

Ninth edition

CORPORATE FINANCE AND INVESTMENT

Decisions and strategies



Richard Pike, Bill Neale
and Saeed Akbar
with Philip Linsley



CORPORATE FINANCE AND INVESTMENT



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Preface

We are very excited that our text, already in its third decade, now enters its ninth edition. It is unusual for a text to have such longevity, and there are a host of people who need thanking – our publishers, who continue to support us in our endeavours to produce a contemporary and informative text, academics who recommend the book, and students who purchase the book and use it in their studies.

Corporate finance and the financial world continue to develop and change at a rapid rate, and the dynamic nature of financial markets is evident in movements in share prices and stock indices across the world. The financial crisis that commenced in 2007–8 is still having fundamental repercussions and making headlines, not least in the ongoing debate about the ‘correct’ level of interest rates. The crisis fully underlines why finance should be widely studied and that the potential consequences of financial decisions need to be understood, both on the upside and the downside. Further, the crisis demonstrates that what happens in finance can have important ramifications for governments and individuals as well as businesses. Risk has always been a key facet of finance and financial markets but now seems to have even greater significance. As a consequence, risk management has risen in prominence.

These considerations reinforce our view that finance should be about developing, explaining and, above all, *applying* key concepts and techniques to a broad range of contemporary management and business policy concerns and challenges. It is becoming more appropriate, certainly at the undergraduate level, to demonstrate the role finance has to play in explaining and shaping business development rather than concentrating on rigorous, quantitative aspects.

The focus of the ninth edition, as in previous ones, is distinctly corporate, examining financial issues from a managerial standpoint. To simplify greatly, we have tried, wherever possible, to present the reader with the question ‘OK, but how does this help the managerial decision-maker?’ and also to provide a few answers, or at least pointers.

Some might say we should include chapters on other financial issues deemed to have a degree of importance equivalent to those covered here. Yet we believe, as ever, that there is a trade-off between comprehensiveness and manageability. This edition is directed at those issues, which in our experience are regarded as the central issues in finance.

■ Distinctive features

The ninth edition retains a set of distinctive features, including the following:

- *A strategic focus.* Students often regard financial management as a subject quite distinct from management and business policy. We attempt to relate the subject to these matters, emphasising the integration of the finance function within the context of managerial decision-making and corporate planning, and to the wider external environment.
- *A practical approach.* Financial theory increasingly dominates some texts. Theory has its place, and this text covers an appreciable amount; however, we seek to blend theory and practice: to ask why they sometimes differ, and to assess the role of less-sophisticated financial approaches. In other words, we do not elevate theory above common sense and intuition.

- *A clear and accessible style.* Personal experience and feedback suggest that much of our target readership prefers a more descriptive, rather than heavily mathematical, approach but appreciates worked examples and illustrations. There is a place for formulae, proofs and quantitative analysis; however, where possible, an alternative narrative explanation is provided.
- *An international perspective.* Although emanating from the United Kingdom, our text continues to use, where appropriate, examples drawn from other regions and countries, especially mainland Europe and the United States.

■ Teaching and learning features

A range of teaching and learning features is provided, including the following:

- *Mini case studies.* Topical cameos, applying financial management principles to well-known companies, are presented at the start of chapters and elsewhere within the text.
- *Learning objectives.* Specified at the outset of each chapter, these highlight what the reader should achieve in terms of concepts, terminology and skills.
- *Worked examples.* Integrated throughout the text to illustrate the key principles.
- *Extracts from the press.* Each chapter includes articles mainly from the *Financial Times* and *The Economist* but also includes other media, focusing on key issues addressed in the chapter.
- *Key revision points.* Provided at the end of each chapter to summarise the main concepts covered.
- *Annotated further reading.* At the end of each chapter, a number of key books and articles are suggested to offer additional perspectives and enable subjects to be studied in more depth. Full details of all books and articles are given in the References at the end of the text.
- A quick reference *glossary* of simple definitions.

■ Assessment features

Flexible study and assessment is facilitated by a variety of activities:

- *Self-assessment activities (SAAs).* These include both short questions and simple numerical exercises designed to reinforce a point made in the text or to encourage the reader to pursue a particular line of thought. Questions are inserted in the text at appropriate points, and the answers are packaged together at the end of the text in Appendix A.
- *Questions.* These test a mix of numerical, analytical and descriptive skills, offering a spread of difficulty. A selection of solutions is also provided in Appendix B at the end of the text, making these suitable for self-assessment, tutorial or examination purposes.
- *Practical assignments.* These provide the opportunity to look beyond the confines of the text to consider the application of concepts to a company or organisation, or to published financial reports and data, and are suitable where group or individually assessed coursework is set.

■ Readership

The text has proved successful both for newcomers to finance and also for students with a prior knowledge of the subject. It is particularly relevant to undergraduate, MBA and other postgraduate and post-experience courses in corporate finance or financial management. Students seeking a professionally accredited qualification will also find it especially relevant to the financial management papers of the Association

of Chartered Certified Accountants, Institute of Chartered Secretaries and Administrators, Certified Diploma in Finance and Accounting, Chartered Institute of Management Accountants, and the Institute of Chartered Accountants in England and Wales.

■ Changes to the ninth edition

As with previous editions, our revisions are based on extensive market research, including reviewers' questionnaires and direct feedback from adopters and users. Feedback, while always interesting and helpful, was sometimes contradictory. Hopefully, we have achieved a balance between academic rigour and practical application.

In preparing this edition, we have battled with two opposing forces. We wanted to avoid expanding the text to an unmanageable size, yet we have been aware of several gaps in our coverage in previous editions, and the need for 'infill'.

The main changes to this edition in structure and in content are summarised here.

■ Structural changes

In the ninth edition, there is more discussion on topics related to capital structure, risk and return, asset pricing, and behavioural finance. We have built on this from the eighth edition and further extended the discussions on risk management, capital structure theories and empirical evidence, recent examples of acquisitions and restructuring, real option and Islamic finance in the ninth edition.

In pursuing the suggested changes, we have made many changes to different parts of the text. Specific attention is placed on updating financial and accounting data, removal of tired text and inclusion of fresh discussion in some chapters; updated articles from the *Financial Times* and other print and online media; inclusion of the findings of newly published research papers in relevant areas in each chapter; updates of some of the real-world examples; and inclusion of discussion on relevant recent changes in financial theory and practice.

Introduction of new author: Perhaps the most notable change in the ninth edition is the introduction of a new third author to the text. Saeed Akbar is Professor in Accounting and Finance at the University of Hull. He has extensive experience of teaching undergraduate and postgraduate accounting and finance modules in the United Kingdom and abroad. His main research areas cover the relationship between accounting information and stock prices, corporate governance and risk, empirical finance, performance measurement and accounting regulation.

We 'older hands' look forward to a long and productive working relationship with our new partner.

■ Structure and outline

An outline of the text is given here; however, a further description of the purpose and content of each section is given in the introduction to each.

Part I considers the underlying framework for corporate financing and investment decisions; key aspects of this part are the financial objectives of business, the financial environment within which firms operate, the time-value of money and the concept of value.

Part II addresses investment decisions and strategies within firms. Emphasis is placed on evaluation procedures, including treatments of taxation, inflation and capital rationing. Because, in practice, investment decision-making often bears little relationship to the theoretical approaches outlined in some texts, we persist in our attempt to promote an understanding of the practical evaluation of investment decisions by firms.

The importance of value, risk and the expected rate of return are examined in Part III, with six chapters devoted to this theme. Here we consider the investment

project in isolation, including the rapidly developing and exciting field of options analysis. Other chapters view risk and return more from a shareholder perspective. Fundamental to this section are the rate of return on investment required by shareholders and the valuation of the enterprise.

Part IV discusses the short-term financing decisions and policies for acquiring assets. It covers treasury and working capital management.

Part V addresses long-term strategic financing and policy issues. What are the main sources of finance? How much should a company pay in dividends? How much should it borrow? The culminating chapter focuses on corporate restructuring, with particular reference to acquisitions.

Part VI examines international financial management issues. It explains the operation of the foreign currency markets and how firms can hedge against adverse foreign exchange movements, and sets out the principles underpinning firms' evaluation of foreign investment decisions.

A concluding chapter reviews developments in corporate finance, with specific focus on market efficiency and behavioural finance.

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All textbooks include 'acknowledgements' but, on reflection, this seems too weak a word to use when assistance has so often been so freely given. *Roget's Thesaurus* offers as a synonym, 'the act of admitting to something', suggesting rather grudging recognition!

Our recognition of the wide range of people and organisations is anything but grudging. We extend our warm appreciation of the helpful comments provided by you over the years, and also for consent to use your material.

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Tables

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Part I

A FRAMEWORK FOR FINANCIAL DECISIONS

Business financial decisions are not made in a vacuum. An 'obvious' decision may often have to be tempered by an appreciation of the restrictions imposed by the prevailing environment. Although it is beyond the scope of this text to consider the full social, political and economic complexity of the financial decision-making context, we provide an overview of the key features of the UK financial and economic system. A sound grasp of the framework for financial decisions is essential if the reader is to appreciate fully the issues discussed in subsequent chapters.

Part I introduces the scope and the fundamental concepts of financial management. Chapter 1 provides a broad picture of the subject and the important role it plays in business. It examines the nature of financing and investment decisions, the role of the financial manager and the fundamental objective for corporate financial management. This leads on, in Chapter 2, to consideration of the financial and tax environment in which businesses operate. Particular attention is devoted to the characteristics and operation of the London Stock Exchange, which provides a barometer of the success of financial decisions via the market's valuation of the company's shares. The extent to which any market can provide 'accurate' valuations is also considered.

Central concepts in financial management are the time-value of money and present value, which are discussed in Chapter 3. The chapter also provides an understanding of the valuation of bonds and shares. Concepts of value and its measurement play important roles in subsequent chapters, where investment, financing and other key decisions are discussed.

- 1 An overview of financial management 3
- 2 The financial environment 23
- 3 Present values, and bond and share valuation 53

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1

An overview of financial management

Working for shareholders

Tesco and Unilever are two well-known major companies. Like many other successful corporations, they share the same primary focus on shareholder value:

Our model of long-term shareholder value creation has been successful and remains as valid as ever.

(Unilever 2016 Annual Report)

Everything we are doing reflects my determination to deliver shareholder value, an appropriate balance between investing for future growth, and delivering sustainable returns for our shareholders.

(Tesco 2013 Annual Report)

Sources: <http://www.tescopl.com>, <https://www.unilever.com/investor-relations/>

Learning objectives

By the end of this chapter, you should understand the following:

- What corporate finance and investment decisions involve.
- How financial management has evolved.
- The finance function and how it relates to its wider environment and to strategic planning.
- The central role of cash in business.
- The goal of shareholder wealth creation and how investors can encourage managers to adopt this goal.

1.1 INTRODUCTION

The objectives of Tesco and Unilever, summarised at the start, suggest that management has a clear idea of its purpose and key objectives. The mission is to deliver economic value to shareholders in the form of dividend and capital growth. These organisations understand the importance of meeting the requirements of the **shareholders** – the owners of the business who need to be rewarded for their investment risk. Their objectives, strategies and decisions are all directed towards creating value for them.

One of the challenges in any business is to make investments that consistently yield rates of return to shareholders in excess of the cost of financing those projects and better than those of the competitors. This text centres on that very issue: *how can firms create value through sound investment decisions and financial strategies?*

This chapter provides a broad picture of financial management and the fundamental role it plays in achieving financial objectives and operating successful businesses. First, we consider where financial management fits into the strategic planning process. This leads to an outline of the finance function and the role of the financial manager, and what objectives that person may follow. Central to the subject is the nature of these financial objectives and how they affect shareholders' interests. Finally, we introduce the underlying principles of finance, which are developed in later chapters.

■ Starting a business: Brownbake Ltd

Ken Brown, a recent business graduate, decides to set up his own small bakery business. He recognises that a clear business strategy is required, giving a broad thrust to be adopted in achieving his objectives. The main issues are market identification, competitor analysis and business formation. He identifies a suitable market with room for a new entrant and develops a range of bakery products that are expected to stand up well, in terms of price and quality, against the existing competition.

Brown and his wife become the directors of a newly formed limited company, Brownbake Ltd. This form of organisation has a number of advantages not found in a sole proprietorship or partnership:

- *Limited liability.* The financial liability of the owners is limited to the amount they have paid in. Should the company become insolvent, those with outstanding claims on the company cannot compel the owners to pay in further capital.
- *Transferability of ownership.* It is generally easier to sell shares in a company, particularly if it is listed on a stock market, than to sell all or part of a partnership or sole proprietorship.
- *Permanence.* A company has a legal identity quite separate from its owners. Its existence is unaffected by the sale of shares or death of a shareholder.
- *Access to markets.* The above benefits, together with the fact that companies enable large numbers of shareholders to participate, mean that companies can enjoy financial economies of scale, giving rise to greater choice and lower costs of financing the business.

Brown should have a clear idea of why the business exists and its financial and other objectives. He must now concentrate on how the business strategy is to be implemented. This requires careful planning of the decisions to be taken and their effect on the business. Planning requires answers to some important questions. What resources are required? Does the business require premises, equipment, vehicles and material to produce and deliver the product?

The key to industrial capitalism: limited liability

Shares, or 'equities', were first issued in the 16th century, by Europe's new joint-stock companies, led by the Muscovy Company, set up in London in 1553, to trade with Russia. Equity's popularity waxed and waned over the next 300 years or so, soaring with the South Sea and Mississippi bubbles, then slumping after both burst in 1720. Share-owning was mainly a gamble for the wealthy few, though by the early 19th century, in London, Amsterdam and New York, trading had moved from the coffee houses into specialised exchanges. Yet the key to the future was already there. In 1811, from America, came the first limited-liability law. In 1854, Britain, the world's leading economic power, introduced similar legislation.

The concept of limited liability, whereby the shareholders are not liable, in the last resort, for the debts of their company, can be traced back to the Romans. But it was rarely used,

most often granted only as a special favour to friends by those in power.

Before limited liability, shareholders risked going bust, even into a debtors' prison maybe, if their company did. Few would buy shares in a firm unless they knew its managers well and could monitor their activities, especially their borrowing, closely. Now, quite passive investors could afford to risk capital – but only what they chose – with entrepreneurs. This unlocked vast sums previously put in safe investments; it also freed new companies from the burden of fixed-interest debt. The way was open to finance the mounting capital needs of the new railways and factories that were to transform the world.

Source: From The key to industrial capitalism: limited liability by The Economist. Copyright © 31 December 1999. Reproduced by permission of The Economist.

Once these issues have been addressed, an important further question is: how will such plans be funded? However sympathetic his bank manager, Brown will probably need to find other investors to carry a large part of the business risk. Eventually, these operating plans must be translated into financial plans, giving a clear indication of the investment required and the intended sources of finance. Brown will also need to establish an appropriate finance and accounting function, to keep himself informed of financial progress in achieving plans and to ensure that there is always sufficient cash to pay the bills and to implement plans. Such issues are the principal concern of financial management, which applies equally to small businesses like Brownbake Ltd and large multinational corporations like Tesco and Unilever.

1.2 THE FINANCE FUNCTION

In a well-organised business, each section should arrange its activities to maximise its contribution towards the attainment of corporate goals. The finance function is very sharply focused, its activities being specific to the financial aspects of management decisions. Figure 1.1 illustrates how the accounting and finance functions may be structured in a large company. This text focuses primarily on the roles of finance director and treasurer.

The task of those within the finance function is to plan, raise and use funds in an efficient manner to achieve corporate financial objectives. Two central activities are as follows:

- 1 Providing the link between the business and the wider financial environment.
- 2 Investment and financial analysis and decision-making.

■ Link with financial environment

The finance function provides the link between the firm and the financial markets in which funds are raised and the company's shares and other financial instruments are traded. The financial manager, whether a corporate treasurer in a multinational

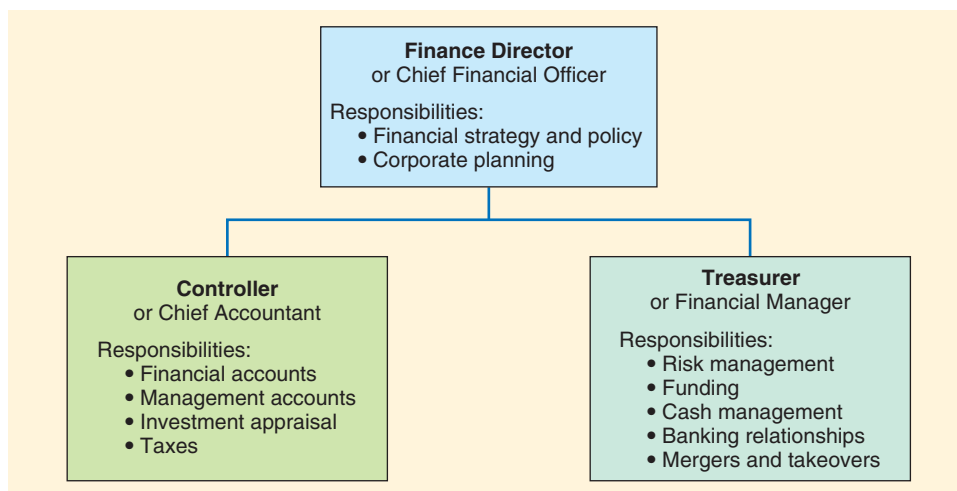


Figure 1.1 The finance function in a large organisation

company or the sole trader of a small business, acts as the vital link between financial markets and the firm. Corporate finance is therefore as much about understanding financial markets as it is about good financial management within the business. We examine financial markets in Chapter 2.

1.3 INVESTMENT AND FINANCIAL DECISIONS

Corporate finance is primarily concerned with investment and financing decisions and the interactions between them. These two broad areas lie at the heart of financial management theory and practice. Let us first be clear what we mean by these decisions.

The *investment decision*, sometimes referred to as the capital budgeting decision, is the decision to acquire assets. Most of these assets will be *real assets* employed within the business to produce goods or services to satisfy consumer demand. Real assets may be tangible (e.g. land and buildings, plant and equipment, and stocks) or intangible (e.g. patents, trademarks and 'know-how'). Sometimes a firm may invest in *financial assets*. Such investment does not form part of trading activity and may be in the form of short-term securities and deposits.

The basic problems relating to investments are as follows:

- 1 How much should the firm invest?
- 2 In which projects should the firm invest (fixed or current, tangible or intangible, real or financial)? Investment need not be purely internal. Acquisitions of other companies represent a form of external investment.

The *financing decision* addresses the problems of how much capital should be raised to fund the firm's operations (both existing and proposed), and what the best mix of financing is. In the same way that a firm can hold financial assets (e.g. investing in shares of other companies or lending to banks), it can also sell 'claims' on its own **real assets**, by issuing shares, raising loans, undertaking lease obligations, etc. A financial security, such as a share, gives the holder a claim on the future profits in the form of a dividend, while a bond (or loan) gives the holder a claim in the form of interest payable. Financing and investment decisions are therefore closely related.

real assets

Assets in the business
(tangible or intangible)

Self-assessment activity 1.1

Take a look at the statement of financial position of Brownbake Ltd.

<i>Assets employed</i>	£
Machinery and equipment	15,000
Vehicles	8,000
Patents	12,000
Stocks	10,000
Debtors	3,000
Cash and bank deposit	4,000
	<u>52,000</u>
 <i>Liabilities and shareholders' funds</i>	 12,000
Trade creditors	8,000
Loans	32,000
Shareholders' equity	52,000

Identify the tangible real assets, intangible assets and financial assets. Who has financial claims on these assets?

(Answer in Appendix A)

1.4 CASH – THE LIFEBLOOD OF THE BUSINESS

Central to the whole of finance is the generation and management of cash. Figure 1.2 illustrates the flow of cash for a typical manufacturing business. Rather like the bloodstream in a living body, cash is viewed as the 'lifeblood' of the business, flowing to all essential parts of the corporate body. If, at any point, the cash fails to flow properly, a 'clot' occurs that can damage the business and, if not addressed in time, can prove fatal!

Good cash management therefore lies at the heart of a healthy business, and the major sources and uses of cash for a typical business are depicted in Figure 1.2.

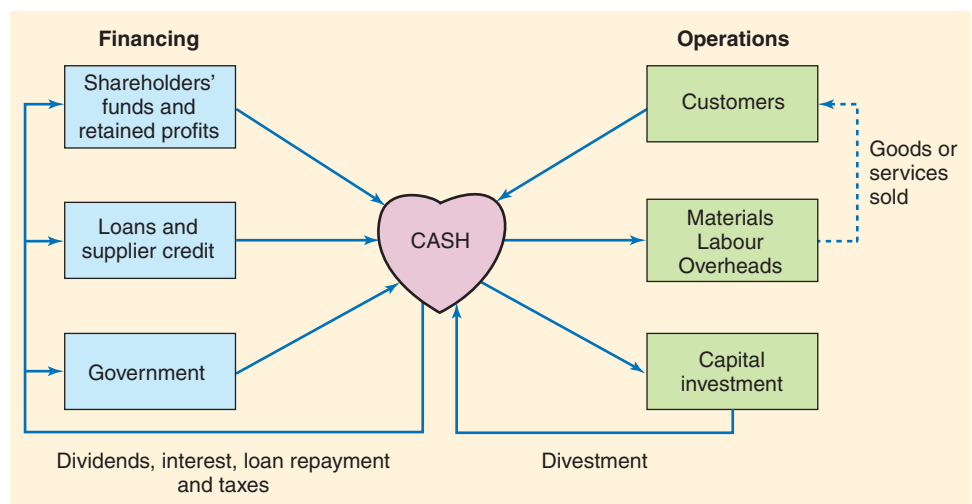


Figure 1.2 Cash – the lifeblood of the business

■ Sources and uses of cash

Shareholders' funds

shareholders' funds or equity capital

Money invested by shareholders and profits retained in the company

The largest proportion of long-term finance is usually provided by shareholders and is termed **shareholders' funds** or **equity capital**. By purchasing a portion of, or shares in, a company, almost anyone can become a shareholder with some degree of control over a company.

Ordinary share capital is the main source of new money from shareholders. The shareholders are entitled to participate in the business through voting in general meetings, and to receive dividends out of the company's profits. As owners of the business, the ordinary shareholders bear the greatest risk but enjoy the main fruits of success in the form of dividends and share price growth.

Retained profits

For an established business, the majority of equity funds will normally be internally generated from successful trading. Any profits remaining after deducting operating costs, interest payments, taxation and dividends are reinvested in the business (i.e. ploughed back) and regarded as part of the equity capital. As the business reinvests its cash surpluses, it grows and creates value for its owners. The purpose of the business is to do just that – create value for the owners.

Loan capital

debt finance/loan capital

Capital raised with an obligation to pay interest and repay principal

corporate bonds

Medium- to long-term borrowing by a company

Money lent to a business by third parties is termed **debt finance** or **loan capital**. Most companies borrow money on a long-term basis by issuing loan stocks (or **corporate bonds**). The terms of the loan will specify the amount of the loan, rate of interest and date of payment, redemption date and method of repayment. Loan stock carries a lower risk to the investor than equity capital and, hence, offers a lower return.

The finance manager will monitor the long-term financial structure by examining the relationship between loan capital, where interest and loan repayments are contractually obligatory, and ordinary share capital, where dividend payment is at the discretion of directors. This relationship is termed **gearing** (known in the United States as leverage).

gearing

Proportion of the total capital that is borrowed

Government

Governments provide various financial incentives and grants to the business community. A major cash outflow for successful businesses will be taxation.

We now turn from longer-term sources of cash to the more regular cash flows from business operations as shown in Figure 1.2. *Cash flows from operations* comprise cash collected from customers less payments to suppliers for goods and services received, employees for wages and other benefits, and other operating expenses. The other major cash flow is long-term expenditure on capital investment.

1.5 THE EMERGENCE OF FINANCIAL MANAGEMENT

While aspects of finance, such as the use of compound interest in trading, can be traced back to the Old Babylonian period (c. 1800 BC), the emergence of financial management as a key business activity is a far more recent development. During the 20th century, financial management evolved from a peripheral to a central aspect of corporate life. This change was brought about largely through the need to respond to the changing economic climate.

With continuing industrialisation in the United Kingdom and much of Europe in the first quarter of the last century, the key financial issues centred on forming new businesses and raising capital for expansion and acquisitions.

As the focus of business activity moved from growth to survival during the depression of the 1930s, finance evolved by focusing more on business liquidity, reorganisation and insolvency.

Successive Companies Acts, Accounting Standards and corporate governance mechanisms have been designed to increase investors' confidence in published financial statements and financial markets. However, the US accounting scandals in 2002, involving such giants as Enron and Worldcom, have dented this confidence.

The 2007 credit crisis brought huge turmoil into the financial markets. This crisis continued to have significant repercussions for governments, businesses and individuals. The UK decision to leave the European Union in 2019 will have a significant impact on all aspects of industry and commerce, including finance and capital markets.

Recent years have seen the emergence of financial management as a major contributor to the analysis of investment and financing decisions. The subject continues to respond to external economic and technical developments:

- 1 Successive waves of merger activity over the past 40 years have increased our understanding of valuation and takeover tactics. With governments committed to freedom of markets and financial liberalisation, acquisitions, mega-mergers and management buy-outs have become a regular part of business life.
- 2 Technological progress in communications and the liberalisation of markets have led to the globalisation of business. Modern computer technology not only makes globalisation of finance possible, but also brings complex financial calculations and financial databases within easy reach of every manager.
- 3 Complexities in taxation and the enormous growth in new financial instruments for raising money and managing risk have made some aspects of financial management highly specialised.
- 4 Deregulation in the City is an attempt to make financial markets more efficient and competitive, although the lack of regulation in the banking sector was also judged a major factor in the 2007 banking crisis and has led to more stringent controls.
- 5 Greater awareness of the need to view all decision-making within a strategic framework is moving the focus away from purely technical to more strategic issues. For example, a good deal of corporate restructuring has taken place, breaking down large organisations into smaller, more strategically compatible businesses.

1.6 THE FINANCE DEPARTMENT IN THE FIRM

The organisational structure for the finance department will vary with company size and other factors. The board of directors is appointed by the shareholders of the company. Virtually all business organisations of any size are limited liability companies, thereby reducing the risk borne by shareholders and, for companies whose shares are listed on a stock exchange, giving investors a ready market for disposal of their holdings or for making further investment.

The financial manager can help in the attainment of corporate objectives in the following ways:

- 1 *Strategic investment and financing decisions.* The financial manager must raise the finance to fund growth and assist in the appraisal of key capital projects.
- 2 *Dealing with the capital markets.* The financial manager, as the intermediary between the markets and the company, must develop good links with the company's bankers and other major financiers and be aware of the appropriate sources of finance for corporate requirements.
- 3 *Managing exposure to risk.* The finance manager should ensure that exposure to adverse movements in interest and exchange rates is effectively managed. Various techniques for hedging (a term for reducing exposure to risk) are available.

- 4 *Forecasting, coordination and control.* Virtually all important business decisions have financial implications. The financial manager should assist in and, where appropriate, coordinate and control activities that have a significant impact on cash flow.

Self-assessment activity 1.2

What are the financial manager's primary tasks?

(Answer in Appendix A)

1.7 THE FINANCIAL OBJECTIVE

For any company, there are likely to be a number of corporate goals, some of which may, on occasions, conflict. In finance, we assume that the objective of the firm is to *maximise shareholder value*. Put simply, this means that managers should create as much wealth as possible for the shareholders. Given this objective, any financing or investment decision expected to improve the value of the shareholders' stake in the firm is acceptable. You may wonder why shareholder wealth maximisation is preferred to profit maximisation. Quite apart from the problems associated with profit measurement, it ignores the *timing* and *risks* of the profit flows. As will be seen later, value is heavily dependent on when costs and benefits arise and the uncertainty surrounding them.

The Quaker Oats Company (now part of Pepsico) was one of the first firms to adopt this goal:

Our objective is to maximise value for shareholders over the long term ... Ultimately, our goal is the goal of all professional investors – to maximise value by generating the highest cash flow possible.

However, many practising managers might take a different view of the goal of their firm. In recent years, a wide variety of goals have been suggested, from the traditional goal of profit maximisation to goals relating to sales, employee welfare, manager satisfaction, survival and the good of society. It has also been questioned whether management attempts to maximise, by seeking optimal solutions, or to seek merely satisfactory solutions.

Managers often seem to pursue a sales maximisation goal subject to a minimum profit constraint. As long as a company matches the average rate of return for the industry sector, the shareholders are likely to be content to stay with their investment. Thus, once this level is attained, managers will be tempted to pursue other goals. As sales levels are frequently employed as a basis for managerial salaries and status, managers may adopt goals that maximise sales subject to a minimum profit constraint.

A popular performance target is **earnings per share (EPS)** and EPS growth. EPS focuses on the shareholder, rather than the company's performance, by calculating the earnings (i.e. profits after tax) attributable to each equity share.

Other subsidiary targets may be employed, often more in the form of a constraint ensuring that management does not threaten corporate survival in its pursuit of shareholder goals. Examples of such secondary goals which are sometimes employed include targets for:

- 1 *Profit retention.* For example, 'distributable profits must always be, say, at least three times greater than dividends'.
- 2 *Borrowing levels.* For example, 'long-term borrowing should not exceed 50 per cent of total capital employed'.
- 3 *Profitability.* For example, 'return on capital employed should be at least 15 per cent'.

earnings per share (EPS)

Profit available for distribution to shareholders divided by the number of shares issued

Multiple objectives at GlaxoSmithKline (GSK)

GSK describes itself as a 'science-led global healthcare company that researches and develops a broad range of innovative products in three primary areas of Pharmaceuticals, Vaccines and Consumer Healthcare' and has a mission 'to help people do more, feel better, live longer'.

The company operates internationally and in 2016 achieved annual revenue of £27.9 billion and core operating profit of £7.8 billion.

The company does not solely seek to create shareholder value, but has multiple objectives:

Delivering innovation and maximising access to our products generates value for patients, shareholders and society more widely and enables us to reinvest back into the business.

Our primary contribution is to make products that provide benefits to patients and consumers.

Successful delivery of this generates profitable and sustainable performance. In turn this allows us to generate value and returns for our shareholders and enables us to reinvest in the business.

We also create value by making direct and indirect economic and social contributions in the countries where we operate. These wider benefits to society include contributions through tax, employment and enhancing the well-being of local communities through our global community initiatives.

Source: <http://www.gsk.com>

- 4 *Non-financial goals.* These take a variety of forms but basically recognise that shareholders are not the only group interested in the company's success. Other stakeholders include trade creditors, banks, employees, the government and management. Each stakeholder group will assess corporate performance in a slightly different way. It is therefore to be expected that the targets and constraints discussed earlier in this chapter will, from time to time, conflict with the overriding goal of shareholder value, and management must seek to manage these conflicts.

The financial manager has the specific task of advising management on the financial implications of the firm's plans and activities. The shareholder wealth objective should underlie all such advice, although the chief executive may sometimes allow non-financial considerations to take precedence over financial ones. It is not possible to translate this objective directly to the public sector or to not-for-profit organisations. However, in seeking to create wealth in such organisations, the 'value for money' goal perhaps comes close.

Alternative objectives: Divine Chocolate – a Fairtrade social enterprise

Divine Chocolate was set up in the 1990s as a Fairtrade chocolate company. The shares of the company are 45 per cent owned by Kuapa Kokoo farmers' co-operative, and two people from the co-operative are on the board of directors. This structure is to ensure the cocoa farmers 'receive a better deal for their cocoa and additional income to invest in their community'.

The company is not focused on shareholders but has a social mission:

To grow a successful global farmer-owned chocolate company using the amazing power of chocolate to delight and engage, and bring people together to create dignified trading relations, thereby empowering producers and consumers.

Source: <http://www.divinechocolate.com/uk/about-us/inside-divine>

Self-assessment activity 1.3

It is common for companies to have multiple objectives and not to focus solely on shareholder value. What pressures do companies face that might cause them to have a range of objectives?

(Answer in Appendix A)

1.8 THE AGENCY PROBLEM

Potential conflict arises where ownership is separated from management. The ownership of most larger companies is widely spread, while the day-to-day control of the business rests in the hands of a few managers who usually own a relatively small proportion of the total shares issued. This can give rise to what is termed *managerialism* – self-serving behaviour by managers at the shareholders' expense. Examples of managerialism include pursuing more perquisites (splendid offices and company cars, etc.) and adopting low-risk survival strategies and 'satisficing' behaviour. This conflict has been explored by Jensen and Meckling (1976), who developed a theory of the firm under agency arrangements. Managers are, in effect, agents for the shareholders and are required to act in their best interests. However, they have operational control of the business, and the shareholders receive little information on whether the managers are acting in their best interests.

principal-agent

The agent, such as board of directors, is expected to act in the best interests of the principal (e.g. the shareholder)

agency costs

Costs that owners (principals) have to incur in order to ensure that their agents (managers) make financial decisions consistent with their best interests

A company can be viewed as simply a set of contracts, the most important of which is the contract between the firm and its shareholders. This contract describes the **principal-agent** relationship, where the shareholders are the principals and the management team the agents. An efficient agency contract allows full delegation of decision-making authority over use of invested capital to management without the risk of that authority being abused. However, left to themselves, managers cannot be expected to act in the shareholders' best interests but require appropriate incentives and controls to do so. **Agency costs** are the difference between the return expected from an efficient agency contract and the actual return, given that managers may be tempted to act more in their own interests than the interests of shareholders.

Self-assessment activity 1.4

Identify some potential agency problems that may arise between shareholders and managers.
(Answer in Appendix A)

1.9 MANAGING THE AGENCY PROBLEM

To attempt to deal with such agency problems, various incentives and controls have been recommended, all of which incur costs. Incentives frequently take the form of bonuses tied to profits (profit-related pay) and share options as part of a remuneration package scheme.

Share options have value only when the actual share price exceeds the option price; managers are thereby encouraged to pursue policies that enhance long-term wealth creation. Most large UK companies now operate share option schemes, which are spreading to managers well below board level. The figure is far higher for companies recently coming to the stock market: virtually all of them have executive share option schemes, and many of these operate an all-employee scheme. However, a major problem with these approaches is that general stock market movements, due mainly to macroeconomic events, are sometimes so large as to dwarf the efforts of managers. No matter how hard a management team seeks to make wealth-creating decisions, the effects on share price in a given year may be undetectable if general market movements are downward. A good incentive scheme gives managers a large degree of control over achieving targets. Chief executives in a number of large companies have recently come under fire for their 'outrageously high' pay resulting from such schemes – especially the banks where 'huge' bonuses were paid that had only recently been bailed out by the government.

Incentivising executives at Marks and Spencer

To manage the principal–agent relationship at Marks and Spencer, executives are remunerated as follows:

The Company has a straightforward and transparent approach to executive remuneration which comprises base salary, benefits, cash and shares awarded under an annual incentive scheme and shares awarded under a long-term incentive scheme. Three elements of our executive remuneration framework are performance-related

and two are subject to a three year deferral or performance period in order to encourage executive directors to remain with the Company and align their interests with those of shareholders. Executive directors are also required to hold a minimum number of shares in the Company within five years of their appointment.

Source: 2013 Annual Report, <http://corporate.marksandspencer.com/investors>

Executive compensation schemes, such as those outlined in the Marks and Spencer cameo, are imperfect, but useful, mechanisms for retaining able managers and encouraging them to pursue goals that promote shareholder value.

Another way of attempting to minimise the agency problem is by setting up devices to monitor managers' behaviour. Examples include:

- 1 audited accounts of the company;
- 2 management audits and additional reporting requirements;
- 3 restrictive covenants imposed by lenders, such as ceilings on the dividend payable on the maximum borrowings.

To what extent does the agency problem invalidate the goal of maximising the value of the firm? In an efficient and highly competitive stock market, the share price is a 'fair' reflection of investors' perceptions of the company's expected future performance. So, agency problems in a large, publicly quoted company will, before long, be reflected in a lower-than-expected share price. This could lead to an *internal* response – the shareholders replacing the board of directors with others more committed to their goals – or an *external* response – the company being acquired by a better-performing company where shareholder interests are pursued more vigorously.

1.10 SOCIAL RESPONSIBILITY AND SHAREHOLDER WEALTH

Is the shareholder wealth maximisation objective consistent with concern for social responsibility? In most cases, it is. As far back as 1776, Adam Smith recognised that, in a market-based economy, the wider needs of society are met by individuals pursuing their own interests: 'It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.' The needs of customers and the goals of businesses are matched by the 'invisible hand' of the free market mechanism.

Of course, the market mechanism cannot differentiate between 'right' and 'wrong'. Addictive drugs and other socially undesirable products will be made available as long as customers are willing to pay for them. Legislation may work, but often it simply creates illegal markets in which prices are much higher than before legislation. Other products have side-effects adversely affecting individuals other than the consumers, e.g. passive smoking and car exhaust emissions.

There will always be individuals in business seeking short-term gains from unethical activities. But, for the vast majority of firms, such activity is counterproductive in the longer term. Shareholder wealth rests on companies building long-term relationships with suppliers, customers and employees and promoting a reputation for honesty,

financial integrity and corporate social responsibility. After all, a major company's most important asset is its good name.

Not all large businesses are dominated by shareholder wealth goals. The John Lewis Partnership, which operates department stores and Waitrose supermarkets, is a partnership with its staff electing half the board. The Partnership's ultimate aim, as described in its constitution, 'shall be the happiness in every way of all its members'. The Partnership rule book makes it clear, however, that pursuit of happiness shall not be at the expense of business efficiency. Its constitution requires it to take account of its suppliers, customers and local community. In 2017, the firm announced a 21 per cent increase in profits for the previous year but a drop in annual bonus for staff to 6 per cent of basic salary, in order to retain more profits and strengthen the balance sheet.

Stakeholder theory asserts that managers should make decisions that take into account the interests of all the firm's stakeholders. This will include shareholders, employees, suppliers, customers, local communities, the government and the environment. It is undoubtedly true that management should consider all stakeholders in its decision-making, but where interests conflict, it becomes a highly complex task to maximise multiple objectives. This shareholder focus that also recognises the needs of other stakeholders is sometimes termed 'enlightened shareholder value'.

Environmental concerns have in recent years become an important consideration for the boards of large companies, including the source of supplies, such as timber and paper from 'managed forests'. Investors are also becoming more socially aware, and many are channelling their funds into companies that employ environmentally and socially responsible practices. In 2010, Nestlé changed its sourcing of cocoa for its Kit Kat chocolate bar to Fairtrade. This benefits thousands of small farmers in Ivory Coast (which produces 40 per cent of the world's cocoa) by giving them a better price which helps them invest in long-term community and business development projects.

1.11 THE CORPORATE GOVERNANCE DEBATE

In recent years, there has been considerable concern in the United Kingdom about standards of corporate governance, the system by which companies are directed and controlled. While, in company law, directors are obliged to act in the best interests of shareholders, there have been many instances of boardroom behaviour where it was difficult to reconcile with this ideal.

There have been numerous examples of spectacular collapses of companies, often the result of excessive debt financing in order to finance ill-advised takeovers, and sometimes laced with fraud. Many companies have been criticised for the generosity with which they reward their leading executives. The procedures for remunerating executives have been less than transparent, and many compensation schemes involve payment by results in one direction alone. Many chief executives have been criticised for receiving pay increases several times greater than the increases awarded to less exalted staff.

In the train of these corporate collapses and scandals, a number of committees have reported on the accountability of the board of directors to their stakeholders and risk management procedures, brought together as the UK Corporate Governance Code (Combined Code).

The first version of the UK **Corporate Governance Code** was introduced by the Cadbury Committee in the form of Cadbury Report in 1992. Later on, the code was revised and presented as the UK Combined Code on Corporate Governance in 2003 (and subsequently revised, the latest being in 2016), which applies to all UK listed companies. According to the code, 'Corporate governance is the system by which companies are directed and controlled'. The main purpose of the code is therefore regarded

as the facilitation of an effective governance system that can reduce risk-taking practices by firms and deliver shareholders value over the long term. Due to changes in the business environment, financial innovations and several other changes in organisations, the code needs regular updating by the Financial Reporting Council (FRC). The main aspects of the UK Corporate Governance Code 2016 for financial management are summarised here.

1 *Directors and the board*

- There should be a clear division of responsibilities between the running of the board (chairman) and the executive responsibility for the running of the business (chief executive).
- In large companies, at least half of the board (excluding the chairman) should include independent non-executive directors, whereas in smaller companies, presence of at least two independent non-executive directors are required on their boards.
- While evaluating the board, one should consider the balance of skills, experience, independence, diversity (including gender) and other factors relevant to the board's effectiveness.
- The board should evaluate its own performance and that of its committees and directors on a consistent basis.
- The non-executive directors (taking into account the views of executive directors) are responsible for the performance evaluation of the chairman.

2 *Directors' remuneration*

- A company should establish a remuneration committee, including at least three independent non-executive directors (or two in the case of smaller companies).
- The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be transparent and strictly applied.
- Shareholders should be involved in approving all new long-term incentive schemes as well as bringing changes to existing schemes.

3 *Accountability and audit*

- The board should present an impartial and balanced assessment of the company's position and prospects.
- The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.
- The board should maintain a sound system of internal control and risk management to safeguard shareholders' investment and the company's assets as well as maintain an appropriate relationship with the auditors.
- The board should establish an audit committee to monitor the integrity of financial statements.

4 *Relations with shareholders*

- The board should maintain regular contact with shareholders and keep in touch with shareholder opinion in whatever ways are practical and efficient.
- The board should have separate resolutions on all major matters at general meetings.
- It is the responsibility of the chairman to ensure that opinions of shareholders are conveyed to the board and that the issues and concerns of shareholders are taken into account in the company affairs.

Corporate governance is an important issue throughout the world, and most countries have developed a code or recommendations. (A website for the relevant country codes is given at the end of this chapter.)

The main reservations centre on the issues of compliance and enforcement. These changes in the rules and responsibilities of directors and auditors are non-statutory. The Stock Exchange may not withdraw the listings of companies that fail to comply,

although it hopes that any adverse publicity will whip offenders into line. This lack of 'teeth' has raised suspicions that determined wrongdoers can still exert their influence on weak boards of directors, to the detriment of the relatively ill-informed private investor in particular.

The current form of capitalism that ranks shareholders as the most important stakeholder group has been greatly debated, with questions being raised about fundamentally important issues such as trust, risk management, regulation of markets and the role of government in business. These debates will, inevitably, impact on future reforms of corporate governance codes.

1.12 THE RISK DIMENSION

The primary objective of Tesco and Unilever is to deliver shareholder value, as outlined at the start of the chapter. To create shareholder value requires a company to take risks. Some financial decisions incur very little risk (e.g. investing in government stocks, since the interest is known); others may carry far greater risk (e.g. investing in shares). Risk and expected return tend to be related: the greater the perceived risk, the greater the return required by investors. This is seen in Figure 1.3.

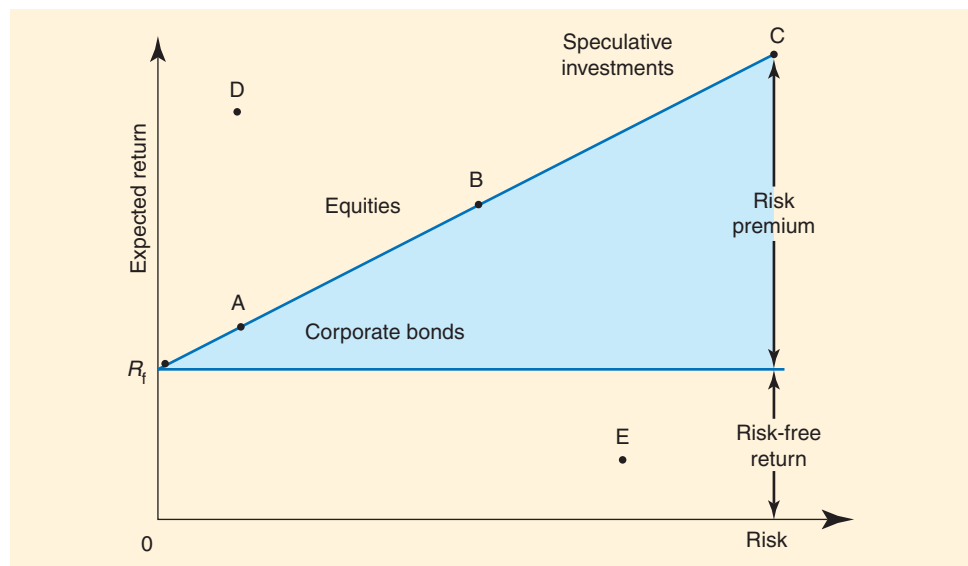


Figure 1.3 The risk–return trade-off

When the finance manager of a company seeks to raise funds, potential investors take a view on the risk related to the intended use of the funds. This can best be measured in terms of a **risk premium** above the risk-free rate (R_f) obtainable from, say, government stocks to compensate investors for taking risk. The capital market offers a host of investment opportunities for private and corporate investors, but in all cases, a clear relationship exists between the perceived degree of risk involved and the expected return. For example, R_f in Figure 1.3 represents the return on three-month UK Treasury Bills: point A represents a long-term fixed interest corporate bond; point B, a portfolio of ordinary shares in major listed companies; and point C, a more speculative investment, such as non-quoted shares. Studies indicate that the

risk premium

The additional return demanded by investors above the risk-free rate to compensate for exposure to systematic risk

long-term average return on an investment portfolio consisting of the market index (e.g. the FTSE 100) is up to six percentage points higher than that from holding risk-free government securities.

One task of the financial manager is to raise funds in the capital markets at a cost consistent with the perceived risk, and to invest such funds in wealth-creating opportunities in the business. Here, it is quite possible – because of a firm’s competitive advantage, or possession of superior brand names – to make highly profitable capital projects with relatively little risk (see D in Figure 1.3). It is also possible to find the reverse, such as project E. If the goal is to deliver cash flows to shareholders at rates above their cost of capital, managers should seek to invest in projects, such as D, that offer returns better than those obtainable on the capital market for the same degree of risk (A in Figure 1.3).

1.13 THE STRATEGIC DIMENSION

To enhance shareholder value, managers could adopt a wide range of strategies. Strategic management may be defined as a systematic approach to positioning the business in relation to its environment to ensure continued success and offer security from surprises. No approach can guarantee continuous success and total security, but an integrated approach to strategy formulation, involving all levels of management, can go some way towards this.

Strategy can be developed at three levels:

- 1 *Corporate strategy* is concerned with the broad issues, such as the types of businesses the company should be in. Strategic finance has an important role to play here. For example, the decision to enter or exit from a business – whether through corporate acquisitions, organic growth, divestment or buy-outs – requires sound financial analysis. Similarly, the appropriate capital structure and dividend policy form part of strategic development at the corporate level.
- 2 *Business or competitive strategy* is concerned with how strategic business units compete in particular markets. Business strategies are formulated which influence the allocation of resources to these units. This allocation may be based on the attractiveness of the markets in which business units operate and the firm’s competitive strengths.
- 3 *Operational strategy* is concerned with how functional levels contribute to corporate and business strategies. For example, the finance function may formulate strategies to achieve a new dividend policy identified at the corporate strategy level. Similarly, a foreign currency exposure strategy may be developed to reduce the risk of loss through currency movements. A typical strategic planning process is shown in Figure 1.4.

■ Strategic planning and value creation

The importance of competitive forces in determining shareholder wealth cannot be overestimated. They largely determine the price at which goods and services can be sold, the quantities sold, the cost of production, the level of required investment and the risks inherent in the business.

However, individual companies can develop strategies leading to long-term financial performance well above the industry average. Figure 1.5 illustrates the main factors influencing the value of the firm. In any industry, all firms will be subject to much the same underlying economic conditions. Rates of inflation, interest and taxation and competitive forces in the industry will affect all businesses, although not necessarily to

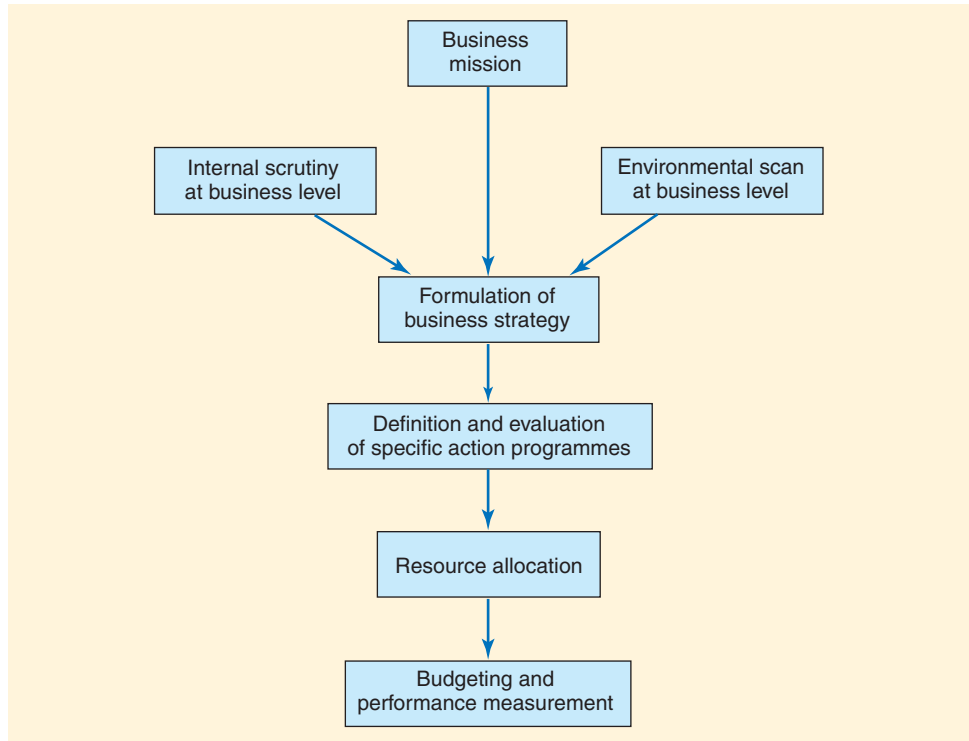


Figure 1.4 Main elements in strategic planning

the same degree. The firm will develop corporate, business and operating strategies to exploit economic opportunities and to create sustainable competitive advantage. We are mainly concerned with those strategies affecting investment, financing and dividends. Operating and investment decisions create cash flows for the business, while financing decisions influence the cost of capital. The value of the firm depends upon the cash flows generated from business operations – their size, timing and riskiness – and the firm’s cost of capital. Depending on the success of the firm’s strategies and decisions, the value of the firm will increase or shrink.

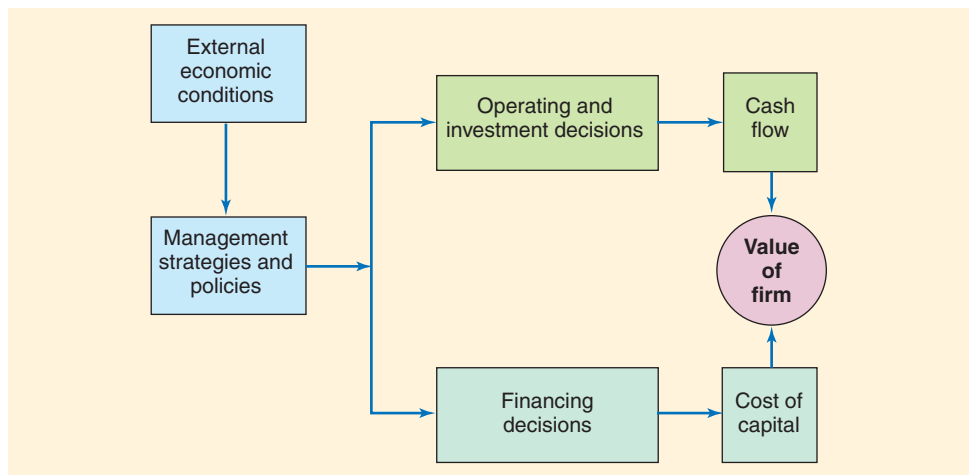


Figure 1.5 Factors influencing the value of the firm

While, in practice, some decisions appear to lack any rational process, most approaches to decisions of a financial nature have five common elements:

- 1 *Clearly defined goals.* It is particularly noticeable how, in recent years, corporate managements have realised the importance of defining and communicating their declared mission and goals, some more quantifiable than others, and some more relevant to financing decisions.
- 2 *Identifying courses of action to achieve these objectives.* This requires the development of business strategies from which individual decisions emanate. The search for new investment and financing opportunities for any organisation is far better focused and more cost-effective when viewed within well-defined financial objectives and strategies. Most decisions have more than one possible solution. For instance, the requirement for an additional source of finance to fund a new product launch can be satisfied by a multitude of possible financial options.
- 3 *Assembling information relevant to the decision.* The financial manager must be able to identify what information is relevant to the decision and what is not. Data gathering can be costly, but good, reliable information greatly facilitates decision analysis and confidence in the decision outcome.
- 4 *Evaluation.* Analysing and interpreting assembled information lies at the heart of financial analysis. A large part of this text is devoted to techniques of appraising financial decisions.
- 5 *Monitoring the effects of the decision taken.* However sophisticated a firm's financial planning system, there is no real substitute for experience. Feedback on the performance of past decisions provides vital information on the reliability of data gathered, the efficacy of the method employed in decision appraisal and the judgement of decision-makers.

Throughout this text, we shall attempt to allow for practical, real-world considerations when considering appropriate financial policy decisions. However, we hope that a clearer understanding of the concepts, together with an awareness of the degree of realism in their underlying assumptions, will enable the reader to make sound and successful investment and financial decisions in practice.

SUMMARY

This chapter has provided an overview of strategic financial management and the critical role it plays in corporate survival and firms' success. We examined how financial management has evolved over the years. The main functions of financial management and its association with strategic planning and objectives were explained. The chapter also provided an overview of the role of cash in firms and the tools used by investors for encouraging managers to pursue shareholder wealth. The requirements for good corporate governance were also explored.

Key points

- It is the task of the financial manager to plan, raise and use funds in an efficient manner to achieve corporate financial objectives. This implies (1) involvement in investment and financing decisions, (2) dealing with the financial markets, and (3) forecasting, coordinating and controlling cash flows.
- Cash is the lifeblood of any business. Financial management is concerned with cash generation and control.
- Financial management evolved during the last century, largely in response to economic and other external events (e.g. inflation and technological developments), making globalisation of finance a reality and the need to concentrate on more strategic issues essential.

- The distinction should be drawn between accounting – the mere provision of relevant financial information for internal and external users – and financial management – the utilisation of financial and other data to assist financial decision-making.
- In finance, we assume that the primary corporate goal is to maximise value for the shareholders.
- The agency problem – managers pursuing actions not totally consistent with shareholders' interests – can be reduced both by managerial incentive schemes and by closer monitoring of their actions.
- Investors require compensation for taking risks in the form of enhanced potential returns.
- Most of the assumptions underlying pure finance theory are not particularly realistic. In practice, market and other imperfections must also be considered in practical financial decision-making.
- Financial management has an essential role in strategic development and implementation at strategic, business and operational levels. Competitive forces, together with business strategy, influence the value drivers that impact on shareholder value.

Further reading

Students should get into the habit of reading the *Financial Times* and relevant pages of *The Economist* and *Investors Chronicle*.

Volume 22, Issue 1 (2010) of the *Journal of Applied Corporate Finance* contains a series of articles on executive compensation in the wake of the 2007 global financial crisis. Similarly, Volume 52, Issue 4 (2016) of *ABACUS* is a special issue dedicated to 'Issues in Executive Compensation'. Volume 24, Issue 4 (2015) of the *European Accounting Review* also covers Regulation and Disclosure of Executive Compensation.

In addition to published papers in the special issues of the above-mentioned journals, other studies such as Firth, Fung and Rui (2006), Kumar and Sivaramakrishnan (2008), Goergen and Renneboog (2011) and Graham, Li and Qiu (2012) contain detailed discussions on managerial compensation. Jensen and Meckling (1976) and Fama (1980) are important articles on agency costs, while Brickley *et al.* (2003) give a useful insight into organisational ethics and social responsibility. Koller *et al.* (2010) argue that shareholder wealth creation is good for all stakeholders, productivity and employment, and Girerd-Potin *et al.* (2014) discuss how social responsibility can affect investors' risk perceptions of companies. Akbar, Kharabsheh, Poletti-Hughes and Shah (2017) discuss the relationship between corporate board structure and risk taking in the UK financial sector. Discussions and critiques of shareholder value maximisation are provided by a range of studies, including Travlos, Trigeorgis and Vafeas (2001), Adams, Licht and Sagiv (2011), Andreadakis (2012) and Stont (2012), amongst others. Details on these and other references are provided at the end of the text.

Useful websites

Financial Times: www.ft.com

Guardian: www.guardian.co.uk/money

The Economist: www.economist.com

Corporate governance codes in other countries: www.ecgi.org/codes/all_codes.php

Companies House: www.companieshouse.gov.uk

QUESTIONS

Questions with a coloured number have solutions in Appendix B on page 767.

- 1 Why is the goal of maximising owners' wealth helpful in analysing capital investment decisions? What other goals should also be considered?
- 2 Poldark plc is a young dynamic company which became listed on the stock market three years ago. Its management is very keen to do all it can to maximise shareholder value and, for this reason, has been advised to pursue the goal of maximising earnings per share. Do you agree?
(Solution on companion website at www.booksites.net/pikeneale)
- 3 (a) 'Managers and owners of businesses may not have the same objectives.' Explain this statement, illustrating your answer with examples of possible conflicts of interest.
(b) In what respects can it be argued that companies need to exercise corporate social responsibility?
(c) Explain the meaning of the term 'Value for Money' in relation to the management of publicly owned services/utilities.
(ACCA)
- 4 Discuss the importance and limitations of ESOPs (executive share option plans) to the achievement of goal congruence within an organisation.
(ACCA)
- 5 (a) A group of major shareholders of Zedo plc wishes to introduce a new remuneration scheme for the company's senior management. Explain why such schemes might be important to the shareholders. What factors should shareholders consider when devising such schemes?
(b) Eventually a short-list of three possible schemes is agreed. All pay the same basic salary plus:
(i) A bonus based upon at least a minimum pre-tax profit being achieved.
(ii) A bonus based upon turnover growth.
(iii) A share option scheme.
Briefly discuss the advantages and disadvantages of each of these three schemes.
(ACCA)
- 6 The primary financial objective of companies is usually said to be the maximisation of shareholders' wealth. Discuss whether this objective is realistic in a world where corporate ownership and control are often separate, and environmental and social factors are increasingly affecting business decisions.
- 7 The main principles of financial management may be applied to most organisations. However, the role of the financial manager may be affected by the type of organisation in which he or she works.

Required

Describe the key characteristics of the financial management function and the role of the financial manager in each of the following types of organisation.

- (a) Quoted high-growth company
(b) Quoted low-growth company
(c) Unquoted company aiming for a stock exchange listing
(d) Small family-owned business
(e) Non-profit-making organisation; for example, a charity
(f) Public sector; for example, a government department
(CIMA)
- 8 (a) The Cleevemoor Water Authority was privatised in 2007, to become Northern Water plc (NW). Apart from political considerations, a major motive for the privatisation was to allow access for NW to private-sector supplies of finance. During the 1980s, central government controls on capital expenditure had resulted in

relatively low levels of investment, so that considerable investment was required to enable the company to meet more stringent water quality regulations. When privatised, it was valued by the merchant bankers advising on the issue at £100 million and was floated in the form of 100 million ordinary shares (par value 50p), sold fully paid for £1 each. The shares reached a premium of 60 per cent on the first day of stock market trading.

Required

In what ways might you expect the objectives of an organisation like Cleevemoor/NW to alter following transfer from public to private ownership?

- (b) Selected biannual data from NW's accounts are provided below relating to its first six years of operation as a private-sector concern. Also shown, for comparison, are the pro forma data as included in the privatisation documents. The pro forma accounts are notional accounts prepared to show the operating and financial performance of the company in its last year under public ownership as if it had applied private-sector accounting conventions. They also incorporate a dividend payment based on the dividend policy declared in the prospectus.

The activities of privatised utilities are scrutinised by a regulatory body which restricts the extent to which prices can be increased. The demand for water in the area served by NW has risen over time at a steady 2 per cent per annum, largely reflecting demographic trends.

Key financial and operating data for year ending 31 December (£m)

	2017 (pro forma)	2019 (actual)	2021 (actual)	2023 (actual)
Turnover	450	480	540	620
Operating profit	26	35	55	75
Taxation	5	6	8	10
Profit after tax	21	29	47	65
Dividends	7	10	15	20
Total assets	100	119	151	191
Capital expenditure	20	30	60	75
Wage bill	100	98	90	86
Directors' emoluments	0.8	2.0	2.3	3.0
Employees (number)	12,000	11,800	10,500	10,000
P:E ratio (average)	–	7.0	8.0	7.5
Retail Price Index	100	102	105	109

Required

Using the data provided, assess the extent to which NW has met the interests of the following groups of stakeholders in its first six years as a privatised enterprise.

If relevant, suggest what other data would be helpful in forming a more balanced view.

- (i) shareholders
- (ii) consumers
- (iii) the workforce
- (iv) the government, through NW's contribution to the achievement of macroeconomic policies of price stability and economic growth.

Practical assignment

Examine the annual report for a well-known company, particularly the chairman's statement. Are the corporate goals clearly specified? What specific references are made to financial management? What does it say about corporate governance and risk management?

What does it say about corporate social responsibility and sustainability?



2

The financial environment

Serco finance director departs as company seeks emergency funding

Scandal-hit outsourcing company Serco – the business embroiled in controversy over billing the government for electronically tagging prisoners who had died – has parted company with its finance director after unveiling plans to raise an emergency £170m by selling new shares.

Serco, which runs services ranging from prisons to rail franchises and London's cycle hire scheme, said it would be 'uncomfortably close' to breaching its banking agreements and intended to sell nearly 50m new shares to raise cash.

The company commented: 'The proposed equity placing has a single purpose: to give us the opportunity to conduct a thorough review of the strategy of the business whilst remaining within the terms of our debt facilities.' The company, which has already warned it will take a big hit to profits as a result of the tagging scandal, said its performance this year had been 'more challenging than expected'.

Source: Copyright Guardian News & Media Ltd 2018.

Learning objectives

By the end of this chapter, the reader should understand the nature of financial markets and the main players that operate within them. Particular focus is placed on the following topics:

- The functions of financial markets.
- The operation of the Stock Exchange.
- The extent to which capital markets are efficient.
- How taxation affects corporate finance.

Enhanced ability to read financial statements and the financial pages in a newspaper should also be achieved.