Financial Management & Decision Making

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FINANCIAL MANAGEMENT AND DECISION MAKING

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PREFACE

Financial Management and Decision Making is designed for use both by the academic student and the practising manager. MBA and undergraduate students who need to be aware of the workings of financial markets and of the techniques for decision making on financial issues within companies will each find this book useful. It is also designed to be used by those studying for the financial management examinations of the professional accounting bodies.

This book is written by the authors of the larger volume: *Management of Company Finance* which was first published in 1971. By 1995, *MCF* had reached its sixith edition. In its near 30 year life to date it has so far sold around 150,000 copies. It has proved its value to students and professionals. The sixth edition of *Management of Company Finance* had grown to over 1,000 pages.

It was decided, therefore, to produce a related text with a sharper focus on key issues and which contained less mathematics and fewer theoretical technicalities. Moreover, unlike most books on financial management, *Financial Management and Decision Making* is not based on the situation in the United States. It is firmly grounded on the situation in the UK, in Europe.

The book emphasises the importance of the links between company financial management and the financial community. The reactions of the stock market and the financial institutions to a company's decisions are especially important to the company, and the future of the management of a company can depend upon the stock market. A text on financial management should, therefore, attach considerable importance to the workings of the financial community.

The 1990s have seen the rapid growth in the global financial markets, with a resulting increase in risks. The movement of funds around the world can cause problems for national governments, as has been seen directly in Asian economies such as Indonesia, Thailand, Korea and Japan, and in other parts of the world such as Mexico. Repercussions can be global and the volatility in foreign exchange rates and in interest rates increase the financial risks faced by companies. There is, therefore, an emphasis in *Financial Management and Decision Making* on risk management. Another change over recent years has been the increasing importance of financial derivatives. This topic is also thoroughly covered in the book.

It is surprising how rapidly the subject of company finance alters, what is appropriate at the time of one economic situation becomes outdated by new circumstances. The theory of the subject does not, of course change so quickly, but tends to evolve as new ideas and techniques are developed over time. It is in the day-to-day problems faced by financial managers that most changes occur and for which the perspective provided by *Financial Management and Decision Making* should be valuable.

We would like to express our thanks for help we hav received in the preparation both of this book and the editions of *MCF*, in particular to Scott Goddard, whose imaginative questions have often been used to enliven a particular

section. We would also like to thank the Institute of Chartered Accountants in England and Wales and the Association of Chartered Certified Accountants for permission to reproduce a number of their examination questions. And special thanks to Margaret Watson and Karen Hanson for valuable assistance in the preparation of *Financial Management and Decision Making*.

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CONTENTS

1 THE FINANCIAL ENVIRONMENT

Learning Outcomes

By the time the reader has finished studying this chapter he or she should:

- understand the issues involved in ascertaining the objectives of the company
- appreciate the complexity of the relationship between the owners of the company and those who manage the company
- understand the significance of institutional investors
- have a basic knowledge of how taxation issues influence company decision making
- have a basic knowledge of the alternative measures of company performance

1.1 Introduction

In this chapter we shall examine the objectives of the firm. Are the decisions made by those who manage the firm designed to maximize the wealth of the owners of the firm? How are the interests of the other parties involved in a firm taken into account?

We then introduce the theory of business finance. We consider the shareholders, the interest group who are legally the owners of the company, and examine the financial aspects of the relationship between shareholders and managers. By focusing on this relationship we are not suggesting that it is more or less important than that between any of the other interested parties and the company, but these other relationships are subjects for other primarily non-financial books. We consider some of the problems that exist in the relationship between the investment community and companies, problems in the financial environment in which companies have to operate.

Finally we introduce the subject of corporate taxation, an important aspect of the financial environment, and a factor influencing the decision in most areas of finance.

A company has a responsibility towards employees, customers, shareholders, creditors and society. Each of these interest groups sees the role of that company in a slightly different way. This book is concerned with the financial aspects of companies, with the optimal use of their financial resources. Sound financial management is necessary for a company's survival and for its growth. All interest groups benefit from good financial management.

The types of questions that financial management seeks to answer are as follows.

1 What percentage of funds needed by a business should be obtained from borrowing and what percentage from the owners?
2 What percentage of the annual profits should be paid out to shareholders as dividends?

3 Is it worthwhile for the company to replace its existing manufacturing machines with a new computer-integrated system?
4 The earnings per share figure for the company is falling, despite the fact that the manufacturing facilities have been recently modernized. Should a shareholder be concerned?
5 A potential customer has enquired whether the company will sell goods to him or her now, and allow the customer six months to pay. Is it profitable to do so?
6 The bank keeps offering me new types of business loans, but I like the traditional overdraft arrangement. Should I, as financial manager, change my policy?

1.2 Objectives of the company

One of the long-term objectives of a company must be to make money for its owners, and its future is guaranteed or jeopardized according to the satisfaction, or lack of it, that the shareholders exhibit regarding its performance on their behalf. There are of course many other stakeholders in a company, for example, employees, directors and customers, whose interests must be considered, but it is not possible to compromise on the financial objective.

During particular periods of time it may seem rather optimistic to think in terms of making money for the owners, and in the short term all efforts may have to be devoted to keeping the company liquid and to maintaining the value of the owners' investment. These are, however, only short-term situations, and in the long run the owners of capital must be encouraged to invest in companies by the prospect of gains which are at least as great as those they can obtain from investing elsewhere.

The last century and a half has seen the rise and fall of more than one business philosophy dedicated to the problem of a company's rationale. When enlightened self-interest was a notion dear to the hearts of nineteenth-century capitalists, it was fashionable to justify the company almost exclusively as a quasi-benevolent institution satisfying a yawning social need by generously providing employment and other opportunities. Today, cynicism permits us to recognize this as a half-truth inspired by some real benevolence and more real guilt. The fact is, and was, that a company must make sufficient money to be able to offer the providers of its capital an attractive return. This is not to deny that it should also attempt to provide all its employees, from directors down, with the means to enjoy an attractive life and to consider the interests of other stakeholders.

All who agree with some form of the capitalist system should not find anything contentious in the preceding paragraphs. However, when we start to consider whether the owners' position should be maximized and the employees' position satisfied or the shareholders' position satisfied and the employees' position maximized, we immediately enter into the political arena – as we do when we start to consider whether the employees of the firm should receive a 2% annual pay rise and the directors of the firm a 20% increase.

The classical view of the firm is that it should be operated so as to maximize profits. Hayek states: 'the only specific purpose which corporations ought to serve is to secure the highest long-term return on their capital' [1]. Milton Friedman states: 'there is one and only one social responsibility of business – to use its resources and to engage in activities designed to increase its profits as long as it stays within the rules of the game [2].

According to this classical approach the objective of the firm should be to maximize the shareholders' wealth, subject to a number of constraints. However, in certain periods of time this approach might not be satisfactory to the values of society. There are many interests represented in a company, and the importance attached to each interest depends on the political system, the attitudes of the community at a particular time, and the bargaining power of the interests at the time. The 1980s and 1990s have been a period where shareholders interests dominate.

The theory of business finance is based on the assumption that the company should seek to maximize the wealth of the shareholder. The shareholders own the company and there is therefore some logic in the idea that it should be run in their interests. Although this is the theory, it is recognized that in practice companies do not always make decisions based on this assumption.

Stakeholders' interests

In recent years much has been written about the fact that companies exist within society and have responsibilities to that society.

We now refer to the stakeholders in a business. These are not only the shareholders and managers, but all employees, customers, suppliers, the local community, and the environment. It is argued that the interests of no one group should prevail to the extent that it excludes the interest of others.

Although much is written about stakeholders' interests, such interests are often only seen as relevant to the extent that they help create shareholder values. Although there is discussion on stakeholders' interests, there is also increasing emphasis on economic values and the creation of shareholder value. There is also increasing concern with making managers more accountable to shareholders.

Do managers or directors really run the business in the shareholders' interests or their own? Managers have considerable discretion. Managers have more information about the opportunities available to a company than do shareholders. Managers do on occasions have different interests from those of shareholders. For example, in some circumstances managers might be less willing to become involved in a risky investment than would a shareholder. If a project fails the manager's career might be ruined, but to a diversified shareholder, it is just a loss in one part of a portfolio.

In many situations it is difficult for the shareholders of a company to know whether or not a manager is doing a good job. Without knowing the opportunities available to managers, outsiders tend to compare the performance of a company 'relative' to the performance of similar companies. This provides an incentive for managers in different companies to pursue similar strategies: for them not to stick their head out.

Even some compensation schemes which are designed to encourage goal congruence are based on relative performance. For example, executive share-option schemes reward directors for movements in the company's share price which are influenced by the overall level of stock-market prices, rather than offering rewards for extraordinary performance.

A commonly assumed objective of business is to maximize profits. The theory of finance refined this concept and for a long period of time it was assumed that the objective of a business was to maximize the owners' wealth. With the separation of ownership and control of many businesses, it became appreciated that widely dispersed shareholders often only exercise a limited control over managers.

Managers, the so-called agents of the owners, have in many companies a considerable amount of freedom. It is in managers' interests to produce corporate plans and mission statements written in terms of creating 'shareholder value', but in reality we have to appreciate that certain decisions taken within a company will be of greater benefit to managers than to shareholders.

The difficulty arises because in large and medium-sized companies control and investment are usually in different hands. The shareholders have to leave the decision making to the top management of the company, who may well be looking for rewards other than through returns on the small number of shares that they own. Top management is concerned with salaries, pensions, executive life style and security. Top management is in a good position to look after its own interests.

The top managers are acting as agents of the shareholders. Shareholders may attempt to bring about 'goal congruence' through share-option schemes. But with other rewards to take into account there is no reason to believe that top management will always be seeking to maximize shareholders' wealth. It is not easy for the owners to monitor the actions of the top managers, and it is expensive to try to do so. In using the funds they manage, to look after their own position and/or that of the shareholders, it is often said that in the UK this leads to 'short-termism'. The environment in which they manage gives greater rewards for short-term performance than for long-term performance. They are motivated to take advantage of any short-term opportunities that arise.

Whether the directors maximize or satisfy the shareholders' interests, at least they must be aware of the share price, for it is through capital gains, i.e. increases in share price, that the shareholders receive much of their return. They must be aware of how the decisions they take will influence the share price.

Not only must a company earn a return on its shareholders' funds, it must ensure that its earning power is reflected in its share price. It is possible to have two companies with identical profit performance and potential, and yet for one to have a higher stock-market value than the other simply because one group of directors is more concerned than the other group about their stock-market image.

The stock-market price is possibly the most important single criterion by which the company is judged. An increasing share price, or one that is falling less quickly than the market index, will keep the shareholders content, and the management will have little reason to worry about survival or a takeover. If the company is prospering nicely but failing to reflect the fact in its share price, it becomes of course an ideal candidate for a takeover, and in the event of being swallowed up – or fired – the management would have no one to blame but themselves for neglecting the shareholders' interests by failing to ensure that the company's true future earning ability was reflected in its share price.

1.3 The shareholders

The importance ascribed to the role of the shareholders has changed in recent years. It was once common to play down their influence; though legally the owners of the business, it was assumed that they did not much concern themselves with the way that the company was run. Some of them might make their opinions known at the annual general meeting, but usually few of them attend, and in any case the directors could well have obtained enough proxy votes to overcome any opposition.

This position has changed, partly because of a change in the type of shareholder, partly as a result of takeover activity and partly because of social pressure.

The characteristics of the typical shareholder have changed. No longer can he or she be regarded as an individual afflicted with a comforting inability to read a balance sheet. The growth of shareholding by institutions has been dramatic, and these institutions employ experts to advise on the investment of their funds. The financial performance of a company is thus judged by a knowledgeable body of people who may be either existing or potential shareholders. The company must accordingly be run in a way that guarantees the satisfaction of the shareholder – an increasingly sophisticated shareholder, who will be both competent and keen to assess the truth behind any optimistic statements.

Table 1.1 *Beneficial ownership of UK equities (in percentages) 1963–93*

	1963	1969	1975	1981	1990	1993
Pension funds	6.4	9.0	16.8	26.7	31.6	34.2
Insurance companies	10.0	12.2	15.9	20.5	20.4	17.3
Unit trusts	1.3	2.9	4.1	3.6	6.1	6.6
Banks	1.3	1.7	0.7	0.3	0.7	0.6
Investment trusts, and other financial institutions	11.3	10.1	10.5	6.8	2.3	3.1
Individuals	54.0	47.4	37.5	28.2	20.3	17.7
Other personal sector	2.1	2.1	2.3	2.2	1.9	1.6
Public sector	1.5	2.6	3.6	3.0	2.0	1.3
Industrial and commercial sector	5.1	5.4	3.0	5.1	2.8	1.5
Overseas	7.0	6.6	5.6	3.6	11.8	16.3
Total	100	100	100	100	100	100

Source: Central Statistical Office.

In the UK, as in many other countries with a developed financial system, institutions now own the vast majority of shares. In the UK they now own nearly 85% of the value of listed equity shares. The main institutional holders are the insurance companies, the pension funds, the investment trusts and the unit trusts. This ownership pattern results from the savings of individuals flowing to pension funds and insurance companies partly because of the tax advantages arising from contractual savings schemes. The unit trusts have also been successful in attracting the savings of private investors.

Table 1.1 shows the estimated ownership of UK equity shares by different categories up to 1993. The points to observe are:

1 The dramatic increase in the percentage of total shares held by the pension funds and to a lesser extent by the insurance companies. Although these institutions only account for a small percentage of the total bargains conducted on the Stock Exchange, the average bargain size with which they are involved makes them the major players in the markets.

2 The growth of overseas ownership of UK equities. The increase has been particularly fast in recent years; it increased from 11.8% in 1990 to 13.1% in 1992 and then to 16.3% in 1993. This growth reflects the globalization of financial markets with portfolio funds moving around the world seeking high returns.

It should be appreciated that most of this investment is by institutional investors. The US accounted for 41.8% of the known origin of this investment, with European Union countries responsible for only 15%.

3 The considerable decline in the percentage of shares held by individuals. The importance of the individual investor declined, but not the number of investors.

4 The banks in the UK only own a very small percentage of the equity of companies. This contrasts with the position in many other countries, and reflects a deliberate policy on the part of UK banks. By way of contrast, in Japan banks own 19% of the equity shares of listed companies, and in Germany banks own 10%.

5 Other companies (non-financial) only own a small percentage of outstanding shares. This again contrasts with the situation in certain other countries that have a different system of corporate governance. What is called 'interlocking shareownership' is common in Germany, where non-financial companies own 42% of the listed equity shares, and in Japan, where they own 25%.

This trend in institutional holdings has caused concern because of the increasing levels of concentration of ownership. It has also caused problems because, as a result of the channelling of the funds available for investment into a few hands, certain classes of business have found it difficult to obtain finance. The institutions have shown a preference for listed shares and, in particular, for the shares of the very large companies.

The reasons are perfectly understandable. The institutions wish to hold investments that are easily marketable, and it can be difficult to dispose of shares in unquoted companies. It is easy for them to obtain information on the large publicly quoted companies. The administrative costs are reduced if an institution invests in a few large shareholdings rather than holding a few shares in many companies. It is not necessary to hold shares of a large number of companies in order to spread risk. It has been shown that most of the advantages of diversification can be obtained from holding the shares of 30–40 companies. Yet another reason, if another is needed, is that the institutions wish to be in a position to unload a large number of shares on the stock market quickly without moving the share price by more than a few pence, and this would not be possible if the shares were those of a smaller company where the one holding would be a large proportion of the total company shares.

The attitude towards investing in smaller and medium-sized companies has changed over recent years. Partly because of political pressure, partly because of changes in the capital markets and partly because of tax changes, the equity shares of smaller companies have become attractive to investors. The Alternative Investment Market (AIM), like its predecessor, the Unlisted Securities Market (USM), attracts both new smaller and medium-sized companies seeking funds and financial institutions with funds to invest. There is even a market in the shares of unquoted companies.

1.4 Corporate governance

This topic, which became of increasing interest in the late 1980s, is concerned with who governs a company and in whose interest it is run. In small private companies there is usually no conflict of interest. The owners of the company are the same people who make the key management decisions and who control the company. But with larger companies there has been for a long time a 'divorce' of ownership and control. Those who provide the funds are not the same people as those who control the company.

The various Companies Acts are explicit, in that the directors of a company are supposed to run the company in the interests of the shareholders. However, when ownership and control become separated there are situations in which there is a potential conflict of interest between shareholders and managers. Managers may be motivated to behave in a way which from the shareholders' point of view is sub-optimal. In 1989 Charkham, in a Bank of England discussion paper, raised the question of whether there is the possibility that our system (the UK system), 'so excellent when viewed in isolation, may put us at a disadvantage in international competition by those who have superior linkages and lines of accountability within it, and a greater sense of patience?' [3].

The governance debate centres on whether the relationship between the owners and the controllers of a business that exists in the UK puts us at a disadvantage to our European and Japanese competitors. A similar concern exists in the USA. The UK and US Systems are similar in that they rely on the market to exercise control (an external control system). This contrasts with the more flexible relationship between providers of finance and managers to be found with many of our major competitors, who have stronger internal control systems.

Internal control means that within the structure of the company through committees and boards, the top management of the company is subject to control. Top management is accountable. External control means that investors in the market place control top management. If they do not like decisions being made by the directors of a company or are dissatisfied with the performance of the company they let their feelings be known. They can do this either by voting at annual general meetings (using their voice) or they can take an 'exit' route by selling their shares (voting with their feet). With external control top management might not be strongly controlled within the company, but they are aware they are ultimately accountable in the market place. We will briefly examine (a) problems with the system in the UK, (b) how the system of corporate governance in the UK differs from that in our 'competitor' countries and (c) what is being done to change the position in the UK.

The ideal model for accountability in the UK is:

Shareholders	←	Market for corporate control
↑	←	Efficient capital market
↑	←	AGM
	←	Accounting reports true and fair view
Board of directors		
↑	←	Board controls executives
Executive management		

Some of the things that are alleged to have gone wrong with the system in the UK are:

- shareholders pursue own short-term goals (portfolio investors);
- directors act in own interests;
- boards dominated by executive directors;
- non-executive directors in weak position/not independent;
- AGMs do not work (shareholders keep arm's-length relationship);
- market for corporate control (takeovers and mergers):
  - expensive;
  - it is not always the good company that acquires the bad company;
- poor accounting standards (poor monitoring);
- stock market not always efficient.

These failings in the UK system have allegedly resulted in what is known as 'short-termism'. The owners of the company, the vast majority in the UK being institutional shareholders, have been accused of avoiding a long-term involvement with a company. The institutions are themselves under pressure to show good financial performance, so they need to be able to buy and sell the shares of a company as the opportunity for profits arises. They are portfolio investors rather than long-term stakeholders in a company.

There are pressures on institutional investment managers to show good relative returns each quarter in the funds they manage. If they find the performance on their portfolios amongst the lower rankings of the performance league tables they themselves will be removed.

Similar criticisms have been made about the system in the USA. Donaldson [4] and Jensen [5] have pointed to a number of possible areas of conflict which arise in the financial field. One problem is that shareholders and managers have different attitudes towards risk. Shareholders can spread their risks by investing their money in a number of companies; one company may go into liquidation but a diversified shareholders' financial security is not threatened. A manager's financial security, however, usually depends on what happens to the one company that employs him or her. The manager could therefore be less inclined than the shareholder to invest the company's funds in a risky investment. The manager is interested in the total risk position of the company, whereas a diversified shareholder is interested in the systematic risk. These terms will be explained later in the book.

A further situation in which conflict can arise is when a company is the subject of a takeover bid. It has been shown in many studies that the shareholders of acquired firms very often receive above normal gains in share price. However, shareholders of companies that have been the subject of unsuccessful takeover bids do not receive such gains. It can therefore be argued that it is not always in the shareholders' interests for the managers of sought-after companies to put up such a defence as to drive the bidder away. Yet many managers lose either their jobs or their status if the company that employs them is taken over. In whose interests, therefore, do the managers act when their company is the subject of a takeover bid?

Jensen wrote an article entitled 'The eclipse of the public corporation' [6]. He expressed the view that in certain industries for a variety of reasons the present relationship between owners and managers is out of date. He believes it is changing and needs further change. He argues that the clear separation of ownership and control has worked against efficiency and growth. His views are representative of those who want fundamental change. He makes the point that many investors are dissatisfied, and that managers have been putting their own interests first over the last 10–20 years. Golden parachute-type contracts and other perks have shown that managers are not taking the interest of the investor seriously enough.

Rappaport, disagreeing with Jensen, argues against fundamental change. He believes that the existing system will be improved when the USA (and UK) moves to a 'governance system that provides effective monitoring of and checks on managerial authority' [7]. It seems to be agreed that the present system in the UK and USA, with a strong emphasis on external control, is not an effective monitoring system.

There are significant differences between countries within the EU in the form of ownership and control of companies. The UK system is based on the promotion of free markets, and close links between investors and managers, are discouraged by law and stock exchange rules. A major concern is the prevention of insider dealing and the protection of minority-interest shareholders. One result is that with an arm's-length relationship between owners and managers the annual financial reports take on a greater significance. Also there is less opportunity for owners to monitor the decisions and policies of managers.

In France and Germany, traditionally far less emphasis has been placed on the operations of the stock markets. There are therefore less restrictions on the closeness of the relationship between owners and managers. More information is exchanged informally. The financial reports are therefore of less significance, with a more established informal communication system.

Another important difference between countries within the European Union arises because of the different structure of financing by companies. As is well known, UK companies have traditionally worked with lower levels of gearing than companies in other European countries. Debt and equity lead to different forms of corporate governance. Debt governance works mainly through rules, with covenants and other legal restraints restricting the actions of those who manage companies. Equity governance, on the other hand, allows much greater discretion. With a greater proportion of funds being provided through equity, those who run UK companies are more concerned than management in other European countries in creating a favourable impression in the stock market. With an over-active market in corporate control (takeovers and mergers) the short-term survival of the UK manager depends on it.

In Germany, companies have a two-tier board structure. The supervisory board consists of representatives of many interest groups, with far more outside directors involved than is found in a UK company. Most countries have some criticisms of their own system. In Germany the minority shareholders feel their interests are not represented. It is the power and influence of the large banks – through (a) their direct share-holdings in companies, (b) the loans advanced to companies and (c) the votes they can control through the proxy system – that worries many people.

The Cadbury Report and after

In the UK in response to increasing concern about the system of corporate governance, a committee was set up to examine the financial aspects of corporate governance (known as the Cadbury Committee) [8]. They concluded that the basic system of corporate governance in the UK was sound, but did recommend a number of changes.

Two key areas where they thought that changes were necessary were in connection with making the board of directors more effective and increasing the long-term commitment to a company of its institutional shareholders.

They were concerned to prevent a board of directors being dominated by a powerful person, who was both the chairman and chief executive. They wished to ensure that the views of non-executive directors (NEDs) carry weight in board decisions. They recommend that there will be at least three NEDs on a board, and that the people appointed to such positions be of independent minds who could represent the shareholders' interests.

They wished the NEDs to take a leading role in the remuneration committee and audit committees to be set up within companies. They wished to improve the system of internal control that existed in some companies.

The recommendations of the Cadbury Committee were accepted by the Stock Exchange.

The Cadbury Committee was intended to be only the first step towards improved corporate governance in the UK. Following the initial report and recommendations there have been two further committees looking at the problems.

The Greenbury Report on directors' remuneration suggested that institutional investors use their power to influence the way company directors behaved [9]. This was followed by the Hampel Committee [10] which supported the conclusion of the other two committees. It found little fundamentally wrong with the UK system of corporate governance, it endorsed the unitary board structure and rejected the idea of introducing the dual board structure (a supervisory board and a management board) which is prevalent in other European countries.

1.5 Performance measurement

Shareholders of a company need to be able to monitor the past performance of a company so as to be able to judge the performance of managers. They also need information to enable them to assess the future prospects of a company.

Managers also need performance indicators to enable them to make decisions on some rational basis, and to enable them to control present activities.

What measures should be used to assess performance?

How can we determine whether or not a company is performing well? This of course depends on who is judging the company and what is their relationship to the company. A shareholder wishes to see his or her wealth increase. They wish to see increases in the share price. An employee wants a high income and security. A customer wants a product that is good value for the price paid. An environmentalist has other expectations.

As this book is about finance we are mainly concerned with financial measures.

We have a choice of measures. There are the traditional accounting numbers, such as earnings per share and return on capital employed, and a vast number of new 'trendier' measures.

The managers of companies, or at least some of them, seem surprisingly gullible. They are susceptible to the latest fashionable concept (fad) which is being marketed by business gurus and/or management consultants. In recent years we have been introduced to a number of new ideas or techniques, which, it is suggested, if followed will lead to success for companies. These include:

- mission statements;
- total quality management;
- balanced scorecards;
- financial re-engineering;
- downsizing;
- focus;
- shareholder value added;
- economic value added.

Each of the ideas has been promoted by some management 'guru'. For a while the guru and the supporters of the fad claim that they have discovered an approach which, if followed, will lead to business success. The guru who thinks of the idea and the consulting company that is willing to help with the introduction of the approach of course benefit. The with-it management that follow the latest idea have been referred to as 'fad surfers'. They ride 'the crest of the latest management panacea then paddle out in time for the next one' [11].

Each of these ideas has a life of about five to ten years. Roach, one of the gurus who in the 1980s coined the phrase 'downsizing' (a euphemism for redundancies) was in the 1990s admitting his earlier ideas were wrong. He is reported to have said in the 1990s that if a company competes by building it has a future, but if it competes by cutting it does not.

One interesting anecdote on the subject relates to the stock market's reaction to a Marks and Spencers announcement. In 1996 the chairman of the company announced a 12% increase in annual profits over the previous year's level. He also announced that the company was to create 2000 new jobs. He explained that the company could in the short run make more money by cutting out jobs, but explained that he was 'not interested in the short term. I'm interested in where we are going to be four years from now'. He pointed out that the company 'offer quality products and quality service', and that the new jobs were necessary to maintain standards.

What happened to the share price following this announcement? The shares fell in value: the largest fall in that day of any of the FTSE top 100 companies.

At the time the downsizing ideas were being criticized, a new literature began to appear on 'intellectual capital'. This pointed out that in many businesses investing in fixed assets was becoming of less relevance to success, and it was the intellectual ability of employees that determined business success. It is argued that companies should measure the value of the 'intellectual capital' of their business, and should invest in this. This is what Marks and Spencers are doing.

Of course there are stakeholders who benefit from short term performance.

The problem is that each of the new concepts or ideas referred to above has a use. But none of them provides an answer in all situations. Too many managers seem to be looking for the one management technique that is perfect. Managers and analysts want one performance indicator that can be used to judge success. There is not one. Life and business are not that simple. We will return to this topic in Chapter 2.

1.6 Regulation of the City

The control and regulation of the financial sector of the economy is the key to the contribution that sector makes to the growth of the economy and to the distribution of wealth. The two major issues are:

1 Should the regulations be set at a level which will not discourage the inward flow of international finance and so will allow the rapid growth of the 'City' and its institutions or set at a level which keeps 'hot' money out of the City and offers a high degree of protection to investors?
2 Whether supervision should be exercised by those who manage the financial institutions (what is called 'self-regulation') or by those who are more concerned with the interests of the savers and the investors.

Until 1997 the UK relied on self-regulation, the Bank of England regulated the banks and money markets. A number of what were known as self-regulating organizations (SROs) were responsible for controlling different sectors of the investment industry. There were, for example, separate SROs for building societies, for life insurance companies, for the Stock Exchange, for dealers in securities and futures (SFA), for investment managers (IMRO) and for independent personal financial advisers (PIA).

There is a danger that self-regulating bodies can become anti-competitive in nature. An SRO can become more concerned with protecting the interests of its members than with looking after the interests of companies and investors. There is always a danger that bodies representing the interests of one group begin to believe that what is good for their members is good for everyone.

A further problem that emerged was that at the very time when large financial conglomerates were being formed that could deal with all aspects of finance, the regulatory bodies were fragmented. The Department of Trade and Industry does not have the time or experience to be able to handle detailed consideration of the competing interests of the different SROs and to monitor the changes taking place within each aspect of the securities and investment industry.

The self-regulation system in the UK became expensive and not particularly effective. In 1997 the position changed with a move against self-regulation. There were at least three reasons for the change:

1 A number of financial scandals (e.g. BCCI, Barings, Barlow Clowes and the £2 billion involved in the misleading selling of private pension schemes) had indicated that not all was working well with the existing system, investors' interests were on many occasions not being protected.
2 The distinction between the different types of financial institution was becoming increasingly blurred. Building societies becoming banks. Barings, a bank, collapsed as a result of its securities trading activities.
3 A change in government, from Conservative to Labour, meant a different belief in the effectiveness of self-regulators.