

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 Tenth Edition

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

What is new in the tenth 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 ninth 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. (We discuss corporate debt and default risk in more detail in Chapter 23.)
- Short-term and long-term financial planning are now combined in **Chapter 29**. We decided that covering financial planning in two chapters was awkward and inefficient.
- **Chapter 28** 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 12**, which discusses executive compensation; **Chapter 13**, where the review of market efficiency includes an expanded discussion of asset price bubbles; **Chapter 14**, where the section on financial institutions covers the causes and progress of the crisis; **Chapter 23**, where we discuss the AIG debacle; and **Chapter 30**, where we note the effect of the crisis on money-market mutual funds.

The first edition 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 16**.

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. **Chapters 27** (Managing International Risks) and **33** (Governance and Corporate Control around the World) are **exclusively devoted to international issues**. We have also found more and more opportunities in other chapters 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 10 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 34 chapters in this book are divided into 11 parts. Parts 1 to 3 cover valuation and capital investment decisions, including portfolio theory, asset

pricing models, and the cost of capital. Parts 4 to 8 cover payout policy, capital structure, options (including real options), corporate debt, and risk management. Part 9 covers financial analysis, planning, and working-capital management. Part 10 covers mergers and acquisitions, corporate restructuring, and corporate governance around the world. Part 11 concludes.

We realize that instructors will wish to select topics and may prefer a different sequence. We have therefore written chapters so that topics can be introduced in several logical orders. For example, there should be no difficulty in reading the chapters on financial analysis and planning before the chapters on valuation and capital investment.

## ► Acknowledgments

We have a long list of people to thank for their helpful criticism of earlier editions and for assistance in preparing this one. They include Faiza Arshad, Alejda de Cazenove Balsan, Kedran Garrison, Robert Pindyck, Sara Salem, and Gretchen Slemmons at MIT; Elroy Dimson, Paul Marsh, Mike Staunton, and Stefania Uccheddu at London Business School; Lynda Borucki, Michael Barhum, Marjorie Fischer, Larry Kolbe, Michael Vilbert, Bente Villadsen, and Fiona Wang at The Brattle Group, Inc.; Alex Triantis at the University of Maryland; Adam Kolasinski at the University of Washington; Simon Gervais at Duke University; Michael Chui at The Bank for International Settlements; Pedro Matos at the University of Southern California; Yupana Wiwattanakantang at Hitotsubashi University; Nickolay Gantchev, Tina Horowitz, and Chenying Zhang at the University of Pennsylvania; Julie Wulf at Harvard University; Jinghua Yan at Tykhe Capital; Roger Stein at Moody's Investor Service; Bennett Stewart at EVA Dimensions; and James Matthews at Towers Perrin.

We want to express our appreciation to those instructors whose insightful comments and suggestions were invaluable to us during the revision process:

Neyaz Ahmed *University of Maryland*  
 Anne Anderson *Lehigh University*  
 Noyan Arsen *Koc University*  
 Anders Axvarn *Göteborg University*  
 Jan Bartholdy *ASB, Denmark*  
 Penny Belk *Loughborough University*  
 Omar Benkato *Ball State University*  
 Eric Benrud *University of Baltimore*  
 Peter Berman *University of New Haven*  
 Tom Boulton *Miami University of Ohio*  
 Edward Boyer *Temple University*

Alon Brav *Duke University*  
 Jean Canil *University of Adelaide*  
 Celtin Ciner *University of North Carolina, Wilmington*  
 John Cooney *Texas Tech University*  
 Charles Cuny *Washington University, St. Louis*  
 John Davenport *Regent University*  
 Ray DeGennaro *University of Tennessee, Knoxville*  
 Adri DeRidder *Gotland University*  
 William Dimovski *Deakin University, Melbourne*  
 David Ding *Nanyang Technological University*  
 Robert Duvic *University of Texas at Austin*  
 Alex Edmans *University of Pennsylvania*  
 Susan Edwards *Grand Valley State University*  
 Robert Everett *Johns Hopkins University*  
 Frank Flanegin *Robert Morris University*  
 Zsuzanna Fluck *Michigan State University*  
 Connel Fullenkamp *Duke University*  
 Mark Garmaise *University of California, Los Angeles*  
 Sharon Garrison *University of Arizona*  
 Christopher Geczy *University of Pennsylvania*  
 George Geis *University of Virginia*  
 Stuart Gillan *University of Delaware*  
 Felix Goltz *Edhec Business School*  
 Ning Gong *Melbourne Business School*  
 Levon Goukasian *Pepperdine University*  
 Gary Gray *Pennsylvania State University*  
 C. J. Green *Loughborough University*  
 Mark Griffiths *Thunderbird, American School of International Management*  
 Re-Jin Guo *University of Illinois, Chicago*  
 Ann Hackert *Idaho State University*  
 Winfried Hallerbach *Erasmus University, Rotterdam*  
 Milton Harris *University of Chicago*  
 Mary Hartman *Bentley College*  
 Glenn Henderson *University of Cincinnati*  
 Donna Hitscherich *Columbia University*  
 Ronald Hoffmeister *Arizona State University*  
 James Howard *University of Maryland, College Park*  
 George Jabbour *George Washington University*  
 Ravi Jagannathan *Northwestern University*  
 Abu Jalal *Suffolk University*  
 Nancy Jay *Mercer University*  
 Kathleen Kahle *University of Arizona*  
 Jarl Kallberg *NYU, Stern School of Business*  
 Ron Kaniel *Duke University*  
 Steve Kaplan *University of Chicago*  
 Arif Khurshed *Manchester Business School*  
 Ken Kim *University of Wisconsin, Milwaukee*  
 C. R. Krishnaswamy *Western Michigan University*  
 George Kutner *Marquette University*  
 Dirk Laschanzky *University of Iowa*  
 David Lins *University of Illinois, Urbana*

David Lovatt *University of East Anglia*  
 Debbie Lucas *Northwestern University*  
 Brian Lucey *Trinity College, Dublin*  
 Suren Mansinghka *University of California, Irvine*  
 Ernst Maug *Mannheim University*  
 George McCabe *University of Nebraska*  
 Eric McLaughlin *California State University, Pomona*  
 Joe Messina *San Francisco State University*  
 Dag Michalson *BI, Oslo*  
 Franklin Michello *Middle Tennessee State University*  
 Peter Moles *University of Edinburgh*  
 Katherine Morgan *Columbia University*  
 Darshana Palkar *Minnesota State University, Mankato*  
 Claus Parum *Copenhagen Business School*  
 Dilip Patro *Rutgers University*  
 John Percival *University of Pennsylvania*  
 Birsal Pirm *University of Illinois, Urbana*  
 Latha Ramchand *University of Houston*  
 Rathin Rathinasamy *Ball State University*  
 Raghavendra Rau *Purdue University*  
 Joshua Raugh *University of Chicago*  
 Charu Reheja *Wake Forest University*  
 Thomas Rhee *California State University, Long Beach*  
 Tom Rietz *University of Iowa*  
 Robert Ritchey *Texas Tech University*  
 Michael Roberts *University of Pennsylvania*  
 Mo Rodriguez *Texas Christian University*  
 John Rozycki *Drake University*  
 Frank Ryan *San Diego State University*  
 Marc Schauten *Eramus University*  
 Brad Scott *Webster University*  
 Nejat Seyhun *University of Michigan*  
 Jay Shanken *Emory University*  
 Chander Shekhar *University of Melbourne*  
 Hamid Shomali *Golden Gate University*  
 Richard Simonds *Michigan State University*  
 Bernell Stone *Brigham Young University*  
 John Strong *College of William & Mary*  
 Avaniidhar Subrahmanyam *University of California,  
 Los Angeles*  
 Tim Sullivan *Bentley College*  
 Shrinivasan Sundaram *Ball State University*  
 Chu-Sheng Tai *Texas Southern University*  
 Stephen Todd *Loyola University, Chicago*

Walter Torous *University of California, Los Angeles*  
 Emery Trahan *Northeastern University*  
 Ilias Tsiakas *University of Warwick*  
 Narendar V. Rao *Northeastern University*  
 David Vang *St. Thomas University*  
 Steve Venti *Dartmouth College*  
 Joseph Vu *DePaul University*  
 John Wald *Rutgers University*  
 Chong Wang *Naval Postgraduate School*  
 Kelly Welch *University of Kansas*  
 Jill Wetmore *Saginaw Valley State University*  
 Patrick Wilkie *University of Virginia*  
 Matt Will *University of Indianapolis*  
 Art Wilson *George Washington University*  
 Shee Wong *University of Minnesota, Duluth*  
 Bob Wood *Tennessee Tech University*  
 Fei Xie *George Mason University*  
 Minhua Yang *University of Central Florida*  
 Chenying Zhang *University of Pennsylvania*

This list is surely incomplete. We know how much we owe to our colleagues at the London Business School, MIT's Sloan School of Management, and the University of Pennsylvania's Wharton School. In many cases, the ideas that appear in this book are as much their ideas as ours.

We would also like to thank all those at McGraw-Hill/Irwin who worked on the book, including Michele Janicek, Executive Editor; Lori Koettters, Managing Editor; Christina Kouvelis, Senior Developmental Editor; Melissa Caughlin, Senior Marketing Manager; Jennifer Jelinski, Marketing Specialist; Karen Fisher, Developmental Editor II; Laurie Entringer, Designer; Michael McCormick, Lead Production Supervisor; and Sue Lombardi Media Project Manager.

Finally, we record the continuing thanks due to our wives, Diana, Maureen, and Sally, who were unaware when they married us that they were also marrying the *Principles of Corporate Finance*.

**Richard A. Brealey**  
**Stewart C. Myers**  
**Franklin Allen**