have careful surveys of firms' capital investment practices and payout and financing policies. We review these surveys and look at how they cast light on competing theories.

Many financial decisions seem less clear-cut than they were 20 or 30 years ago. It no longer makes sense to ask whether high payouts are always good or always bad, or whether companies should always borrow less or more. The right answer is, "It depends." Therefore we set out pros and cons of different policies. We ask "What questions should the financial manager ask when setting financial policy?" You will, for example, see this shift in emphasis when we discuss payout decisions in **Chapter 12**.

This edition builds on other changes from earlier editions. We recognize that financial managers work more than ever in an international environment and therefore need to be familiar with international differences in financial management and in financial markets and institutions. Accordingly, we have found more and more opportunities to draw cross-border comparisons or use non-U.S. examples. We hope that this material will both provide a better understanding of the wider financial environment and be useful to our many readers around the world.

As every first-grader knows, it is easier to add than to subtract. To make way for new topics we have needed to make some judicious pruning. We will not tell you where we have cut out material, because we hope that the deletions will be invisible.

Making Learning Easier

Each chapter of the book includes an introductory preview, a summary, and an annotated list of suggested further reading. The list of possible candidates for further reading is now voluminous. Rather than trying to list every important article, we have largely listed survey articles or general books. More specific references have been moved to footnotes.

Each chapter is followed by a set of **basic questions, intermediate questions** on both numerical and conceptual topics, and a few **challenge questions**. Answers to the odd-numbered basic questions appear in an Appendix at the end of the book.

We have added a **Real-Time Data Analysis** section to chapters where it makes sense to do so. This section now houses some of the Web Projects you have seen in the previous edition, along with new Data Analysis problems. These exercises seek to familiarize the reader with some useful Web sites and to explain how to download and process data from the Web. Many of the Data Analysis problems use financial data that the reader can download from **Standard & Poor's Educational Version of Market Insight**, an exclusive partnership with McGraw-Hill.

The book also contains 7 end-of-chapter **mini-cases**. These include specific questions to guide the case analyses. Answers to the mini-cases are available to instructors on the book's Web site.

Spreadsheet programs such as **Excel** are tailor-made for many financial calculations. Several chapters now include boxes that introduce **the most useful financial functions** and provide some short practice questions. We show how to use the Excel function key to locate the function and then enter the data. We think that this approach is much simpler than trying to remember the formula for each function.

Many tables in the text appear as spreadsheets. In these cases an equivalent "live" spreadsheet appears on the book's Web site. Readers can use these live spreadsheets to understand better the calculations behind the table and to see the effects of changing the underlying data. We have also linked end-of-chapter questions to the spreadsheets.

We conclude the book with a glossary of financial terms.

The 19 chapters in this book are divided into 7 parts. Parts 1 to 3 cover valuation and capital investment decisions, and Parts 4 to 6 discuss long-term financing. Part 7 focuses on financial planning and short-term financial decisions.

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