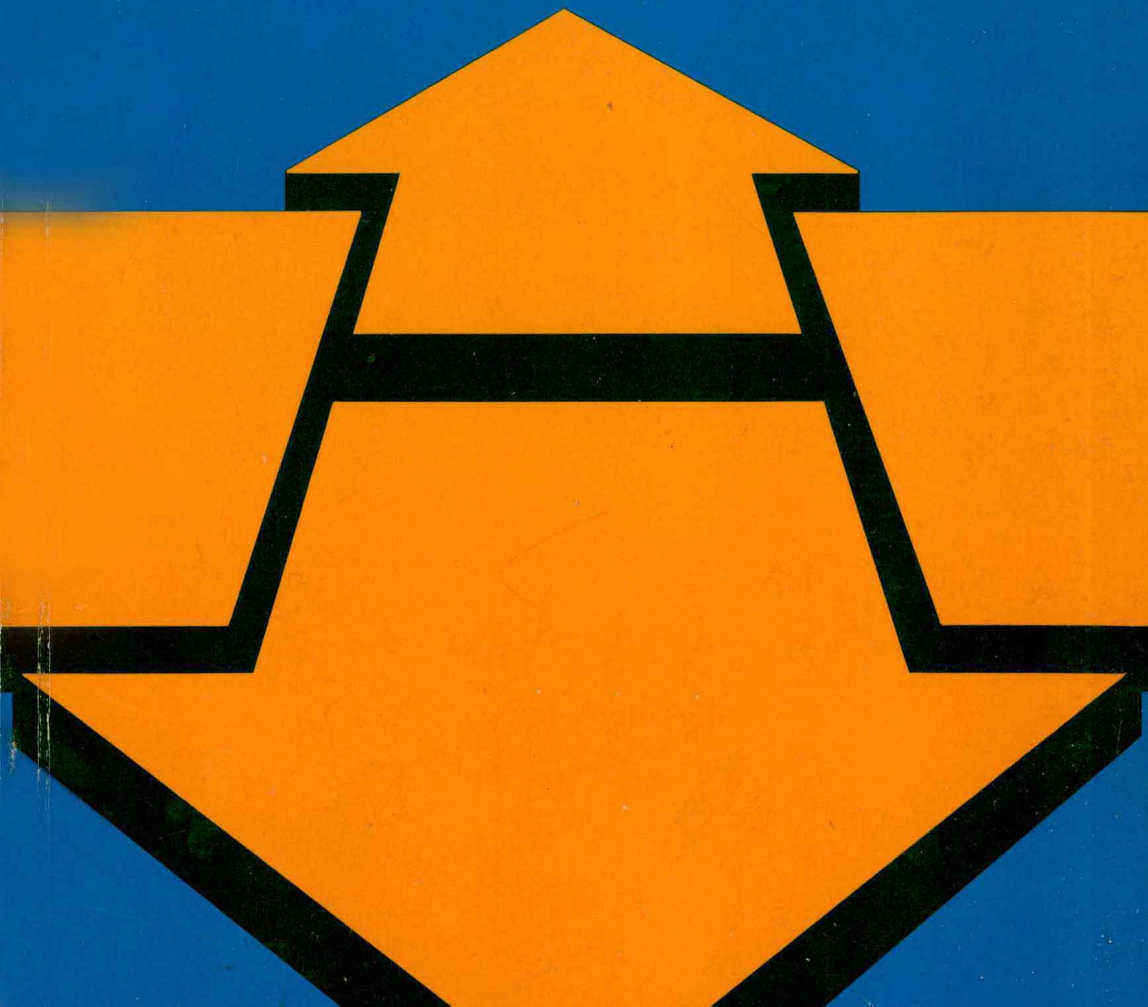


The Management of BUSINESS FINANCE

John Freeear



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Preface

My primary intention in this book has been to examine financial decisions in a way which emphasizes the relationship between theoretical and institutional material, with particular reference to the United Kingdom. This intention is based, partly at least, on the ground that theories cannot remain in a vacuum if they are to add to our understanding of events and institutions, and if they are to aid decision making.

I have not moulded the book around the 'capital asset pricing model'. Instead, I have set the development of the model in the context of developments in finance theory, and I have considered some of the model's implications for financial decisions.

The point of view which I have adopted is that of the person responsible for the financial decisions of a business, whom I have called the 'finance manager'. He, of course, must be aware of the point of view of his fellow managers and others, such as the firm's customers, suppliers, other employees and investors.

I do not offer neat and tidy solutions to the problems which the finance manager might be expected to face, but, instead, I indicate methods of thought and approach which may be helpful.

There is no need, here, to outline the contents of the book, as the 'contents list' adequately performs this task. However, I should draw attention to the inclusion of the chapter on the Government's impact on the decision environment, and to the chapters on business failure, small firms and international comparisons, as being, in my view, desirable constituents of a book on finance.

In the book, I have used simple mathematical notation where I think it aids understanding. I have avoided completely the use of footnotes, which I find distracting to the reader.

I have included a substantial number of references in the text, and guidance to further reading is given at the end of chapters. I have referred frequently to the reports and evidence published by the Wilson Committee, which contain much relevant and up-to-date material. At the time of writing, the Committee has not produced its final report, and is still publishing evidence and research reports.

I have used the word 'firm' where the precise form of the organization is

unimportant, and ‘company’ where corporate form is intended. Also, the reader who feels strongly about such matters may read ‘she’ for ‘he’ throughout.

The book is aimed at readers who have some knowledge of economics and accounting. It is appropriate to undergraduate and graduate courses and to ‘professional’ courses. Practising finance managers should also find it of interest and use.

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I wish to record my gratitude: to my colleagues Peter Bird, Roisin Bresnihan and Graeme Macdonald, for their many helpful observations on various chapters, and to Elizabeth Oxborrow, for preparing the discounting and compounding tables; to Sally Freear, my wife, for reading the book and suggesting improvements; to Anna Akhurst, for patiently typing so many pages of manuscript; to Janice Sewell, Muriel Waring and colleagues in the Rutherford College secretarial office, for their help with the typing and preparation of the book; to Alfred Waller, Eric Dalton, Lindsay Watson and others at Pitman Publishing, for their courteous encouragement and assistance; and to anyone else whom I have neglected to thank, for help given.

This book has long been an uncomfortable lodger with my family. I thank my wife, Sally, and my daughters, Helen and Kate, for suffering it so stoically, and for their support whenever the muse deserted me. Despite all this help, I remain responsible for the result.

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John Freear
January 1980

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1 Objectives and Decisions

1.1 Introduction

Each day, most people take several decisions; some decisions they take almost automatically, but not necessarily painlessly, such as the decision to get out of bed in the morning. Failure to do so, except for such reasons as death or incapacity, may be described as a decision not to get out of bed. In both cases, the person taking the decision may have some idea, however ill-formed, of the likely consequences of his decision, and this awareness will influence the decision taken. Staying in bed for an extra five minutes may result in later decisions to forgo cornflakes at breakfast time, or to run rather than walk to the station, in order to mitigate the effects of that first decision of the day. Other decisions may be less automatically taken because they have to be taken less frequently, or because they are too important for such treatment. In all cases, if the decision is to be taken on a rational basis, the decision maker will need information about the likely outcome and consequences of his decision. The luxury of being in a position to take a decision arises because more than one course of action (including inaction) is open, in the future, to the decision maker. Otherwise, there is only one course of action and no decision.

The intention of this book is to examine the nature of a particular set of decisions in a particular environment. The decisions are about the provision of finance. The environment is the economic unit known as the 'firm', which can be a one-man organization or a large corporate entity (or 'company'). Most of the discussion will centre on the United Kingdom experience, but not to the exclusion of that of other countries. Just as the term 'firm' encompasses a wide range of operations, so too the term 'decision' covers the planning, implementation and control of the provision of finance. Firms are involved in a wide variety of decisions, many, indeed most, of which have financial implications. Decisions about production affect and are affected by decisions about pricing, investment, finance, sales, purchasing and personnel. Thus, any organization has continually to control and co-ordinate the taking, implementation and subsequent control of many sets of inter-related decisions to ensure that they are compatible with the overall requirements of that organization.

To separate decisions about the provision of finance from these other

decisions is clearly unrealistic and misleading. Yet it has to be done, in substantial measure, in order to make the subject manageable. You will be reminded of the relevance of other decisions at appropriate points throughout the text. The set of decisions most closely related to financing decisions is that concerned with the deployment of resources, commonly known as investment decisions. To neglect these in a book on finance would be, adapting Marshall's analogy, to fail to appreciate that two blades are needed for the proper operation of a pair of scissors. Therefore, the early chapters of this book will attempt to set financing decisions in their context, which includes emphasizing the importance and relevance of investment decisions to financing decisions.

It is usually helpful to oversimplify the early stages of the exposition of a topic, in order to emphasize its basic elements, and connections. Therefore, investment decisions are first presented in circumstances of perfect markets and certainty about future outcomes, so as to establish their nature and connections with consumption and financing decisions. As the assumptions of perfect markets, and then certainty, are relaxed, such decisions become more complex and less susceptible to simple treatment. By this stage, however, the understanding acquired from the initial, simplified, exposition should help you to understand the structure of the more complex analysis without losing sight of its purposes or of its basic similarity to the initial exposition.

1.2 Decisions and models

For there to be a decision, at least two possible courses of action have to be open to the decision maker. He will need to consider, with varying degrees of uncertainty, the likely outcomes associated with each course of action. Decisions and outcomes do not take place in a vacuum, so that the state of the environment will play an important role in influencing the outcome of the decision. The decision maker must have a reasonably well-formed idea of what his objectives are, otherwise it will be impossible to arrive at rational criteria for choosing among the various available courses of action. He may be deterred from choosing a course of action by government regulation or company policy. These factors inherent in decision making may be drawn together to offer the decision maker some guidelines for the way in which he might take his decisions.

These guidelines may be set out in the form of a decision 'model'. The term 'model' has a similar meaning in finance and economics to that in everyday usage. A model is a representation of the real thing. It is not a slavish copy but a simplified, scaled-down version, like a newspaper report of some disaster or other event. The primary intention of all models is to portray an often complex structure in an understandable way. The model

must be a compromise between complexity and simplicity. If it is too simple, it risks unreliability. The decision maker may be able easily to understand the relationships expressed in the model, but these may not be reliable representations of reality. Increasing accuracy and reliability, brought about by the inclusion of more detail and greater complexity, can put the model beyond the comprehension of the decision maker and hence beyond his ability to use it. The ideal model would give the decision maker enough information—but not too much—to enable him to take a rational decision. He must both understand and evaluate the working of the model and be able to assess the reliability of what goes into the model and what comes out of it.

The typical decision model has the following components: first, the objectives of the decision maker must be known. The nature of the decision will influence the degree to which the objectives need to be specified. Although this anticipates the discussion in a later section, it may be sufficient at this point to accept that the broad aim of the decision maker or his organization is the maximization of profits or wealth, and subsequently, to lay down more detailed criteria which are in line with the overall objective and yet are usable in the context of the particular decision. Second, the problem about which a decision is to be taken must be recognized and delineated. In some ways, recognition that there is a problem is the most important element in the decision process and one to which corporate strategists have rightly devoted much attention. Experienced managers might be forgiven for holding the view that problems are easily recognized by the frequency of their occurrence and the force with which their presence is felt. This is to miss the point. Although the uncertainties of the business environment make it inevitable that some problems cannot be foreseen, the anticipation of future problems is surely part of the manager's function. Failure to anticipate means that the manager must fall back on his ability to react quickly and correctly under pressure to recognize, define, and solve the unanticipated problems as they arise.

The third component of the typical decision model is the search for feasible ways of dealing with the defined problem. If the problem has been wrongly or inadequately defined, then the decision maker will consequently be seeking solutions to the wrong problem. On the assumption that he is seeking solutions to the right problem, he may rely on his own intuition or he may engage in more formal search procedures, which may range from 'back of an envelope' lists to using the services of a specialized planning department. In any case, he will need to have a clear assessment of the current resource position and of the environment in which the decision is to be taken. Fourth, having discovered a number of possible solutions, the decision maker must evaluate them in order to choose that solution which he considers is most likely to produce the best result, in

terms of his objective. This evaluation may be done by building a model of the problem itself which describes the various available solutions, the possible environments, the likely outcomes, and the anticipated relationships among each of these. Forecast values can then be inserted into the model to see which solution has the best expected performance. Very often, before this is done for a current decision, past data is used to test the model's validity and reliability. If it performs well on past data, in that it predicts accurately the now known outcome, then, it is argued, there is a good chance of similar performance when predicting future outcomes.

The decision model briefly outlined above must be seen as a guide to the decision maker rather than a mechanical device, which can be used unthinkingly to produce 'the right decision'. Given the many problems inherent in the building and use of such a model, and the considerable difficulties posed by uncertainty about the future and by inadequate information, the decision maker's experience, expertise and judgement are critical. Indeed, he must constantly consider whether or not the costs of acquiring additional information will be outweighed by the consequent expected benefits to the quality of the decision. He must also be prepared to review each component in the model if the work on the other components so suggests. For example, the process of evaluating the available possible solutions might open up the possibility of a radically different approach to the problem and a consequently different set of possible solutions. Or the criteria for solution, based on the decision maker's objectives, might be found to be impractical in that none of the possible solutions meets the criteria. Perhaps most importantly of all, the decision maker should be aware that his prejudices and preconceptions, and those of others involved in the decision, may predispose him towards some solutions at the expense of others. A trained engineer might instinctively prefer the most technically attractive solution which may not necessarily best meet the assumed objective of wealth maximization. Or a decision may be made in favour of a large capital spending programme largely because 'it seems a good idea' and because spare resources are available within the firm—an example of 'organizational slack' (Cyert and March, 1963; Cohen and Cyert, 1965).

Cyert, Dill and March (1958) discuss an interesting case concerning the introduction of more sophisticated control systems for overhead cranes, in which an accident to an employee crystallized the view, already encouraged by the presence of spare resources, that the introduction of the newer and safer control system ought to be accelerated, even though the blame for the accident had never been placed on the older control system. However, over the course of the two years following the accident, the initial optimistic and superficial estimates of the cost of replacing the existing control system were gradually made more realistic. This, combined with a trade recession and the erosion of the spare resources which were to

have been used, eventually led to the accelerated replacement programme being abandoned.

If used with such cautionary words in mind, the modelling approach to decisions is potentially helpful to the decision maker. It enables him to seek a structure in the decision, and in so doing, the better to understand its nature. Deployed with care and thought, it can be an important aid to rational and consistent decision making. As with other techniques, misuse and abuse, particularly by popularizers over-stating its usefulness, can bring it into disrepute with the very people it is intended to help, the managers. The following sections concentrate on possible objectives, and are followed by an introduction to a simple model of the economic behaviour of an individual.

1.3 Objectives and rationality

Goods are produced and services are provided in a variety of ways, ranging from the individual working alone and using minimal quantities of equipment and resources, to huge combinations of individuals and resources often spanning many countries and continents. However, the decisions at each extreme are essentially similar, and concern the acquisition and organization of sufficient resources to produce the right output at the right time and place and at the right price. Uncertainty about the future and imperfect knowledge of the present make the achievement of these purposes very difficult, and in a constantly changing environment it is often impossible accurately to assess, after the event, the degree of achievement. Further, the use of the adjective 'right' to describe output, time, place and price, conceals the fact that criteria of 'rightness' may differ from person to person, or organization to organization.

Nevertheless, it may reasonably be supposed that most people, whether trading on their own or employed by a large organization, would prefer to use resources as economically as possible. That is, for a given output, they would wish to minimize the input; or they would like to maximize the output from a given input. The more scarce the resource relative to the demand for it, the more expensive it is likely to be and the more economically it will probably be used. These ideas, combined with an assumption that man is substantially motivated by self-interest, which can be adequately expressed in financial terms, are the basis of the notion of 'economic rationality'. According to this, each person will decide in favour of that course of action which will maximize his wealth. It is then possible to predict what he will do when faced with a range of possible courses of action.

Why should a book on finance concern itself with the prediction of the behaviour of individuals or groups of individuals? It is a popular myth that