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财务管理

FINANCIAL MANAGEMENT

D. R. 米蒂雷登 著

D. R. Myddelton

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《工商管理精要系列·影印版》

出　版　说　明

《工商管理精要系列·影印版》是中国人民大学出版社和西蒙与舒斯特国际出版公司继《工商管理经典译丛》之后，共同合作出版的一套大型工商管理精品影印丛书。

本丛书由欧洲著名管理学院和管理咨询公司的教授和专家撰写，它将90年代以来国际上工商管理各专业的最新研究成果，分门别类加以精练浓缩，由享誉世界的最大教育图书出版商Prentice Hall出版公司出版。每一本书都给出了该专业学生应掌握的理论框架和知识信息，并对该专业的核心问题和关键理论作了全面而精当的阐述。本丛书虽然篇幅不长，但内容充实，信息量大，语言精练，易于操作且系统性强。因此，自90年代初陆续出版以来，受到欧洲、北美及世界各地管理教育界和工商企业界读者的普遍欢迎，累计发行量已达数百万册，是当今国际工商管理方面最优秀的精品图书之一。

这套影印版的出版发行，旨在推动我国工商管理教育和MBA事业的发展，为广大师生和工商企业界读者，提供一套原汁原味反映国外管理科学研究成果的浓缩精品图书。有助于读者尽快提高专业外语水平，扩大知识面，掌握工商管理各专业的核心理论和管理技巧。

本丛书可作为管理院校的专业外语教材和各类企业的培训教材，对于那些接受短期培训的企业管理者、MBA学生，以及想迅

速了解工商管理各专业核心领域的师生来说，本丛书更是极具价值的藏书和参考资料。

为了能及时反映国际上工商管理的研究成果，中国人民大学出版社今后将与 Prentice Hall 出版公司同步出版本丛书的其他最新内容并更新版本，使中国读者能借助本丛书，跟踪了解国际管理科学发展的最新动态。

1997 年 8 月

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Preface

Financial management is largely about *matching*:

- the maturities of liabilities with the lives of assets;
- the currencies of borrowings with those of earnings; and
- the required rate of return on investments with their risk.

So, as the figure below shows, this book 'matches' four asset chapters (3–6) with four finance ones (7–10). The other three chapters cover both assets and finance: the introduction (Chapter 1), among other topics, outlines the structure of balance sheets; interest rates (Chapter 2) affect not merely the cost of finance, but also the valuation of assets; and in Chapter 11, while mergers combine assets of different firms, reconstructions mainly reallocate interests between creditors and shareholders.

1. Introduction	
2. Interest rates	
Assets	*Finance*
3. Cash	7. Borrowing
4. Working capital	8. Ordinary shares
Capital project appraisal:	9. Valuing equity
5. Basic	10. Corporate finance
6. Refinements	
11. Mergers and reconstructions	

This book probably does contain rather more on assets (and therefore rather less on finance) than most text-books on financial management. There may not be much financial theory relating to working capital, but in many firms current assets represent the bulk of total assets. Managing them properly is thus important. It is critical, for instance, for marketing managers to appreciate the key variables in extending credit to customers, and for production managers to understand the total costs of holding stock. It is no coincidence that management consultants often concentrate first on the management of working capital. They recognize that many firms are weak in this area – not so much because it is difficult, but because it requires continual vigilance.

Capital project appraisal is familiar territory in text-books. This book explains discounted cash flow methods by referring first to the Net Terminal Value method, before moving on to Net Present Value. The reason for this approach is the more explicit discussion of what the interest rate (or discount rate) actually means – it is an 'opportunity cost', representing what else the investing firm could have done with the money. It is more important to understand what the interest rate means than to be the world's leading expert on calculating it to three places of decimals. In general, people – not just students – tend to be absurdly credulous in the accuracy of the 'information' they sometimes assume a company will have available.

The chapter on capital project appraisal refinements contains a detailed analysis of the impact of inflation, and its interaction with tax writing-down allowances and with investment in working capital. The author is now enough of a veteran to have witnessed many Chancellors of the Exchequer over the decades state or hint that we need not worry about inflation in future. At the time of writing UK markets seem to be expecting inflation over the next fifteen years to average nearly 5 per cent a year. This may (or may not) turn out to be too gloomy; but if it happens it is by no means negligible.

The chapter on borrowing looks at this form of finance both from the lender's and from the borrower's point of view; and also contains a section on valuing debt. It also distinguishes short-term from longer-term borrowing.

There are two chapters on ordinary share capital, one mainly descriptive (though with a more analytical section on dividend policy), and the other concerned with methods of valuing equity. The fact is, of course, that it is usually extremely difficult to assess (a) what will be the future cash flows for a business, and (b) what is an appropriate discount rate to apply to those future cash flows. So it should not be surprising that valuing equity shares involves very large margins of error indeed.

Chapter 10 on corporate finance covers the tricky area of 'cost of capital'. The most difficult part of this topic is estimating the cost of equity capital; on which it would be a mistake to expect too much from financial theory. In the area of capital structure, again financial theory has failed to explain the real world very convincingly. But there is probably fairly widespread agreement that it matters more in which assets a firm invests than how it finances the investment. The section on 'The corporate life cycle' is largely based (with permission) on *Corporate Financial Strategy* by my colleague Professor Keith Ward.

This book is one of a series of texts on the 'Essence' of various business and management topics. I have tried not to overlap too much with Financial Accounting, International Finance, and so forth. Rather than only include inadequate exercises to illustrate problems, because of limits of space, I have chosen to omit them altogether. I hope I have given enough examples in the text, as a rule, to allow quantitative understanding of the points covered. Many textbook problems tend to be unrealistic because they assume that things are known for certain which in fact often have to be estimated with a very wide margin of error. Recognition of what one does not know may be the beginning of wisdom. (In teaching finance, I am often reminded of Tennyson's profound line: 'Knowledge comes but wisdom lingers.')

I would like to thank those MBA students at the Cranfield School of Management who were kind enough to comment on the book in draft form. And as usual I am very grateful to my secretary, Sheila Hart, not only for her efficiency, which I have come to take for granted, but especially for her cheerfulness and support.

Contents

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1

Introduction

Business finance

Financial objectives of a business

The main **financial objective** of a business enterprise is to maximize the **wealth** of its owners. This means nearly the same as maximizing **profits**, except that measuring wealth allows for the timing of profits. Thus companies try to make profits and to avoid losses. The profit and loss account reflects success or failure in this respect.

Why are profits ever possible, above a normal rate of interest on capital invested? Essentially because of ignorance. If people dealing on markets (both buyers and sellers) already knew everything there was to be known, the prices of products would already fully reflect consumers' valuations. This **arbitrage** view of profit emphasizes the information content of price signals in the market. (Hence the destructiveness of price controls: they distort signals.)

In order to succeed in the longer term, a business must survive in the short term. Among other things, this means being able to pay its bills when they become due. Financial managers have to arrange to have cash available at the right time. The balance sheet contains details of current (short-term) assets and liabilities.

The market system

Businesses aim to make a profit by satisfying customers. It is a mistake to regard managers and workers as the two 'sides' of industry or commerce. The real distinction is between consumers on the one hand, and producers – owners, managers and workers – on the other. (Hence consumers may welcome the competition from foreign producers which domestic producers deplore.)

The market system is not a zero-sum game. If the seller makes a profit, there is no reason why the buyer must somehow *lose* to the same extent. In normal competitive markets both buyer and seller can expect to gain from voluntary market exchanges. This is because they differ in their subjective valuations of the goods or services traded. (The Greek word for 'exchange' [catallassein] also means to 'change from enmity into friendship'.) The higher the total amount of profits, the more people will have become better off as a result of market transactions. That is why, as a rule, profits are a good thing.

Consumers will not pay more than they think goods or services are worth (to them). This puts a ceiling on producers' total costs. It also gives producers an incentive to discover how much goods or services *are* worth to customers – and to find ways to add more value. Making a better or cheaper mousetrap is a good start, but consumers have to find out about it. Hence advertising is an essential part of the market system, spreading *knowledge* about new products (and reminding people about old ones).

The market economy is not static; it is a dynamic process, always having to adapt to changing conditions. The market may tend towards equilibrium, but never reaches it. New disturbing features continually appear. What has been called 'the gale of creative destruction' means long-term competition from new commodities, new technologies, new sources of supply, or new types of organization. Such basic challenges to existing products and ways of business may command a *decisive* cost or quality advantage. If so, they can strike at the very foundations of the profits and outputs of existing firms.

There are three main kinds of market in the economy: financial markets (see below); product markets, both industrial and retail; and labour markets. These deal respectively with money, goods, and people. Each is vitally important, and of course the markets are interlinked in many ways.

Owners and managers

The directors of the largest 100 UK companies between them own less than one-tenth of 1 per cent of the equity shares in their firms. With very few exceptions, they are professional managers, not owners. This gives rise to agency problems. How can principals (owners) monitor the actions of their agents (the managers), and induce them to act in the owners' interests?

Professional managers build careers on their track record of success in business. It is always open to the owners to dismiss unsuccessful managers, and hire others they hope will do better. The most important function of annual company accounts, **audited** by independent accountants, is to record the **stewardship** of managers.

It has become fashionable to reward managers partly by means of share option schemes or profit-related bonuses. But many share option schemes simply amount to methods of paying larger amounts to top managers who are already heavily committed to the success of their firms. And bonus schemes linked to reported profits may have encouraged creative (dishonest) accounting.

In contrast, owner/managers of small businesses suffer from no such potential conflict of interest. But they may not always aim to maximize their business profits. For example, the owner/manager of a small shop may prefer to close early, and not open on Saturdays, in order to enjoy more leisure. As a sole owner, he is perfectly entitled to do this if he thinks it will maximize his own psychic satisfaction. But it would hardly please the owners of a large business if its managers deliberately failed to maximize profits in order to enjoy more leisure! A competitive market would (sooner or later) replace such managers with others who *would* try to serve the owners by maximizing their wealth.

Most limited companies are private, not public ('ltd' not 'plc'). They may be too small, or too new, to meet the minimum criteria for listing. They may not need to raise more equity capital. Their main **shareholders** may not wish to realize some of their capital by selling (some of) their shares. The owner/managers may prefer to remain private, to retain control and avoid the risk of takeover. They may not relish the pressures of public **listing** – both the stock exchange regulations and the demands of investors for regular growth in earnings and dividends.

The financial environment

Financial markets

Financial markets can broadly be split between the following:

1. **Money markets**, which deal in short-term finance.

2. Foreign exchange markets, which deal in currencies (either on a spot or a forward basis).
3. **Capital markets**, which deal in long-term finance, both debt (e.g. the Eurobond market) and equity (e.g. the International Stock Exchange).
4. **Derivatives** markets, dealing in options and futures.

It is these markets which are normally open twenty-four hours a day, based on the three major centres of London, New York and Tokyo.

Financial institutions

The main private sector institutions are banks, building societies, pension funds and insurance companies. Banks are the main source of short-term and medium-term loans for businesses; while for larger firms, pension funds and insurance companies are the main source of long-term finance (both debt and equity).

The clearing banks provide for debt settlement through their system of clearing cheques and direct debits. They are also important financial **intermediaries**, receiving small amounts of savings from a large number of people and then lending them out again to individuals and businesses.

Building societies used to operate mainly by receiving deposits of savings and lending them out to enable people to buy houses and flats. (The UK's rented housing sector is smaller than it is in most other European countries.) But after deregulation of financial services in the 1980s, the larger building societies now offer a complete range of retail banking services.

Merchant (wholesale) banks arrange finance for companies (both debt and equity), and give financial advice, for example on mergers and acquisitions or on foreign currency dealing. They also manage the funds (portfolios) of pension funds, insurance companies, and investment trusts and unit trusts (see Chapter 8).

Life insurance companies and pension funds receive long-term savings from people during their working lives, often through contractual arrangements. They pay these out again, together with interest, during retirement (pensions) or on death (life assurance). (The state pension scheme is not 'funded': it runs on a 'pay-as-you-go' basis.) Partly for tax reasons, life insurance companies and pension funds have become the main owners of UK equities (see Table 1.2).

There is an important practical difference between 'defined benefit' pension schemes and 'defined contribution' schemes. At present the former are widespread. The rising stock market in the 1980s, together with 'downsizing' by many large companies, led to the pension schemes of many large employers becoming overfunded. This led to 'pension holidays' for the employers for a number of years, while the surpluses in the funds were run down. In 'defined contribution' schemes no surplus or deficit can arise in the fund: the employee simply gets whatever pension his contributions (and his employers') have earned.

In the public sector, the key financial institution is the **Bank of England**, which was founded in 1694 and nationalized in 1946. The Bank has several important functions:

1. It is the government's banker, taking in tax revenues and making payments, and managing the national debt.
2. It advises on and operates the government's monetary policy, issues bank notes and coins, and holds the country's foreign currency reserves.
3. It acts as banker for the clearing banks, and acts as lender of last resort to the financial system.
4. It supervises the banking system, and has a wider (less formal) responsibility for overseeing the financial system as a whole.

Formally the Bank of England is subordinate to the Treasury (a government department), but in practice it has a good deal of discretion. The main exception has been in the politically sensitive area of short-term interest rates. From time to time relations are somewhat strained. The Treasury is said to think of the Bank of England as its 'East End branch'; but the Bank tends to regard the Treasury as its 'West End branch'! Two recent Chancellors of the Exchequer (Nigel Lawson and Norman Lamont) have (after leaving office) revealed their support for the idea of an 'independent' Bank of England. It might have an explicit statutory duty to preserve the value of the currency – which would certainly be quite a change!

Financial sectors

The economy is split between five financial sectors: personal; industrial and commercial companies; financial institutions; government (central government, local authorities and public corporations); and overseas. Their annual financial surpluses or deficits

Table 1.1 Financial surpluses and deficits by sector, 1988–92 (£bn.)

	1988	1989	1990	1991	1992
Personal	−14	−6	+4	+18	+33
Industrial and commercial companies	−8	−22	−23	−8	−7
Financial institutions	−1	0	+3	−4	+1
	−23	−28	−16	+6	+27
Public sector					
Government	+6	+5	−2	−14	−36
Overseas sector	+17	+23	+18	+8	+9

represent the net differences between huge aggregates. Table 1.1 shows surpluses (+) and deficits (−) by sector for each of the five years 1988–92.

Table 1.2 shows the distribution of shareholding in ordinary shares of listed UK companies at five dates between 1963 and 1989. The main long-term trend is well known: between 1963 and 1989 there has been a massive switch away from personal ownership (down from 54 per cent to 21 per cent) towards pension funds (up from 6 per cent to 30 per cent). This trend has been mirrored (to a somewhat lesser extent) in the United States. And the large privatizations in the late 1980s and early 1990s have hardly interrupted it. Many of the individual subscribers to the offers for sale sold their shares within twelve months.

Accounting

The **accounts** of a company (or group of companies) consist of three main financial statements – the balance sheet; the profit and loss account; and the cash flow statement (see Chapter 3) – together with the notes to the accounts and the auditors' report.

Balance sheet

The **balance sheet** shows a firm's financial position as at the end of an accounting period. It classifies items between assets (*uses* of funds) and liabilities (*sources* of funds). Table 1.3 sets out a simple example of a balance sheet.

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