



C a n a d i a n E d i t i o n

BASIC
FINANCIAL
MANAGEMENT

PETTY
KEOWN
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BASIC FINANCIAL MANAGEMENT

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C a n a d i a n E d i t i o n

BASIC
FINANCIAL
MANAGEMENT

To our families...

PREFACE

Historical circumstances are a driving force underlying the development and practice of financial management. For example, in the 1970s volatile energy prices, interest rates, and exchange rates dominated both the financial press and the economic environment within which financial decisions were made. These factors led to the development of new commodity and financial futures markets in which firms could hedge their risk exposure and speculate on the directions of anticipated price movements. Similarly, in the 1980s corporate control contests have resulted in the restructuring of corporate Canada. This unprecedented wave of transactions has included corporate divestitures, leveraged buyouts, joint ventures, spin-offs, split-ups, employee stock option plans (ESOPs), partial public offerings, project financings, and a host of other types of transactions which have filled the financial press during the 1980s and early nineties.

Some have characterized this latest wave of corporate control contests simply as evidence of the continual tug-of-war between the capital market and corporate managements for control over financial resources. If this is true, then it would appear that the 1980s were a time of unprecedented victory for the capital markets. Many of the largest corporations have fallen victim to the “bust-up merger” as they have been bought up and their assets sold to the highest bidder. This, in turn, means that the investment and financing decisions of even the very largest firms are subject to an unprecedented level of scrutiny by the capital markets.

Some practicing financial managers have cried foul, saying that investors in the capital markets are too short-term oriented or myopic. This, they argue, has placed undue pressure on the corporate manager to produce short-term profits to the exclusion of making long-term commitments. The evidence from the academic community, however, has not supported this contention. Furthermore, as the pressures of international competition continue unabated, serious consideration must be given to the impact the capital markets have on the firm’s competitiveness in world markets through its influence on the firm’s investment and financing choices. Consequently, it is our belief that the events of the 1980s and early 1990s have heightened the importance of corporate finance in the overall formula for corporate competitiveness and success.

In this text we have endeavoured to provide the introduction to financial decision making, which is rooted in both the current state of our understanding of financial theory and in current world economic conditions. This focus is evident in a number of ways, perhaps the most obvious being the attention to the concepts of risk and return, the related notion of opportunity costs, capital markets and their influence on corporate financial decisions. We believe the increased emphasis on capital markets is consistent with their influence on corporate financial decisions.

Pedagogy and Target Audience

Basic Financial Management provides the reader with an overview of financial management as intended for an introductory course in the subject. Such a course might be taught over one academic year or two semesters. The orientation continues to be managerial with an emphasis on the identification and solution of the financial problems confronting the business enterprise.

Decision making within an enterprise valuation framework is stressed throughout the text, and thereby, provides a unifying theme across all discussions. In the preparation of the manuscript, three primary standards were used. First, we have made a strong effort to offer completeness in the treatment of each topic. Second, we have given readability a high priority. We have taken extra care to use a clear and concise writing style, especially in the treatment of concepts requiring the use of mathematics. Third, complete, step-by-step examples are frequently used to increase clarity and to crystallize the critical issues in the student's mind. In summary, the pedagogical approach taken, particularly for the more difficult topics, progresses from an intuitive presentation of the problem to the introduction and illustration of the appropriate decision-making framework.

The First Canadian Edition

Besides the expanded emphasis on the role of the capital markets in corporate financial decision making, there are a number of important features in this text that may not be so obvious.

1. We have worked to add life to the chapter presentations by adding a number of readings on Canadian business practice, called "Basic Financial Management in Practice."
2. Also, given the continued ethical questions being addressed in the press, we have, on several occasions, offered the student value orientations we believe will be helpful. The basic notion of what constitutes ethical behaviour is not clear-cut. However, we have tried to provide some definitions, which will provide a fundamental starting point for considering the issues as they relate to financial decision making.
3. In view of the continued globalization of world markets, we have included "International Financial Management" sections throughout the text.
4. A separate appendix has been added that demonstrates the use of a calculator (the Texas Instruments BA II Plus). We have also designed an insert card to the text that shows how to find the compound value interest factors and the present value interest factors without use of the table values. (In the student guide, we provide a complete article on the use of all the popular financial calculators.)
5. Chapters include self-test questions and study problems for quantitative analyses of topics covered.

In addition to these features just mentioned, we also would like to emphasize the following examples of financial topics found in the first Canadian edition of *Basic Financial Management*:

1. In our introduction to the financial environment, we have examined the financial structure of financial markets, the term structure of interest rates, and the Canadian income tax system. We have also featured one of the major players in this environment, the Canadian banks.
2. We have emphasized the influence of capital markets by examining the risk and return framework by which financial decisions are made. This presentation includes a discussion on the capital asset pricing model and the importance of systematic risk. The arbitrage pricing model is examined in the appendix of Chapter 3 to give the instructor added flexibility.

3. Chapter 4 has integrated the principles of financial valuation in order for the student to appreciate how we can value financial assets such as single period payments, annuities, mortgage loans, bonds, preferred shares, and common shares.
4. Chapter 5 includes material on determining the weighted marginal cost of capital and the required rate of return of individual projects.
5. In Chapter 6, we examine capital budgeting decisions by emphasizing how to measure a project's benefits and costs. Consequently, the student will find the concept of "relevant cash flows" easier to understand.
6. Chapter 7 examines the application of capital budgeting techniques to expansion and replacement projects. We also discuss the importance of incorporating risk techniques into capital budgeting decisions.
7. In the Chapters 8, 9 and 10 we discuss leverage, capital structure theory, and the relevance of dividend policy. Furthermore, we examine empirical evidence from surveys of management opinions on capital structure and dividend policy. We also discuss business cycles and financing behaviour.
8. Chapter 11 and 12 examine the topics of financial performance and financial forecasting. The appendix of Chapter 12 includes a discussion on how to use a spreadsheet to develop a cash budget.
9. Chapters 13, 14, 15, and 16 discuss the major topics of working capital management. The emphasis of these chapters is to introduce the business practices used in managing cash, accounts receivable, inventory and accounts payable. We also examine how to determine the cost of using short-term financing.
10. Chapters 17, 18, 19, and 20 examine how funds are raised in capital markets in Canada and some of the financial instruments used to raise funds. This discussion has incorporated Canadian business practice and regulations. We also discuss some of the financial instruments used in hedging risk of a portfolio.
11. Chapters 21, 22, 23 and 24 include special topics in financial management. In Chapter 21 we look at the restructuring of firms, which has become a predominant issue in the media. To bring the chapter up to date, we have added a section on why mergers and acquisitions might create value, an important question with no easy answer for those managers contemplating such a decision. We also look at the more recent approaches used in valuing a firm, which include what we refer to as the chop-shop approach and the free-cash flow valuation model. Chapter 22 has included Canadian business practices used in the financial reorganization of a firm. Changes to the Insolvency and Bankruptcy Act in 1992 have changed the business practices of Canadian firms in financial distress. Chapter 23 examines the impact of international business finance on financial management in the Canada. Finally, Chapter 24 examines the relevance of capital budgeting techniques for the owner-manager of the small firm. Small firms have been criticized for not joining the bandwagon of the discounted cash flow models. Maybe there is a rationale for such actions on the part of the small-firm managements. This issue is now addressed in the chapter.

This list does not completely describe all the major changes made to the first Canadian edition. However, it highlights the types of changes we have com-

mitted ourselves to making in order that *Basic Financial Management* will reflect the very best thinking that financial scholars have to offer.

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Readers wishing further information on excerpts provided through the cooperation of Statistics Canada may obtain copies of related publications by mail from: Publications Sales, Statistics Canada, Ottawa, Ontario, K1A 0T6.

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Even with the very fine efforts of all involved in preparing the first Canadian edition of *Basic Financial Management*, some errors inevitably will exist. For these, the authors must accept final responsibility.

J.D.M
J.W.P
A.J.K.
D.F.S.
D.W.M

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