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Theory and Practice

Eddie McLaney

8th Edition

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Theory and Practice

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Eddie McLaney

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Guided tour of the book

Objectives Bullet points at the start of each chapter show what you can expect to learn from that chapter, and highlight the core coverage.

Chapter 2

A framework for financial decision making

Objectives In this chapter we shall deal with the following:
- the steps in financial decision making
- the various objectives that, it has been suggested, might be followed by businesses
- some evidence on objectives that UK businesses actually follow
- the problem that arises from businesses being run by professional managers on behalf of the shareholders
- some theoretical rules for financial decision making; the separation theorem

2.1 Financial decision making

Like any other decision-making area, financial decisions involve choices between two or more possible courses of action. If there is only one possible course of action, no decision is needed. Often, continuing with a situation that has existed until the time of the decision is one option open to the decision maker. All decision making should involve the following six steps.

Step 1: Define objectives

The decision maker should be clear what the outcome of the decision is intended to achieve. A person leaving home in the morning needs to make a decision on which way to turn into the road. To do this, it is necessary to know what the immediate objective is. If the objective is to get to work, it might require a decision to turn to the right; if it is a visit to the local shop, the decision might be to turn left. If our decision maker does not know the desired destination, it is impossible to make a sensible decision on which way to turn. Likely objectives of businesses will be considered later in this chapter.

Step 2: Identify possible courses of action

The available courses of action should be recognised. In doing this, consideration should be given to any restrictions on freedom of action imposed by law or other forces not within the control of the decision maker.

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Key terms The key concepts and techniques in each chapter are highlighted in colour where they are first introduced, with an adjacent icon in the margin to help you refer back to the most important points.

Bullet point chapter summary Each chapter ends with a 'bullet point' summary. This highlights the material covered in the chapter and can be used as a quick reminder of the main issues.

Examples At frequent intervals throughout most chapters, there are examples that pose a problem and provide step-by-step workings to follow through to the solution.

Chapter 5 • Practical aspects of investment appraisal

Multi-period capital rationing

Linear programming

Where the constraint operates for more than one time period, a more sophisticated approach needs to be adopted. **Linear programming** (LP) is such an approach.

Example 5.7

Listed below are the cash flow characteristics of four investment projects. Investment finance is rationed at years 0 and 1 to £100,000 at each time. Projects cannot be delayed nor can they be brought forward. The cost of finance is 10 per cent.

Project	*Year 0* £000	*Year 1* £000	*Year 2* £000	*Year 3* £000	*NPV (at 10%)* £000
W	(70)	(20)	60	60	6.44
X	–	(90)	60	50	5.30
Y	(80)	10	60	30	1.18
Z	–	(50)	30	30	1.86

(Note that the NPVs are as at year 0 (now) even for Projects X and Z, which, even if selected, will not commence until year 1. Also note that Project W requires cash outflows in both year 0 and year 1.)

Set out the various statements that must be satisfied so as to maximise NPV, but meet the financing constraints.

Solution

We should seek to undertake such a combination of the four projects as would give the highest possible total NPV, subject to the capital constraints at years 0 and 1. Letting w, x, y and z be the proportions of each of the four projects that it is desirable to undertake, we are seeking to maximise the function

$$NPV = 6.44w + 5.30x + 1.18y + 1.86z$$

subject to

$$70w + 80y \leq 100$$

– that is, the total outlays at year 0 on W and Y being £100,000 or less, and

$$20w + 90x - 10y + 50z \leq 100$$

– that is, the total outlays on projects W, X and Z, less the inflow from Project Y at year 1, must not exceed £100,000.

In fact, further constraints will have to be applied since each of the proportions must be positive or zero and cannot (presumably) exceed 1. Thus:

$$1 \geq w \geq 0$$
$$1 \geq x \geq 0$$
$$1 \geq y \geq 0$$
$$1 \geq z \geq 0$$

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Chapter 4 • Practical aspects of investment appraisal

Summary

Cash/accounting flows
- Net present value (NPV), internal rate of return (IRR) and payback period (PBP) all require the use of cash flows.
- Need to adjust accounting flows for depreciation, by adding it back to accounting profit.
- Capital expenditure and disposal proceeds cash flows need to be identified as to amount and timing.
- Working capital (WC) needs to be treated as a cash outflow early in the project and an inflow at the end.

Relevant cash flows
- Only those that will differ according to the decision should be taken into account. This means that:
  - all past costs should be ignored;
  - all future costs that will be the same irrespective of the decision should be ignored; and
  - differential opportunity costs should be included.

Taxation
- Taxation must be taken into account where the decisions will lead to different tax cash flows.
- Depreciation is not a tax-deductible expense. Capital allowances replace depreciation for tax purposes.

Inflation
- Inflation must be taken into account when using NPV. Either:
  - real cash flows must be discounted using a real discount rate; or
  - money (nominal) cash flows must be discounted using a money (nominal) discount rate.

The two cannot be mixed.
- In practice, it is usually easier to use money cash flows and discount rate.
- (1 + money discount rate) = (1 + real discount rate) × (1 + inflation rate).

Carrying out an NPV appraisal involves five steps
1. Identify all the relevant cash flows and their timing.
2. Total the cash flows for each point in time.
3. Discount each total, according to the appropriate time into the future that the cash flow will occur.
4. Total the present values of the various discounted values to derive the NPV for the project.
5. If the NPV is positive, the project is acceptable, presuming a shareholder wealth maximisation objective.

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Chapter 5 • Practical aspects of investment appraisal

- Uses standard accounting profit and capital invested, but adjusts both of these for the innate conservatism of accounting measures.
- Benefits of EVA® include:
  - Managers are subjected to a charge that is based on capital invested by them and the shareholders' required minimum return.
  - There is no requirement for a separate management information system.
- A problem is that adjusting the accounting figures to remove the biases is subjective.

Real options

- Nearly all business situations offer strategic options, for example delaying a decision until information becomes more available.
- Traditional decision-making approaches tend to ignore or underplay these options.
- The value of the real options involved in a decision should be included in the analysis.

Further reading Most texts on business finance and capital investment appraisal deal to a greater or lesser extent with the practical aspects. The following tend to deal thoroughly with those aspects: Atrill (2009), Arnold (2005) and Brealey, Myers and Allen (2007). Bancroft and O'Sullivan (2000) give clear coverage of linear programming. Johnson, Scholes and Whittington (2004) provide a very readable introduction to strategic planning. Atrill and McLaney (2007) give more detail concerning value-based management. For a very readable introduction to real options, see Dixit and Pindyck (1995), and for some real-life examples of real options, see Leslie and Michaels (1998).

Relevant website The website of Stern, Stewart and Company (www.sternstewart.com), the organisation that developed EVA®, contains information about this approach.

REVIEW QUESTIONS

Suggested answers to review questions appear in Appendix 3.

5.1 Depreciation is taken into account when deducing profit (in the income statement), but ignored in NPV assessments. If both accounting profit and NPV are meant to be decision-making tools, is this illogical?

5.2 Is it logical to include interest payments on cash borrowed to finance a project as cash outflows of the project in an NPV assessment? Explain your answer.

5.3 Is it true that the 'money' rate of interest is equal to the 'real' rate, plus the rate of inflation? Explain your answer.

5.4 When inflation is predicted over the life of a project under assessment, there are two approaches to dealing with inflation. What are these? Which is the better one to use?

5.5 How can it be argued that hard capital rationing does not exist in real life?

5.6 What is meant by a 'profitability index'? Is it a helpful approach to dealing with multi-period capital rationing problems?

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Further reading This section comprises a listing of relevant chapters in other textbooks that you might refer to in order to pursue a topic in more depth or gain an alternative perspective.

Relevant websites Provides full details of suitable sources of information on the WWW.

Review questions These short questions encourage you to review and/or critically discuss your understanding of the main topics covered in each chapter, either individually or in a group. Solutions to these questions can be found on the Companion Website at **www.pearsoned.co.uk/atrillmclaney**

Problems Towards the end of most chapters you will encounter these questions, allowing you to check your understanding and progress. Solutions are provided in Appendix 4.

Problems

PROBLEMS

Sample answers to problems marked with an asterisk appear in Appendix 4.

(Problems 5.1 to 5.4 are basic-level problems, whereas problems 5.5 to 5.8 are more advanced and may contain some practical complications.)

5.1* Dodd Ltd is assessing a business investment opportunity, Project X, the estimated cash flows for which are as follows:

	£000
Investment (cash outflow on 1 January 20X2)	250
Net annual cash inflow (arising on the last day of the year):	
20X2	160
20X3	160
20X4	100
Cash inflow from residual value 31 December 20X4	50

All of the above figures are expressed at 1 January 20X2 prices. Inflation is expected to operate at 5 per cent p.a. throughout the project's life.

The business's 'real' (that is, not taking account of inflation) cost of finance is estimated at 10 per cent p.a.

Corporation tax is charged on profits at the rate of 30 per cent, payable during the year in which the profit is earned (assume that the taxable profit equals the net operating cash flow). The asset, which will be bought in 20X2 and disposed of in 20X4, is of a type that does not give rise to any tax relief on its cost nor a tax charge on its disposal.

Calculate (using 'money' cash flows), the net present value of Project X.

5.2 Lateral plc has a limit of £10 million of investment finance available to it this year, and it has the following investment opportunities available to it:

Project	Investment required this year (£m)	Net present value (£m)
U	8.0	3.3
V	3.2	0.9
W	5.3	1.2
X	2.0	0.5
Y	4.5	2.0
Z	0.5	0.4

Assuming that the capital shortage relates only to the current year and that each project can be undertaken in part, with the NPV scaled down in direct proportion to the proportion undertaken, which projects should Lateral plc undertake?

5.3 The management of Roach plc is currently assessing the possibility of manufacturing and selling a new product. Two possible approaches have been proposed.

Approach A

This involves making an immediate payment of £60,000 to buy a new machine. It is estimated that the machine can be used effectively for three years, at the end of which time it will be scrapped for zero proceeds.

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Chapter 3 • Financial statements and their interpretation

Balance sheet as at 31 December

	Last year £000	This year £000
Non-current assets	8,072	10,456
Current assets		
Inventories	1,850	3,166
Trade receivables	976	1,992
Cash	624	52
	3,450	5,210
Total assets	11,522	15,666
Equity		
Ordinary shares of £0.50 each	6,500	6,500
Capital reserves	500	500
Retained profit	1,744	3,518
	8,744	10,518
Non-current liabilities		
Loan notes	–	600
Current liabilities		
Trade payables	1,320	2,236
Other payables	1,142	1,434
Taxation	316	518
Bank overdraft	–	360
	2,778	4,548
Total equity and liabilities	11,522	15,666

Calculate the suitable financial ratios for High Street Enterprises plc for last year and this year (use year-end figures where balance sheet items are involved) and use the ratios to comment on the performance and position of the business.

There are sets of **multiple-choice questions** and **missing-word questions** available on the website. These specifically cover the material contained in this chapter. These can be attempted and graded (with feedback) online.

There are also **two additional problems**, with solutions, that relate to the material covered in this chapter.

Go to **www.pearsoned.co.uk/atrillmclaney** and follow the links.

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Visit the website www.pearsoned.co.uk/atrillmclaney to enhance your learning with multiple choice questions and missing word questions.

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Preface

This book attempts to deal with financing and investment decision making, with particular focus on the private sector of the UK economy. Its approach is to set out the theories that surround each area of financial decision making and relate these to what appears to happen in practice. Where theory and practice diverge, the book tries to reconcile and explain the differences. It also attempts to assess the practical usefulness of some of the theories that do not seem to be applied widely in practice.

Although the focus of the book is on the UK private sector, the theories and practices examined are, for the main part, equally valid in the context of the private sector of all the world's countries. Also, much of the content of the book is relevant to many parts of the public sector, both in the UK and overseas.

Most of the organisations to which the subject matter of this book relates will be limited companies or groups of companies, though some may be partnerships, cooperatives or other forms. For simplicity, the word 'business' has been used as a general term for a business entity, reference being made to specific legal forms only where the issue under discussion relates specifically to a particular form.

The book attempts to make the subject as accessible as possible to readers coming to business finance for the first time. Unnecessarily technical language has been avoided as much as possible, and the issues are described in a narrative form as well as in more formal statements. The more technical terms are highlighted in blue when they are first mentioned and these are included in the glossary at the end of the book. Detailed proofs of theoretical propositions have generally been placed in appendices to the relevant chapters. Readers should not take this to mean that these proofs are particularly difficult to follow. The objective was to make the book as readable as possible, and it was felt that sometimes formal proofs can disturb the flow if they are included in the main body of the text.

Although the topics in the book are interrelated, the book has been divided into sections. Chapters 1 to 3 are concerned with setting the scene, Chapters 4 to 7 with investment decisions, and Chapters 8 to 12 with financing decision areas, leaving Chapters 13 to 16 to deal with hybrid matters.

Some reviewers have made the point that the subject of Chapter 9 (capital market efficiency) pervades all aspects of business finance and should, therefore, be dealt with in an introductory chapter. After some consideration it was decided to retain the same chapter order as in the previous editions. The logic for this is that a complete understanding of capital market efficiency requires knowledge that does not appear until Chapter 8. A very brief introduction to capital market efficiency appears at the beginning of Chapter 7, which is the first chapter in which capital market efficiency needs to be specifically referred to. It is felt that the chapter ordering provides a reasonable compromise and one that makes life as straightforward as possible for the reader.

In making revisions for this eighth edition, the opportunity has been taken to make the book more readable and understandable. Most of the practical examples have been

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updated and expanded. Where possible, examples of practice in particular businesses are given. This should make the book more focused on the real business world. More recent research evidence has been included, including that relating to the practical frailties of the capital asset pricing model. The opportunity has been taken to reflect the effects that adoption of International Financial Reporting Standards has had on the financial reports of most large businesses in many parts of the world, including the UK. The most obvious changes have been in the terminology used and the way that financial statements are set out. This edition also discusses the role and importance of private equity funds. Securitisation has been introduced, as well as its link to US sub-prime mortgage loans.

Nothing in this book requires any great mathematical ability on the part of the reader. Although not essential, some basic understanding of correlation, statistical probabilities and differential calculus would be helpful. Any reader who feels that it might be necessary to brush up on these topics could refer to Bancroft and O'Sullivan (2000). This reference and each of the others given in the chapters are listed alphabetically at the end of the book.

At the end of each chapter there are six review questions. These are designed to enable readers to assess how well they can recall key points from the chapter. Suggested answers to these are contained in Appendix 3, at the end of the book. Also at the end of most chapters are up to nine problems. These are questions designed to test readers' understanding of the contents of the chapters and to give some practice in working through questions. The problems are graded either as 'basic', that is, fairly straightforward questions, or as 'more advanced', that is, they may contain a few practical complications. Those problems marked with an asterisk (about half of the total) have suggested answers in Appendix 4 at the end of the book. Suggested answers to the remaining problems are contained in the Instructor's Manual, which is available as an accompaniment to this text.

The book is directed at those who are studying business finance as part of an undergraduate course, for example a degree or Higher National Diploma in business studies. It is also directed at postgraduate, post-experience students who are either following a university course or seeking a qualification such as the Certified Diploma in Accounting and Finance. It should also prove useful to those studying for the professional examinations of the accounting bodies.

Eddie McLaney
September 2008

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Plan of the book

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PART 1

The business finance environment

Business finance is concerned with making decisions about which investments the business should make and how best to finance those investments. This first part of the book attempts to explain the context in which those decisions are made. This is not just important in its own right, but also serves as an introduction to later parts of the book.

Chapter 1 explains the nature of business finance. It continues with some discussion of the framework of regulations in which most private sector businesses operate. Chapter 2 considers the decision-making process, with particular emphasis on the objectives pursued by businesses. It also considers the problem faced by managers where people, affected by a decision, have conflicting objectives. Chapter 3 provides an overview of the sources and nature of the information provided to financial decision makers by financial (accounting) statements prepared by businesses on a regular (annual/six-monthly) basis. As is explained in Chapter 1, business finance and accounting are distinctly different areas. Financial statements are, however, a very important source of information upon which to base financial decisions.

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Chapter 1

Introduction

Objectives

In this chapter we shall deal with the following:

- → the role of business finance
- → the importance of the consideration of risk in financial decision making
- → the relationship between business finance and other disciplines, particularly accounting
- → the importance of the limited company as the legal form in which most UK businesses exist
- → the nature of the limited company
- → what is meant by limited liability
- → the formation of limited companies
- → the requirement for businesses trading as limited companies to signal the fact to the world through the company name
- → directors and their relationship with shareholders
- → the duty of directors to account for their actions
- → the way in which companies are managed
- → corporate governance
- → typical means of financing companies and the rights of suppliers of corporate finance
- → liquidation of companies
- → the nature of derivatives
- → private equity funds

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1.1 The role of business finance

Businesses are, in effect, investment agencies or intermediaries. This is to say that their role is to raise money from members of the public, and from other investors, and to invest it. Usually, money will be obtained from the owners of the business (the shareholders) and from long-term lenders, with some short-term finance being provided by banks (perhaps in the form of overdrafts), by other financial institutions and by other businesses being prepared to supply goods or services on credit (trade payables (or trade creditors)).

Businesses typically invest in **real assets** such as land, buildings, plant and inventories (or stock), though they may also invest in **financial assets**, including making loans to, and buying shares in, other businesses. People are employed to manage the investments, that is, to do all those things necessary to create and sell the goods and services in the provision of which the business is engaged. Surpluses remaining after meeting the costs of operating the business – wages, raw material costs, and so forth – accrue to the investors.

Of crucial importance to the business will be decisions about the types and quantity of finance to raise, and the choice of investments to be made. Business finance is the study of how these financing and investment decisions should be made in theory, and how they are made in practice.

A practical subject

Business finance is a relatively new subject. Until the 1960s it consisted mostly of narrative accounts of decisions that had been made and how, if identifiable, those decisions had been reached. More recently, theories of business finance have emerged and been tested so that the subject now has a firmly based theoretical framework – a framework that stands up pretty well to testing with real-life events. In other words, the accepted theories that attempt to explain and predict actual outcomes in business finance broadly succeed in their aim.

Business finance draws from many disciplines. Financing and investment decision making relates closely to certain aspects of economics, accounting, law, quantitative methods and the behavioural sciences. Despite the fact that business finance draws what it finds most useful from other disciplines, it is nonetheless a subject in its own right. Business finance is vital to the business.

Decisions on financing and investment go right to the heart of the business and its success or failure. This is because:

- such decisions often involve financial amounts that are very significant to the business concerned;
- once made, such decisions are not easy to reverse, so the business is typically committed in the long term to a particular type of finance or to a particular investment.

Although modern business finance practice relies heavily on sound theory, we must be very clear that business finance is an intensely practical subject, which is concerned with real-world decision making.

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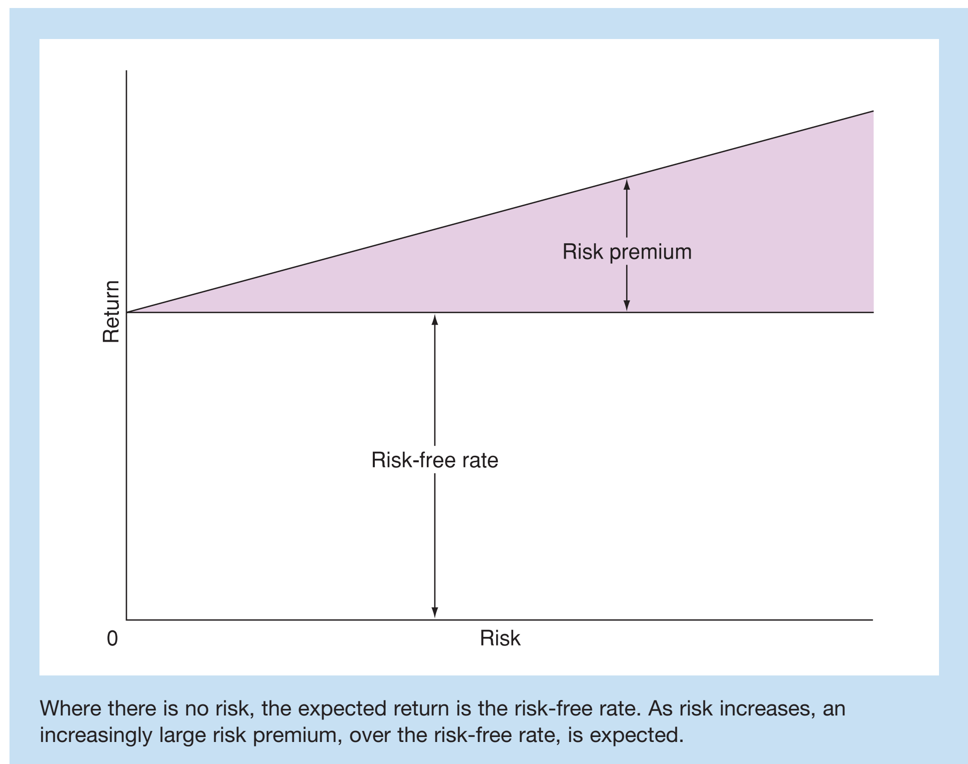
1.2 Risk and business finance

All decision making involves the future. We can only make decisions about the future; no matter how much we may regret it, we cannot alter the past. Financial decision making is no exception to this general rule.

There is only one thing certain about the future, which is that we cannot be sure what is going to happen. Sometimes we may be able to predict with confidence that what will occur will be one of a limited range of possibilities. We may even feel able to ascribe statistical probabilities to the likelihood of occurrence of each possible outcome; but we can never be completely certain of the future. **Risk** is therefore an important factor in all financial decision making, and one that must be considered explicitly in all cases.

In business finance, as in other aspects of life, risk and return tend to be related. Intuitively we expect returns to relate to risk in something like the way shown in Figure 1.1.



Where there is no risk, the expected return is the risk-free rate. As risk increases, an increasingly large risk premium, over the risk-free rate, is expected.

Figure 1.1 Relationship between risk and return

In investment, for example, people require a minimum rate to induce them to invest at all, but they require an increased rate of return – the addition of a risk premium – to compensate them for taking risks. In Chapter 7 we shall consider the extent to which, when considering marketable shares and other securities, there does actually appear to be the linear relationship that Figure 1.1 suggests between levels of risk perceived and the returns that investors expect to receive. Much of business finance is concerned with striking the appropriate balance between risk and return.

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