Managing money and finance

G P E Clarkson
and B J Elliott
Third edition by
Alan Johnson

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and
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Gower

First published in Great Britain by Gower Press Limited, 1969

Second edition 1972

This edition published by Gower Publishing Company Limited, Aldershot, Hants, England
Reprinted 1983

British Library Cataloguing in Publication Data

Clarkson, Geoffrey P.E.
Managing money and finance. – 3rd ed
1. Business enterprises – Finance
I. Title II. Elliot, Bryan J. III. Johnson, Alan
658.1'5 HE4026

ISBN 0-566-02402-0

Printed and bound in Great Britain by
Biddles Ltd, Guildford and King's Lynn

Preface to third edition

This is truly a book for the nineteen-eighties, even though it was first published in the late sixties. The years that have passed since Clarkson and Elliott's *Managing Money and Finance* first appeared have served only to reinforce their message, which is, to put it bluntly, "take care of the cash and the profits will take care of themselves". There are two reasons why this message is now as topical as ever.

First, prolonged recession. Firms are now embroiled in severe, if not terminal, cash flow difficulties. Many firms have to fight their customers for cash, small suppliers versus big customers, manufacturers and processors versus their retail outlets. Banks take large numbers of clients into "intensive care". The crop of business failures grows daily. While profitability and liquidity remain the two financial perennials of business life, but the overwhelming priority now is liquidity.

Second, prolonged high inflation. Most business people agree that inflation on today's scale makes a nonsense of traditional ways of measuring profits. Profit – an increase in shareholders' equity through trading – has never been a straightforward thing to measure, and current efforts to base profits on replacement costs ("inflation accounting") seem to have made things worse. Managers show little enthusiasm for the rationale or complexities of current cost accounting or its alternatives, and are likely to welcome the more objective approach of measurements based on cash flow.

Nevertheless, some revision is called for. I undertook the task because the original authors were not available to do it themselves. All I have done, however, is to delete anachronisms (mainly relating to tax) and introduce a few themes that recent years have brought to the fore. I have not disturbed the underlying assumptions of the chapters on capital structure, namely, that high long-term debt is a sure way to financial growth, that every penny must be channelled into working capital to fuel that growth, and that that growth is undoubtedly there if you look for it. All this sounds nostalgic in the eighties, but every member of the business community must hope that opportunities for growth will return, and return soon. In this sense the book is both behind us and ahead of us.

Managing Money and Finance speaks now to managers in the eighties. I commend to readers the hope with which Clarkson and Elliott take their leave: that the book will help to increase company earnings, "which in turn will raise the real wealth of the entire community".

Alan Johnson
Ashridge Management College
October 1982

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1 *Financial decision making*

The management of money and finance is a vital part of all business enterprise. Manufacturing, trading, and marketing may be a firm's more visible activities, but without adequate financing they cannot be carried out. Many firms consider themselves to be in business to manufacture or trade, a few regard themselves as marketing organisations. We suggest that they are also in business to make and use money. The successful enterprise will regard itself as a complex which is in business to manufacture and trade, to market and to finance. Each facet of the total activity is interdependent, yet each has its own particular needs, skills, and expertise in order to function effectively. This volume is directed to the skills and expertise required by an organisation that is financially efficient.

This first chapter is an introduction to the book. It is a guide to the reader who may wish to pursue selected interests. Both money and finance are important ingredients of industrial enterprise, but some readers may see their interests lying more in one area than the other.

This chapter begins with a discussion of the role of money and finance and their relationship to financial managers, accountants, investors, and others who take part in the world of finance. We recommend that this section be read with some care. It will help the reader to identify his own position with regard to money and finance as well as introducing him to the main them of the book.

The next part presents an outline of the book's structure. Though the entire contents will be of general interest, particular chapters will have special relevance to certain readers.` It is intended that this guide to the book will permit the general reader to pick out his main interests and the specialist to ignore those topics with which he is already familiar.

The final section of this chapter contains a more detailed description of some of the important topics covered. Hence, these two final sections provide a detailed map to this book and to the activity of managing money and finance.

Money and finance

Profit is a reward for a successful business venture. These earnings are the funds from which dividends are paid to yield a suitable cash flow return on the risk money provided by investors. Earnings have an even more important part to play in a business enterprise. They are the source from which a firm finances its growth. Growth in earnings is the highest objective of financial management since a steady rise in earnings entails an equivalent growth in the value of the venture. Company share prices, the worth of proprietor and partnership firms and all capitalised values depend largely upon the generation and growth of earnings from the activities of the enterprise. Profit, earnings, and growth, no matter how prized, are unobtainable without appropriate finance. Hence, the management of finance is a very necessary part of the management of earnings and growth.

To manage an enterprise successfully, a firm must pay detailed attention to financial decision processes. Business finance is not concerned merely with legal and accountancy approaches to financial documents, instruments, and records. These are essential facets of financial operations but are passive services which the financial manager must use. The active management of finance is dedicated to the operations themselves and decision making is the activity of operations.

Financial decision making concerns every phase of a company's operations where the flow of funds and the generation of profit are involved. A firm which is consciously aware of its financial operations can manage its earnings in the same manner and with the same efficiency as it would wish to apply to the production and sale of its goods and services. Active financial decision making leads to positive control of the inflow and outflow of funds. This book is concerned with the management of a firm's finance and describes in detail a number of the more important issues and decision procedures.

To illustrate these remarks, consider a firm which is principally concerned with manufacturing and selling its products. It has never bothered too much with the financial side of its operations. Its attitude to the management of these operations can be described as passive. The firm is doing quite well, when it receives a substantial new order for one of its products. Raw materials are ordered and received and the main plant is put to work at maximum capacity. Suddenly, the managers discover that they are running out of funds. To meet this new order they have spent all their surplus cash on raw materials, wages, and production. To bridge the gap they need a loan, but their overdraft is already fully extended and their bank manager is not able to raise the limit. Money must be raised and it is available at a price. It is the price they have to pay that counts, and it is this price that reflects their lack of financial management. In contrast, a company with an active sense of financial management would have foreseen the need for additional funds. Control of the funds flow is part of their daily life and whenever shortages are predicted they arrange in advance for the credit facilities required. Credit is available from many sources under a variety of interest rates and conditions. Active managers are aware of these opportunities and select among them as circumstances suggest.

Financial manager

In this book we make frequent use of the term "financial manager". By this term we are not necessarily referring to a particular person whether he be the owner, director, or managing director. Though all such individuals play a vital role in a company's affairs, financial managers are those persons who make decisions which directly affect the flow of funds and the generation of profit and earnings. The financial manager may well be the head of a firm when long-term financial policy is being decided. Equally he may be farther down the managerial line making decisions when to pay for the next shipment of stock or whether to take a short-term loan to finance the purchase of some new machinery. Financial management encompasses a company's activities and the financial manager is any person who at a given moment is making a decision affecting the firm's financial position.

In a single proprietor or small partnership firm financial decisions will be taken primarily by the owners. In most cases they will take part in, if not control entirely, the host of decisions that make up the total management of their firm. To these owners we address the complete contents of this book. Larger firms will employ management personnel to conduct the daily affairs of the enterprise, leaving the owner/directors free to decide overall strategy and to handle important decisions of policy. For these companies parts of this book are directed at the owners, while the remainder is addressed to those who carry out the day-to-day management of the firm's finances. In very large companies there will be a finance department with a director who has a seat on the board. To these gentlemen we address the whole of this volume as it is their formal responsibility to give advice and to manage all aspects of their company's financial affairs.

Investors, whether large or small, play a vital role in the life of all commercial enterprise. It is they who provide the capital upon which all such activity is based. To judge the risk and value of investments, information and analysis is required. The contents of this book are directed to all investors. It is our belief that a detailed understanding of a firm's financial operations will enable them to invest their money with greater skill and confidence.

Planning and control

Effective financial management is based upon three factors: analysis of past performance, planning for future activities, and control of current activity. Control is achieved by carrying out decisions in accordance with agreed plans. Accordingly, financial planning is of crucial importance. At one level a plan may need to be no more than a statement of intent to expand production facilities at the end of the year. At other levels a plan will include a detailed description of the expected daily flows of funds. In many cases past performance can serve as a most useful guide to future activity. Most financial ratios and measures are easy to compute and once available can serve as the base line from which to measure improvements. Without plans, control is difficult to achieve or maintain as there are no standards by which performance can be judged. In addition, when the unexpected occurs there is no ready way of adjusting to or compensating for the events that have taken place. Plans are at the heart of all financial management and this volume presents a number of simple techniques to assist in the task of formulating effective plans.

For example, suppose that a project is to be undertaken and estimates are made of the net inflows of funds that will result. Suppose further that there are two possible ways of managing the project. The first produces a stream of income given above in Table 1:1 under the heading Project 1. The

Year	*Project 1*	*Project 2*
1	£2000	£1000
2	1600	1000
3	1400	1400
4	1000	1600
5	1000	2000
Total	£7000	£7000

Table 1:1 Expected net income from two projects

second is expected to produce the income listed under Project 2. Both projects will produce income for five years and both appear to generate the same total income. A financial manager will want to choose the one that yields the highest return. This return must be related to the point in time that the decision is taken. In short, to choose between these two projects the time value of money must be considered. Suppose this company considers their own cost of money to be equivalent to an interest rate of 10 per cent per year. In order to compare the two projects the income in each year will have to be discounted back to the present day at a rate of 10 per cent per year. £2000 received at the end of one year is today worth £2000 x 0.91 = £1820 at a 10 per cent interest rate. Similarly £1600 received at the end of the second year is today worth £1600 x 0.83 = £1328. The complete set of calculations for the two projects are presented in Table 1:2. As can be readily seen Project 1 has the higher present value and hence is to be preferred to Project 2.

Year	*Estimated income*		*Present value of £1 at 10% at the end of given years*	*Present value of Estimated income*	
	Project 1	*Project 2*		*Project 1*	*Project 2*
1	£2000	£1000	0.91	£1820	£910
2	1600	1000	0.83	1328	830
3	1400	1400	0.75	1050	1050
4	1000	1600	0.68	680	1088
5	1000	2000	0.62	620	1240
Total	£7000	£7000	Total	5498	5118
			Present value	£5498	£5118

Table 1:2 Present value of income streams from two projects

Financial planning is responsible for deciding upon the time cost of money to use in the company's financial calculations. A particular interest rate, however, is of no value unless it is used to control the relevant financial decisions. Project 2 might well have been chosen for other than financial reasons until the agreed discount rate was applied. To plan without using the results to effect control is as wasteful of time, money, and effort as to try to control without a plan. Both techniques must be employed if a company is to be efficiently managed. Each subject treated in this book is presented with this dual purpose in mind.