

Preface

Students new to financial management often perceive the finance discipline in the same light as the task before the climber on the cover of this text. Daunting! But rest assured that the climber persevered and made it to the top of the ice wall. You too can find finance a fulfilling challenge by using this text that strives to make the climb as comfortable as possible. *Foundations of Financial Management* is committed to making finance accessible to you.

In this sixth edition we have made content and presentation revisions to make this text an even better tool for providing you with the skills and confidence you'll need to be an effective financial manager. Concepts are explained in as clear a manner as possible, with numerous "Finance in Action" boxes highlighting real world examples and employing Internet resources to reinforce and illustrate these concepts. The extensive and varied problem material examines these concepts in more detail. In the sixth edition, as always, we remain strongly committed to presenting the concepts of finance in an enlightening, interesting, and exciting manner. This text continues to work for you the student.

Reinforcing Prerequisite Knowledge

Employers of business graduates report that the most successful analysts, planners, and executives have both ability and confidence in their financial skills. We couldn't agree more. One of the best ways to increase your ability in financial planning is to integrate knowledge from prerequisite courses. Therefore, this text is designed to build on students' knowledge from basic courses in accounting and economics, with some statistics. By applying the tools learned in these courses, you can develop a conceptual and analytical understanding of financial management.

For some of you, time has passed since you've completed your accounting courses. Therefore, included in Chapter 2, is a thorough review of accounting principles, finance terminology, and financial statements. With a working knowledge of Chapter 2, you will have a more complete understanding of financial statements, the impact of your decisions on financial statements, and how financial statements can

serve you in making effective financial decisions. Furthermore, as you are about to begin your career you will be much better prepared when called on to apply financial concepts.

Module Format Adds Flexibility

Foundations of Financial Management covers virtually every possible topic taught in a financial management course. However it is almost impossible to cover every topic included in this text, within one course. Therefore this book has been carefully crafted to ensure a flexibility that accommodates different course syllabuses and a variety of teaching approaches. We have encouraged instructors to use a format with the text that they find works best for them and for you. After using this text, you may find yourself referring back to those topics that time did not permit you to cover or perhaps to reexamine some of the concepts that you are exploring once again.

Financial management's three basic concerns are the management of working capital, the effective allocation of capital by means of the capital budgeting decision, and the raising of long-term capital with an appropriate capital structure. These topics are covered in Parts 3, 4, and 5 of the text. The introduction to financial management in Part 1 and financial analysis and planning in Part 2 precede these central parts. A broader perspective on finance is addressed in Part 6 of the text.

New Features and Improvements

Integration When applicable we have tried to tie concepts together across chapters. For example:

- The dynamic role of the financial markets in allocating capital, assessing risks, and determining returns is highlighted when appropriate. Examples are found in Chapters 1, 3, 10, 11, and 14.
- The expanded internationalization of the financial markets is a consistent theme, with specific references to the euro, the devaluation of Argentina's peso, and deflation in Japan, found in Chapter 21. Other international examples can be found in Chapters 1, 8, 13, 14, 17, and 19.
- Cost/benefit analysis to emphasize increased value is highlighted in Chapters 7, 12, and 16.
- Leverage in Chapter 5 is connected to the income statement of Chapter 2 and the risks of increased debt in Chapter 16.
- The cash flow cycle of Chapter 6 is tied into the ratio formulas of Chapter 3.

More worked examples Key illustrations are added for hedging (Chapter 6), cash management (Chapter 7), the dividend capitalization model (Chapter 10), and the costs of flotation spread and dilution (Chapter 15).

Simplification If concepts can be simplified it is an improvement. Some examples include:

- The formulas in Chapter 8.
- Deletion of the graphical presentation of time value relationships from Chapter 9.

- Use of the spread as a percentage for flotation cost adjustments in the cost of capital calculation in Chapter 11.
- Deletion of considerable share for share discussion and illustration from Chapter 20.


Tighter focus When appropriate we have tried for a clearer focus in some material. This is evident in:

- **Chapter 1: The Goals and Functions of Financial Management** with a focus on valuation as a role for finance.
- **Chapter 3: Financial Analysis** with a clarified and more user friendly Du Pont method. It also expands on the number of asset utilization ratios.
- **Chapter 14: Capital Markets** with more focused illustrations and an update of the changing financial marketplace.
- **Chapter 19: Derivatives, Convertibles, and Warrants** updates the accounting treatment of warrants.
- **Chapter 21: International Financial Management** includes a discussion of the euro.

Real World Examples Recent “big” names in the news are used for illustrations. These include:

- Nortel in Chapter 3 (big write-offs), Chapter 7 (vendor financing), and Chapter 10 (valuation).
- Enron in Chapter 14 discussing its impact on market efficiency and the fairness of the markets.
- September 11th in Chapter 1 for its impact on financial markets and in Chapter 13 for its influence on risk.

Finance in Action Boxes A popular feature of the text, these now include questions that often require the use of an Internet site and sometimes a stock symbol to find appropriate information related to the chapter material. For example, see Chapter 1, page 18 and Chapter 7, page 227.



**FINANCE
IN ACTION**

Q1 What are current overnight rates in these countries?

www.bankofcanada.ca

The Markets for Valuation and Rates of Return

In 1999 Nortel shares sold in the market for less than \$20.00. By 2000 they sold for over \$120.00 per share and the market value of Nortel shareholders' equity was \$350 billion. By early 2002 the market value was down to \$35 billion and a share sold for about \$11.00. The market had demonstrated drastically different views of Nortel's share value.

The S&P/TSX Composite Index is representative of the market value of the equity of the top companies listed on Canada's premier stock exchange. In August of 2000 the S&P/TSX Composite Index had a value over 11,000. In early 2002 its value was about 7,600. Search for its value under indexes at the TSX web site www.tsx.ca.

The shareholder market value of these companies (primarily Nortel) had dropped considerably in a little over a year. Can you determine the current value of Nortel (NT) and the S&P/TSX Composite Index?

The bedrock interest rate or yield in the economy is the overnight rate, the rate at which financial institutions lend money amongst themselves for one day. Other yields in the economy take their clues from this rate. In 1981 Canada's overnight rate reached 21.57 percent. In early 2002 the overnight rate was down to 2 percent, while in England www.bankofengland.co.uk it was 4 percent (repo rate) and 0.10 percent in Japan (www.boj.or.jp).

Small Business Icons Small business references and examples are highlighted throughout the text with an icon.



Calculator Icons Have been added to this edition of the text to highlight where a financial calculator can be used.



Pedagogy

To provide guidance and insights throughout the text, we've made use of a number of proven pedagogical aids, including:

- **Learning Objectives** At the beginning of each chapter learning objectives will help focus your learning as you proceed through the material. The summary of each chapter responds to each of these objectives.

LEARNING OBJECTIVES

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|---|---|--|
| <p>1 Calculate 13 financial ratios that measure profitability, asset utilization, liquidity, and debt utilization.</p> <p>2 Assess a company's source of profitability using the DuPont system of analysis.</p> | <p>3 Examine the ratios in comparison to industry averages.</p> <p>4 Examine the ratios and company performance by means of trend analysis.</p> | <p>5 Identify sources of distortion in reported income.</p> |
|---|---|--|



- **Calculators** When the use of a calculator is illustrated a calculator icon appears in the margin. Appendix E demonstrates the use of the three most commonly used business calculators, with the illustrations in the text tending to conform to the Sharp calculator. Chapter 9 demonstrates the use of a calculator with time lines, and the use of tables (as an option). The formulas for present value analysis, which are the basis for calculators, tables, or computers, have been included. Answers computed with the calculator will be more accurate, as compared to the tables, due to the rounding of the table factors. A financial calculator tutorial using the TI BAII Plus can be found on the Online Learning Centre for the text at www.mcgrawhill.ca/college/block.
- **“Finance in Action” Boxes** These popular boxes address topics related to the chapter subject matter and deal with the difficulties and opportunities in the financial markets. This edition adds questions appropriate to the topic, often requiring Internet searches for background information. Rewarding discussions of current and historical financial events, issues and practices can begin with this material. Most Finance in Action boxes include at least one web site (URL) relevant to the discussion, which will allow for updating the events outlined in the box. Furthermore, when Canadian companies are discussed their stock market ticker “symbol” is included in the Finance in Action box, as several web sites use this symbol to access information on the company.

End-of-Chapter Material

Practice makes perfect. Each chapter concludes with review and problem materials to help students review and apply what they've learned throughout the chapter. Well over 90 percent of the problems are new or revised from the Fifth Edition.

Summary

1. Financial forecasting allows the financial manager to anticipate events before they occur, particularly the need for raising funds externally. Growth itself may call for additional sources of financing because profit is often inadequate to cover the net buildup in receivables, inventory, and other asset accounts.
2. We develop pro forma financial statements from an overall corporate systems viewpoint. Today computerized spreadsheets greatly facilitate this process. The time perspective is usually six months to a year in the future. In developing a pro forma income statement, we begin by making sales projections; then, we construct a production plan. Finally, we consider all other expenses.

- **Summary** Each chapter ends with a Summary that ties the material back to the specific chapter objectives presented at the beginning of the chapter.

- **Review of Formulas** At the end of every chapter that includes formulas, a list of all formulas used in that chapter is provided for easy reviewing purposes. The formulas from all chapters are included on the tear out perforated card that comes with the text.

Review of Formulas

1.
$$BE = \frac{FC}{P - VC} \quad (5-1)$$

BE is break-even point
FC is fixed costs
P is price per unit
VC is variable cost per unit

$$BE \text{ (cash basis)} = \frac{FC - \text{Amortization}}{P - VC}$$
2.
$$DOL = \frac{Q(P - VC)}{Q(P - VC) - FC} \quad (5-3a)$$

DOL is degree of operating leverage
Q is quantity at which DOL is computed
P is price per unit
VC is variable cost per unit
FC is fixed costs
3.
$$DOL = \frac{S - TVC}{S - TVC - FC} \quad (5-3b)$$

DOL is degree of operating leverage
S is sales (QP) at which DOL is computed
TVC is total variable costs
FC is fixed costs

- **List of Terms** Similarly, you can use the list of key terms provided at the end of each chapter to test your comprehension and retention. Page numbers are provided and the term is also defined in the glossary.

List of Terms

<ul style="list-style-type: none"> leverage (concept in general) 134 operating leverage 135 fixed costs 136 variable costs 136 contribution margin 137 break-even analysis 141 degree of operating leverage (DOL) 141 	<ul style="list-style-type: none"> nonlinear break-even analysis 144 financial leverage 145 degree of financial leverage (DFL) 147 EBIT/EPS indifference point 149 leveraged buyout 150 combined leverage 151 degree of combined leverage (DCL) 152
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- **Internet Resources and Questions** Each chapter has a section that identifies several Internet sites that provide up-to-date information on many of the topics covered in the chapter. The questions that follow encourage you to explore these web sites and to learn about the financial information that is available on the web. Furthermore the questions expand upon the financial concepts and terms discussed in the chapter. Your familiarity with these web sites will expand your skills and your knowledge base, in financial management.

INTERNET RESOURCES AND QUESTIONS

Two Canadian sites rate and grade debt. The ratings determine the spread corporations pay above Government of Canada securities:
www.standardandpoors.com/canada
www.dbrs.com

Two sites identify current yields on bond issues:
www.globecandmail.com
www.scotiacapital.com

The Canoe site identifies current pricing on preferreds and common stock, including P/E ratios, and dividend yields:
www.webfin.com/en

Betas and other useful share information is available on many Canadian companies at Nasdaq Canada and Thomson Financial
www.thomsoninvest.net
www.nasdaq-canada.com

1. Calculate the cost of capital for a corporation listed on one of the major exchanges in Canada. Use current pricing on debt and equity from the sites identified above, and use the latest filed financial statement of the selected company. The financial statements will be available at www.sedar.com.
2. Update the information included in Table 11-2. Have any of the ratings changed? Can you suggest why the ratings have changed?
3. Find the betas, P/E ratios and dividend yields for the companies listed in Table 11-2. What do they tell you about the relative riskiness of the companies?

- **Discussion Questions and Problems** The material in the text is supported by approximately 300 questions and over 500 problems in this sixth edition, to reinforce and test your understanding of the chapter. The problems are a very important part of the text and have been written with care to be consistent with the chapter material. The problems for this edition have been revised, while maintaining the extensive variety and the range of difficulty from previous editions.
- **Comprehensive Problems** Several chapters have Comprehensive Problems that integrate and require the application of several financial concepts into one problem. Some of these comprehensive problems cover several concepts from one or more chapters. For example, see Chapter 3, page 95, Chapter 9, page 316, and Chapter 12, page 460.

Supplemental Material for Students

The Student's Online Learning Centre

The OLC at www.mcgrawhill.ca/college/block includes online study material including Quiz Questions, CBC Video Cases, Web Links, Internet Resources and Questions, Excel Templates (FAST), Learning Objectives, Key Terms and Searchable Glossary, Finance Around the World and more!

Study Guide and Workbook 007-089763-8

This valuable resource, by Dwight C. Anderson and J. Douglas Short provides chapter summaries, and additional problems and multiple-choice questions with solutions to help you better understand financial concepts and to prepare for exams. Ask for it at your bookstore!



Financial Analysis Spreadsheet Templates (FAST)

These templates included with each textbook are designed to help you solve problems using Excel. Several end-of-chapter problems in the text are linked to this software and are indicated with an icon.

Instructional Support

The Instructor's Online Learning Centre

The OLC at www.mcgrawhill.ca/college/block includes a password-protected web site for Instructors. The site offers downloadable supplements and PageOut, the McGraw-Hill Ryerson course web site development centre.

Instructor's CD-ROM

This CD-ROM contains all of the necessary Instructor Supplements, including:

- *Instructor's Manual* Written by the author, this manual integrates the graphs, tables, PowerPoint slides, and problems into a lecture format. Each chapter opens with a brief overview of the chapter and a review of the key learning objectives. The chapter is then outlined in an annotated format to facilitate its use as an in-class reference guide by the instructor. The manual includes *detailed solutions to all problems and questions* at the end of the chapters. The solu-

tions are presented in large type to facilitate their reproduction as transparencies for use in the classroom.

- *Microsoft® PowerPoint® Slide Presentations*, prepared by Terry Fegarty, Seneca College. The PowerPoint package contains relevant tables, figures, and illustrations from the text material that you can customize for your lecture.
- *Computerized Test Bank Software* Prepared by the authors, the test bank includes 1,500 multiple-choice and true-false questions written by the authors according to the revisions of the sixth edition. Additionally there are quiz problems and 10 question matching quizzes, geared to test the student's knowledge of the terms at the end of the chapter. The test bank is available in the Diploma software program. This software includes an easy-to-use menu system that allows quick access to all the powerful features available. The Keyword Search option lets you browse through the question bank for problems containing a specific word or phrase. Questions can be added, deleted or modified.

CBC Video cases, prepared by Denny Dombrower, Centennial College. Accompanying the text is a series of video segments drawn from CBC broadcasts. These videos have been chosen to visually aid students in tying real-world finance issues to the text, and to illuminate key ideas and concepts presented in the text. A set of instructor notes accompanies the segments available at the Instructor Online Learning Centre. The video segments are available in a VHS format for use in class and through video-streaming on the Online Learning Centre accessible by both instructors and students.

PageOut Visit www.mhhe.com/pageout to create a web page for your course using our resources. PageOut is the McGraw-Hill Ryerson web site development centre. This web-page-generation software is free to adopters and is designed to help faculty create an online course, complete with assignments, quizzes, links to relevant web sites, lecture notes, and more in a matter of minutes.

In addition, content cartridges are also available for course management systems, such as *WebCT* and *Blackboard*.

Acknowledgements

I am indebted to those individuals who have been the source of many improvements in this text through their thoughtful and insightful reviews. I was very impressed by the time and wonderful effort given in those comprehensive reviews. Thank you for the source of stimulation, and I hope I've been able to address most of the concerns you raised and that I have also been able to more effectively present the material, for the benefit of our students. As always I've tried to balance competing visions and still provide the material we need to make our individual styles work in the classroom, and now to some extent in e-space. These individuals include:

Cecile Ashman, Algonquin College
 Denny Dombrower, Centennial College
 Terry Fegarty, Seneca College
 Brian Hobson, Georgian College



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Special thanks go to two individuals who over several editions have always been there to help find an answer. Robert Short guides me through the capital markets. Mark Woltersdorf simplifies the Income Tax Act and tax practices for my understanding.

The people at RBC Dominion Securities in Toronto have provided invaluable insights into current practices and financial innovations.

For this sixth edition I had wonderful help from Erin Short in the preparation and review of FAST Excel spreadsheets. In addition, Gabriela Schneider made an effective contribution to the presentation of several FAST worksheets.

There are many individuals who contributed in innumerable ways to earlier editions and their efforts live on in this edition. Thank you to H. Allan Conway for his groundwork in preparing the first Canadian edition of this text. I would like to express my gratitude to Stanley B. Block and Geoffrey A. Hirt for the work and care that they continue to put into the U.S. editions of the text. I also appreciate the latitude that they have allowed in adapting the book for the Canadian environment and student.

To my editor Lynn Fisher, my thanks for her commitment to a text focused on the student. Lynn Fisher's efforts to keep me on course were appreciated. Lynn persevered with my personal peccadilloes and I believe we have come up with an even better text with this sixth edition.

To my developmental editor a sincere thanks. Maria Chu juggled with great skill my cut and pastes, e-files, courier deliveries, and phone calls in putting together a workable manuscript.

I would also like to thank Anne Macdonald and Karen Hunter for their terrific attention to detail on the manuscript.

To the marketing representatives a special thanks for doing such a great job of keeping in touch with the current and future users of this text. Call anytime!

Finally, a thanks to my students. I find finance fascinating because it changes everyday and it reflects the future. It is like you.

J. Douglas Short