

Contents

Preface	xv
Acknowledgements	xvi
How to use this book	xviii
1 Introduction to financial management	1
<i>Introduction</i>	1
<i>Objectives</i>	1
The role of the finance function	1
Structure and organisation of the book	3
The essential features of financial management	4
The objectives of a business	5
Wealth maximisation or profit maximisation?	5
To maximise or to satisfy?	7
Wealth maximisation and management ethics	9
Corporate governance and the agency problem	10
Corporate governance and economic performance	12
Strengthening the framework of rules	12
<i>Summary</i>	14
<i>Key terms</i>	14
<i>Further reading</i>	14
<i>References</i>	14
<i>Review questions</i>	15
2 Financial planning and projected financial statements	16
<i>Introduction</i>	16
<i>Objectives</i>	16
Planning for the future	16
The role of projected financial statements	17
Preparing projected financial statements	19
Step 1 Identify the main inputs to the forecasting process	19
Step 2 Forecast the sales for the period	20
Step 3 Forecast remaining elements of financial statements	21
Step 4 Prepare the projected financial statements	23
Preparing the projected statements: a worked example	24
Projected cash flow statement	25
Projected profit and loss account	28
Projected balance sheet	29
Projected financial statements and decision-making	31
Projected financial statements and risk	34
Sensitivity analysis	34
Scenario analysis	35
Simulations	35
Projected financial statements and spreadsheets	35

Self-assessment question 2.1	37
Summary	38
Key terms	38
Further reading	39
Review questions	40
Exercises	40
3 Analysing and interpreting financial statements	49
Introduction	49
Objectives	49
Financial ratios	49
Financial ratio classification	50
The need for comparison	51
Key steps in financial ratio analysis	52
The ratios calculated	53
Profitability ratios	55
Return on ordinary shareholders' funds (ROSF)	55
Return on capital employed (ROCE)	56
Net profit margin	56
Gross profit margin	57
Efficiency ratios	58
Average stock turnover period	58
Average settlement period for debtors	59
Average settlement period for creditors	60
Sales to capital employed	61
Sales per employee	62
Relationship between profitability and efficiency	63
Liquidity ratios	64
Current ratio	64
Acid test ratio	65
Operating cash flows to maturing obligations	66
Gearing ratios	67
Gearing ratio	68
Interest cover ratio	69
Investment ratios	70
Dividend per share	70
Dividend payout ratio	71
Dividend yield ratio	71
Earnings per share (EPS)	72
Operating cash flow per share	73
Price/earnings (P/E) ratio	74
Self-assessment question 3.1	77
Financial ratios and the problem of overtrading	78
Trend analysis	79
The use of ratios in predicting financial distress	80
Limitations of ratio analysis	84
Summary	87
Key terms	88
Further reading	88

References	88
Review questions	89
Exercises	89
4 Making capital investment decisions	96
Introduction	96
Objectives	96
The nature of investment decisions	96
Methods of investment appraisal	97
Accounting rate of return (ARR)	98
Payback period (PP)	103
Net present value (NPV)	105
Interest lost	106
Risk	107
Inflation	108
Actions of a logical investor	108
Why NPV is superior to ARR and PP	112
Internal rate of return (IRR)	113
Some practical points	117
Investment decision-making in practice	120
Self-assessment question 4.1	122
The process of investment decision-making	122
Investment decisions and human behaviour	127
Summary	127
Key terms	128
Further reading	128
References	128
Review questions	129
Exercises	129
5 Making capital investment decisions: further issues	135
Introduction	135
Objectives	135
Investment decisions when funds are limited	136
Comparing projects with unequal lives	139
Self-assessment question 5.1	142
The NPV approach and the ability to delay	143
The problem of inflation	143
Risk and investment decisions	145
Sensitivity analysis	145
Scenario analysis	149
Simulations	149
Risk preferences of investors	151
Risk-adjusted discount rate	154
Expected values and risk assessment	156
The use of event tree diagrams	158
Risk and the standard deviation	160
The standard deviation and the normal distribution	163
The expected value-standard deviation rule	164

Measuring probabilities	165
Portfolio effects and risk reduction	166
The coefficient of correlation	167
Diversifiable and non-diversifiable risk	169
Summary	171
Key terms	172
Further reading	172
Reference	172
Review questions	173
Exercises	173
6 Financing a business	177
Introduction	177
Objectives	177
Sources of external finance	177
Ordinary shares	178
Preference shares	179
Loan capital	180
Measuring the riskiness of loan capital	181
Junk bonds (high yield bonds)	182
Debentures	184
Eurobonds	184
Deep discount bonds	184
Convertible loans and debentures	185
Warrants	185
Mortgages	186
Ordinary shares, preference shares and loan capital issues compared	187
Interest rates and interest rate risk	187
Finance leases and sale and leaseback arrangements	190
Short-term sources of finance	191
Bank overdrafts	192
Bills of exchange	192
Debt factoring	192
Invoice discounting	195
Long-term versus short-term borrowing	196
Internal sources of finance	197
Retained profits	198
Retained profits and 'pecking order' theory	198
Tighter credit control	199
Reducing stock levels	200
Delaying payments to creditors	201
Self-assessment question 6.1	201
The Stock Exchange	202
The role of the Stock Exchange	202
The Stock Exchange and the problem of short-termism	204
The efficiency of the Stock Exchange	205
The implications of stock market efficiency for managers	208
Are the stock markets really efficient?	209
Providing long-term finance for the small business	212

Venture capital	212
Types of investment	213
The venture capital process	213
Business angels	218
Government assistance	218
Share issues	218
Rights issues	219
Bonus issues	221
Offer for sale	223
Public issue	223
Placing	224
Summary	225
Key terms	225
Further reading	225
References	226
Review questions	227
Exercises	227

7 The cost of capital and the capital structure decision 232

Introduction	232
Objectives	232
Cost of capital	232
Ordinary shares	233
Retained profit	240
Loan capital	241
Preference shares	243
Weighted average cost of capital (WACC)	245
Specific or average cost of capital?	247
Limitations of the WACC approach	248
Financial gearing	250
Degree of financial gearing	252
Gearing and the evaluation of capital structure decisions	255
Constructing a PBIT–EPS indifference chart	259
Self-assessment question 7.1	261
Factors affecting the level of gearing	262
The capital structure debate	263
The traditional view	264
The modernist view	266
MM and the introduction of taxation	270
Summary	272
Key terms	273
Further reading	273
References	273
Review questions	274
Exercises	274

8 Developing a dividend policy 282

Introduction	282
Objectives	282

The payment of dividends	282
Dividend policies in practice	284
Dividend policy and shareholder wealth	286
Two schools of thought	287
The MM position explained	288
The MM assumptions	290
The importance of dividends	291
The clientele effect	291
Information signalling	292
Reducing agency costs	293
Factors determining the level of dividends	295
The dividend policy of other businesses	297
Dividend policy and management attitudes: some evidence	298
Self-assessment question 8.1	299
Alternatives to cash dividends	300
Scrip dividends	300
Share repurchase	301
Summary	302
Key terms	303
Further reading	303
References	303
Review questions	304
Exercises	304
9 Managing working capital	307
Introduction	307
Objectives	307
The nature and purpose of working capital	307
The scale of working capital	309
Management of stock	310
Forecasts of future demand	311
Financial ratios	311
Recording and reordering systems	311
Levels of control	312
Stock management models	313
Management of debtors	317
Which customers should receive credit?	317
How much credit should be offered?	319
Length of credit period	320
An alternative approach to evaluating the credit decision	321
Cash discounts	322
Self-assessment question 9.1	322
Collection policies	322
Reducing the risk of non-payment	325
Management of cash	326
Why hold cash?	326
How much cash should be held?	327
Controlling the cash balance	327

Projected cash flow statements and the management of cash	328
Operating cash cycle	329
Cash transmission	332
Management of trade creditors	332
Controlling trade creditors	334
Management of bank overdrafts	334
Working capital problems of the small business	335
Managing credit	335
Managing stock	336
Managing cash	336
Summary	336
Key terms	337
Further reading	337
References	337
Review questions	338
Exercises	338
10 Measuring and managing for shareholder value	344
Introduction	344
Objectives	344
The quest for shareholder value	344
Creating shareholder value	345
The need for new forms of measurement	346
Net present value (NPV) analysis	347
Extending NPV analysis: Shareholder Value Analysis	348
Measuring free cash flows	349
Managing the business with SVA	353
Implications of SVA	355
Economic value added (EVA®)	355
EVA® and SVA compared	359
EVA® or SVA?	361
Market value added	362
The link between MVA and EVA®	364
The limitations of MVA	364
Total shareholder return	366
Will the shareholder value era end?	366
Self-assessment question 10.1	368
Summary	369
Key terms	369
Further reading	369
References	369
Review questions	370
Exercises	370
11 Mergers, takeovers and the valuation of shares	374
Introduction	374
Objectives	374
Mergers and takeovers	374

The rationale for mergers	376
Benefits of scale	376
Eliminating competition	377
Underutilised resources	378
Complementary resources	378
Surplus funds	379
Diversification	379
Management interests and goals	380
Forms of purchase consideration	380
Cash	381
Shares	381
Loan capital	382
Assessing vulnerability to takeover	384
Resisting a takeover bid	385
Who benefits?	385
Defensive measures for a takeover bid	390
Protecting the interests of shareholders	392
Divestments and demergers	394
The valuation of shares	395
Asset-based methods	397
Stock market methods	400
Cash flow methods	402
Self-assessment question 11.1	405
Choosing a valuation model	407
Summary	408
Key terms	408
Further reading	408
References	409
Review questions	410
Exercises	410
Appendix A Present value table	418
Appendix B Annual equivalent factor table	419
Appendix C Solutions to self-assessment questions	420
Appendix D Solutions to review questions	429
Appendix E Solutions to selected exercises	438
Glossary of key terms	461
Index	469