Eddie McLaney

BUSINESS FINANCE

THEORY AND PRACTICE

Eleventh Edition

BUSINESS FINANCE

Supporting resources

Visit **www.pearsoned.co.uk/mclaney** to find valuable online resources

Companion Website for students

- Multiple choice questions and missing word questions to test your understanding
- Additional problems and solutions to put your learning into practice
- Extensive links to valuable resources on the web
- An online glossary to explain key terms

For instructors

- Complete, downloadable Instructor's Manual
- PowerPoint slides
- Tutorial/seminar questions and solutions

For more information please contact your local Pearson Education sales representative or visit **www.pearsoned.co.uk/mclaney**

Pearson

At Pearson, we have a simple mission: to help people make more of their lives through learning.

We combine innovative learning technology with trusted content and educational expertise to provide engaging and effective learning experiences that serve people wherever and whenever they are learning.

From classroom to boardroom, our curriculum materials, digital learning tools and testing programmes help to educate millions of people worldwide – more than any other private enterprise.

Every day our work helps learning flourish, and wherever learning flourishes, so do people.

To learn more, please visit us at **www.pearson.com/uk**

Eleventh Edition

Business Finance

Theory and Practice

Eddie McLaney

Pearson

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney • Dubai • Singapore • Hong Kong
Tokyo • Seoul • Taipei • New Delhi • Cape Town • Sao Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milan

PEARSON EDUCATION LIMITED
Edinburgh Gate
Harlow CM20 2JE
United Kingdom
Tel: +44 (0)1279 623623
Web: www.pearson.com/uk

First published 1986 by Macdonald & Evans Limited (print)
Second edition published 1991 as *Business Finance for Decision Makers* by Pitman Publishing, a division of Longman Group UK Ltd (print)
Third edition published 1994 as *Business Finance for Decision Makers* by Pitman Publishing, a division of Longman Group UK Ltd (print)
Fourth edition published 1997 by Pitman Publishing, a division of Pearson Professional Limited (print)
Fifth edition published 2000 (print)
Sixth edition published 2003 (print)
Seventh edition published 2006 (print)
Eighth edition published 2009 (print)
Ninth edition published 2011 (print)
Tenth edition published 2014 (print and electronic)
Eleventh edition published 2017 (print and electronic)

© E. J. McLaney 1986, 1991 (print)
© Longman Group UK Limited 1994 (print)
© Pearson Professional Limited 1997 (print)
© Pearson Education Limited 2000, 2003, 2006, 2009, 2011 (print)
© Pearson Education Limited 2014, 2017 (print and electronic)

The right of Eddie McLaney to be identified as author of this work has been asserted by him in accordance with the Copyright, Designs and Patents Act 1988.

The print publication is protected by copyright. Prior to any prohibited reproduction, storage in a retrieval system, distribution or transmission in any form or by any means, electronic, mechanical, recording or otherwise, permission should be obtained from the publisher or, where applicable, a licence permitting restricted copying in the United Kingdom should be obtained from the Copyright Licensing Agency Ltd, Barnard's Inn, 86 Fetter Lane, London EC4A 1EN.

The ePublication is protected by copyright and must not be copied, reproduced, transferred, distributed, leased, licensed or publicly performed or used in any way except as specifically permitted in writing by the publishers, as allowed under the terms and conditions under which it was purchased, or as strictly permitted by applicable copyright law. Any unauthorised distribution or use of this text may be a direct infringement of the author's and the publisher's rights and those responsible may be liable in law accordingly.

All trademarks used herein are the property of their respective owners. The use of any trademark in this text does not vest in the author or publisher any trademark ownership rights in such trademarks, nor does the use of such trademarks imply any affiliation with or endorsement of this book by such owners.

Contains public sector information licensed under the Open Government Licence (OGL) v3.0
http://www.nationalarchives.gov.uk/doc/open-government-licence/version/3/.

The screenshots in this book are reprinted by permission of Microsoft Corporation.

Pearson Education is not responsible for the content of third-party internet sites.

The Financial Times. With a worldwide network of highly respected journalists, *The Financial Times* provides global business news, insightful opinion and expert analysis of business, finance and politics. With over 500 journalists reporting from 50 countries worldwide, our in-depth coverage of international news is objectively reported and analysed from an independent, global perspective. To find out more, visit www.ft.com/pearsonoffer.

ISBN: 978-1-292-13440-6 (Print)
978-1-292-13441-3 (PDF)
978-1-292-13443-7 (ePub)

British Library Cataloguing-in-Publication Data
A catalogue record for the print edition is available from the British Library

Library of Congress Cataloging-in-Publication Data
Names: McLaney, E. J., author.
Title: Business finance : theory and practice / Eddie McLaney.
Description: Eleventh Edition. | New York : Pearson, [2017] | Revised edition of the author's Business finance, 2014.
Identifiers: LCCN 2016053626| ISBN 9781292134406 (Print) | ISBN 9781292134413 (PDF) | ISBN 9781292134437 (ePub)
Subjects: LCSH: Business enterprises--Finance. | Business enterprises--Finance--Problems, exercises, etc. | Corporations--Finance. | Corporations--Finance--Problems, exercises, etc.
Classification: LCC HG4026 .M388 2017 | DDC 658.15--dc23
LC record available at https://lccn.loc.gov/2016053626

10 9 8 7 6 5 4 3 2 1
21 20 19 18 17

Print edition typeset in Palatino LT Pro 9.5/13 by SPi Global
Printed in Slovakia by Neografia

NOTE THAT ANY PAGE CROSS REFERENCES REFER TO THE PRINT EDITION

Contents

Preface xiii
Plan of the book xv
Publisher's acknowledgements xvi

Part 1 The business finance environment

1 Introduction 3

Objectives 3
1.1 The role of business finance 4
1.2 Risk and business finance 5
1.3 The relationship between business finance and accounting 6
1.4 The organisation of businesses – the limited company 6
1.5 Corporate governance and the role of directors 9
1.6 Long-term financing of companies 12
1.7 Liquidation 14
1.8 Derivatives 15
1.9 Private equity funds 16
Summary 17
Further reading 18
Review questions 18

2 A framework for financial decision making 19

Objectives 19
2.1 Financial decision making 19
2.2 Business objectives 21
2.3 Conflicts of interest: shareholders versus managers – the 'agency' problem 25
2.4 Financing, investment and separation 28
2.5 Behavioural finance 31
2.6 Theory and practice 32
Summary 32
Further reading 33
Review questions 33
Problem 33
Appendix: Formal derivation of the separation theorem 35

3 Financial (accounting) statements and their interpretation 41

Objectives 41
3.1 Introduction 41
3.2 The financial statements 42
3.3 Definitions and conventions of accounting 46
3.4 Problems with using accounting information for decision making 49
3.5 Creative accounting 50
3.6 Ratio analysis 53
3.7 Using accounting ratios to predict financial failure 65
Summary 66
Further reading 67
Review questions 67
Problems 68
Appendix: Jackson plc's income statement and statement of financial position for 2016 74

Part 2 Investment decisions

4 Investment appraisal methods 79

Objectives 79
4.1 Introduction 79
4.2 Net present value 80
4.3 Internal rate of return 87
4.4 Payback period 94
4.5 Accounting (or unadjusted) rate of return 97
4.6 Investment appraisal methods used in practice 99
Summary 104
Further reading 106
Review questions 106
Problems 106

5 Practical aspects of investment appraisal 111

Objectives 111
5.1 Introduction 111
5.2 Cash flows or accounting flows? 112
5.3 Do cash flows really occur at year-ends? 115
5.4 Which cash flows? 116
5.5 Taxation 117
5.6 Inflation 119
5.7 An example of an investment appraisal 121
5.8 Capital rationing 125

5.9 Replacement decisions 129
5.10 Routines for identifying, assessing, implementing and reviewing investment projects 131
5.11 Investment appraisal and strategic planning 134
5.12 Value-based management 136
5.13 Real options 142
Summary 143
Further reading 145
Review questions 146
Problems 146

6 Risk in investment appraisal 153

Objectives 153
6.1 Introduction 153
6.2 Sensitivity analysis 154
6.3 Use of probabilities 159
6.4 Expected value 162
6.5 Systematic and specific risk 165
6.6 Utility theory 166
6.7 Attitudes to risk and expected value 169
6.8 Particular risks associated with making investments overseas 174
6.9 Some evidence on risk analysis in practice 174
6.10 Risk – the story so far 174
Summary 175
Further reading 176
Review questions 177
Problems 177

7 Portfolio theory and its relevance to real investment decisions 183

Objectives 183
7.1 The relevance of security prices 183
7.2 The expected value/variance (or mean/variance) criterion 185
7.3 Security investment and risk 186
7.4 Portfolio theory 188
7.5 The capital asset pricing model 197
7.6 CAPM: an example of beta estimation 199
7.7 Assumptions of CAPM 202
7.8 Tests of CAPM 202
7.9 CAPM – why the doubts? 204
7.10 Implications of modern portfolio theory and CAPM 205
7.11 Lack of shareholder unanimity on risky investment 206
7.12 Using CAPM to derive discount rates for real investments – the practical problems 207

7.13 Arbitrage pricing model 209
7.14 Diversification within the business 210
Summary 210
Further reading 212
Review questions 212
Problems 212
Appendix: Derivation of CAPM 214

Part 3 Financing decisions

8 Sources of long-term finance 219

Objectives 219
8.1 Introduction 219
8.2 Ordinary (equity) capital 221
8.3 Methods of raising additional equity finance 225
8.4 Preference shares 235
8.5 Loan notes and debentures 237
8.6 Convertible loan notes 242
8.7 Warrants 242
8.8 Term loans 243
8.9 Asset-backed finance (securitisation) 243
8.10 Leasing 244
8.11 Grants from public funds 246
8.12 Islamic finance 247
8.13 Conclusions on long-term finance 247
Summary 248
Further reading 251
Review questions 251
Problems 252

9 The secondary capital market (the stock exchange) and its efficiency 253

Objectives 253
9.1 Introduction 253
9.2 The London Stock Exchange 254
9.3 Capital market efficiency 257
9.4 Tests of capital market efficiency 260
9.5 The efficient market paradox 268
9.6 Conclusions on, and implications of, capital market efficiency 268
9.7 Behavioural finance 271
Summary 273
Further reading 274
Review questions 275
Problems 275

10 Cost of capital estimations and the discount rate 276

Objectives 276
10.1 Introduction 276
10.2 Cost of individual capital elements 277
10.3 Weighted average cost of capital (WACC) 285
10.4 The discount rate – CAPM versus the traditional approach 290
10.5 WACC values used in practice 292
10.6 The use of WACC in practice 293
10.7 Further points on WACC 293
Summary 293
Further reading 295
Review questions 295
Problems 295

11 Gearing, the cost of capital and shareholders' wealth 298

Objectives 298
11.1 Introduction 298
11.2 Is debt finance as cheap as it seems? 299
11.3 Business risk and financial risk 300
11.4 The traditional view of gearing 302
11.5 The Modigliani and Miller view of gearing 304
11.6 Other thoughts on the tax advantage of debt financing 310
11.7 Capital/financial gearing and operating gearing 310
11.8 Other practical issues relating to capital gearing 311
11.9 Evidence on gearing 312
11.10 Gearing and the cost of capital – conclusion 314
11.11 The trade-off theory 316
11.12 Pecking order theory 317
11.13 Likely determinants of capital gearing 319
11.14 MM, modern portfolio theory and CAPM 319
11.15 Weighted average cost of capital revisited 321
Summary 322
Further reading 323
Review questions 324
Problems 324
Appendix I: Proof of the MM cost of capital proposition (pre-tax) 327
Appendix II: Proof of the MM cost of capital proposition (after tax) 328

12 The dividend decision 330

Objectives 330
12.1 Introduction 330
12.2 Modigliani and Miller on dividends 331
12.3 The traditional view on dividends 333

12.4 Who is right about dividends? 334
12.5 Other factors 335
12.6 Dividends: the evidence 338
12.7 Conclusions on dividends 344
Summary 344
Further reading 345
Review questions 346
Problems 346
Appendix: Proof of the MM dividend irrelevancy proposition 350

Part 4 Integrated decisions

13 Management of working capital 355

Objectives 355
13.1 Introduction 355
13.2 The dynamics of working capital 356
13.3 The importance of the management of working capital 360
13.4 Working capital and liquidity 362
13.5 Overtrading 364
13.6 Inventories (stock in trade) 365
13.7 Just-in-time inventories management 372
13.8 Trade receivables (trade debtors or accounts receivable) 374
13.9 Cash (including overdrafts and short-term deposits) 378
13.10 Trade payables (trade creditors) 384
13.11 Working capital levels in practice 386
Summary 386
Further reading 389
Review questions 389
Problems 389

14 Corporate restructuring (including takeovers and divestments) 392

Objectives 392
14.1 Introduction 392
14.2 Takeovers and mergers 393
14.3 Mergers: the practicalities 396
14.4 Divestments 405
Summary 408
Further reading 409
Review questions 409
Problems 410

15 International aspects of business finance 412

Objectives 412
15.1 Introduction 412
15.2 Foreign exchange 415
15.3 Problems of internationalisation 422
15.4 International investment appraisal 430
15.5 Risks of internationalisation, management of those risks and portfolio theory 431
Summary 434
Further reading 436
Review questions 436
Problems 437

16 Small businesses 438

Objectives 438
16.1 Introduction 438
16.2 Corporate objectives 441
16.3 Organisation of small businesses 441
16.4 Taxation of small businesses 442
16.5 Investment decisions 442
16.6 Risk and the discount rate 443
16.7 Sources of finance 444
16.8 Valuation of small businesses 448
16.9 Gearing 452
16.10 Dividends 452
16.11 Working capital and small businesses 452
Summary 453
Further reading 456
Review questions 456
Problems 457

Appendix 1 Present value table 463
Appendix 2 Annuity table 464
Appendix 3 Suggested answers to review questions 465
Appendix 4 Suggested answers to selected problems 478
Glossary 503
References 509
Index 516

Supporting resources

Visit **www.pearsoned.co.uk/mclaney** to find valuable online resources

Companion Website for students

- Multiple choice questions and missing word questions to test your understanding
- Additional problems and solutions to put your learning into practice
- Extensive links to valuable resources on the web
- An online glossary to explain key terms

For instructors

- Complete, downloadable Instructor's Manual
- PowerPoint slides
- Tutorial/seminar questions and solutions

For more information please contact your local Pearson Education sales representative or visit **www.pearsoned.co.uk/mclaney**

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 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 this topic 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 eleventh edition, the opportunity has been taken to make the book more readable and understandable. Most of the practical examples

have been updated and expanded. Where possible, examples of practice in particular real-life businesses are given. This should make the book more focused on the real business world. More recent research evidence has been included. Discussion of sources of finance for small businesses and been expanded and revised.

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 in business studies. It is also directed at postgraduate, post-experience students who are either following a university course or seeking a professional qualification. It should also prove useful to those studying for the professional examinations of the accounting bodies. It is also hoped that those who are interested in business finance for its own sake will find the book readable and helpful.

Eddie McLaney

Plan of the book

Part 1 The business finance environment

Chapter 1	Chapter 2	Chapter 3
Introduction	A framework for financial decision making	Financial (accounting) statements and their interpretation

Part 2 Investment decisions

Chapter 4	Chapter 5	Chapter 6	Chapter 7
Investment appraisal methods	Practical aspects of investment appraisal	Risk in investment appraisal	Portfolio theory and its relevance to real investment decisions

Part 3 Financing decisions

Chapter 8	Chapter 9	Chapter 10	Chapter 11	Chapter 12
Sources of long-term finance	The secondary capital market (the stock exchange) and its efficiency	Cost of capital estimations and the discount rate	Gearing, the cost of capital and shareholders' wealth	The dividend decision

Part 4 Integrated decisions

Chapter 13	Chapter 14	Chapter 15	Chapter 16
Management of working capital	Corporate restructuring (including takeovers and divestments)	International aspects of business finance	Small businesses
Appendices	Glossary	References	Index

Publisher's acknowledgements

We are grateful to the following for permission to reproduce copyright material:

Figures

Figure 16.1 after *Business demography 2014*, Office of National Statistics (2015), Office for National Statistics licensed under the Open Government Licence v.3.0; Figure 16.2 after *British Enterprise: Thriving or Surviving?*, Centre for Business Research, University of Cambridge (Cosh, A. and Hughes, A. 2007).

Tables

Table 1.1 from *Beneficial ownership of UK shares by value*, Office of National Statistics, 2 September 2015, Office for National Statistics licensed under the Open Government Licence v.3.0; Table 14.1 after National Statistics (2015), *Mergers and acquisitions involving UK companies*, 4th quarter 2015, Tables 8 and 9, Office for National Statistics licensed under the Open Government Licence v.3.0; Table 14.2 after National Statistics (2015), *Mergers and acquisitions involving UK companies*, 4th quarter 2015, Tables 6, 7 and 8, Office for National Statistics licensed under the Open Government Licence v.3.0.

Text

Extract on pages 429–30 from Associated British Foods plc 2015 Annual Report, http://www.abf.co.uk/documents/pdfs/2015/abf-annual-report%202015.pdf.

The business finance environment

Business finance is concerned with making decisions concerning 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 when people who are 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 (for example, annual or 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 for basing financial decisions on.

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

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 funds from various sources and to invest those funds. Usually, funds 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 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 that the business provides. 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; and
- 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.

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.

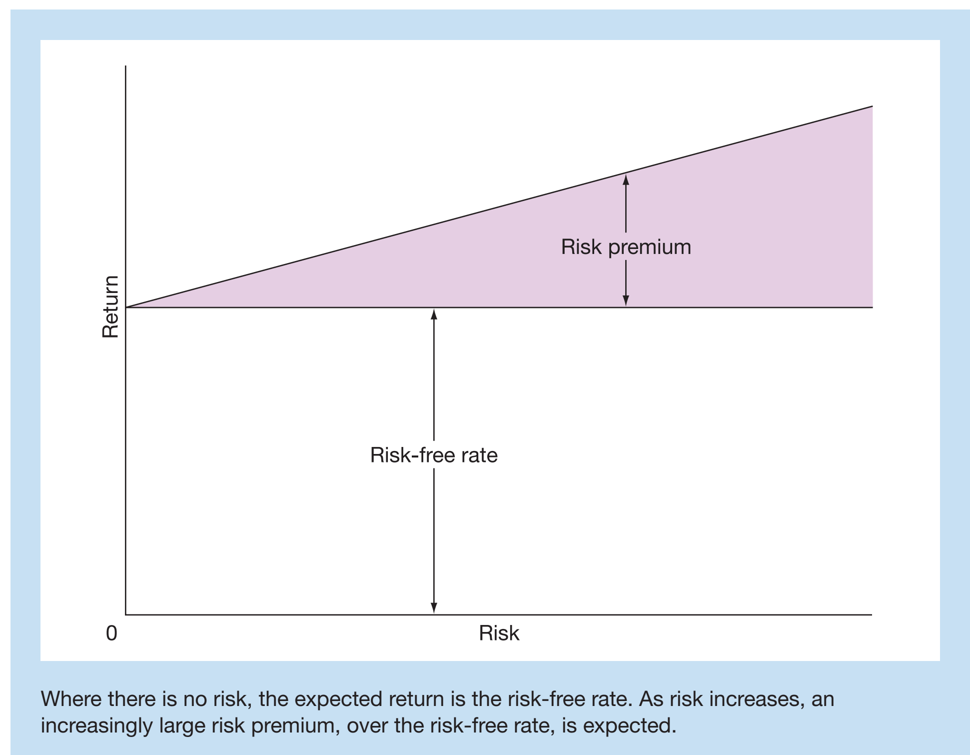

Figure 1.1 Relationship between risk and return

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.

In investment, 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 (straight-line) 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.

1.3 The relationship between business finance and accounting

Business finance and accounting are not the same thing. Accounting is concerned with financial record keeping, the production of periodic reports, statements and analyses. It is also concerned with the dissemination of information to managers and, to some extent, to investors and the world outside the business. It is also much involved with the quality, relevance and timeliness of its information output. Obviously, financial decision makers will rely heavily on accounting reports and the accounting database generally. Knowledge of past events may well be a good pointer to the future, so reliable information on the past is invaluable. However, the role of the financial manager is not to provide financial information but to make decisions involving finance.

In smaller businesses, with narrow portfolios of management skills, the accountant and the financial manager may well be the same person. In a large business, the roles are likely to be discharged by different people or groups of people. Not surprisingly, many financial managers are accountants by training and background, but many are not. With the increasing importance of business finance in the curricula of business schools and in higher education generally, the tendency is probably towards more specialist financial managers, with their own career structure.

1.4 The organisation of businesses – the limited company

This book is primarily focused on business finance as it affects businesses in the private sector of the UK economy. Most of our discussion will centre on larger businesses, that is, those that are 'listed' on the secondary capital market (for example, the London Stock Exchange (LSE)) and where there is fairly widespread ownership of the business among individual members of the public and the investing institutions (insurance companies, pension funds, unit trusts and so forth). 'Listed' means that the shares (portions of the ownership of the company) are eligible to be bought and sold through the stock market. We shall consider why businesses should want their shares to be 'listed' later in the chapter.

Towards the end of the book (in Chapter 16), we shall take a look at smaller, owner-managed businesses to see how the issues which we have discussed up to that point in the context of large businesses apply to this important sector of the economy.

Irrespective of whether we are considering large or small businesses, virtually all of them will be limited companies. There are businesses in the UK – indeed, many of them – that are not limited companies. Most of these, however, are very small (one- or two-person enterprises), or are highly specialised professional service providers such as solicitors and accountants. As at 31 August 2015 there were about 3.6 million active companies in the UK (source: www.companieshouse.gov.uk).

Since the limited company predominates in the UK private sector, we shall discuss business finance in this context. The principles of business finance that will emerge apply equally, however, irrespective of the precise legal status of the business concerned. The private sectors of virtually all of the countries in the world are dominated by businesses that are very similar in nature to UK limited companies.

We shall now briefly consider the legal and administrative environment in which limited companies operate. The objective here is by no means to provide a detailed

examination of the limited company; it is simply to outline its more significant features. More particularly, the aim is to explain in broad terms those aspects that impinge on business finance. Having a broad understanding of these aspects should make life easier for us in later chapters.

What is a limited company?

A limited company is an artificially created legal person. It is an entity that is legally separate from all other persons, including those who own and manage it. It is quite possible for a limited company to take legal action, say for breach of contract, against any other legal persons, including those who own and manage it. Actions between limited companies and their owners or managers do occur from time to time.

Obviously, an artificial person can only function through the intervention of human beings. Those who ultimately control the company are the owners who each hold one or more shares in the ownership (or equity) of it.

Limited liability

One of the results of the peculiar position of the company having its own separate legal identity is that the financial liability of the owners (shareholders) is limited to the amount that they have paid (or have pledged to pay) for their shares. If the company becomes insolvent (financial obligations exceed the value of assets), its liability is, like that of any human legal person, limited only by the amount of its assets. It can be forced to pay over all of its assets to try to meet its liabilities, but no more. Since the company and the owners are legally separate, owners cannot be compelled to introduce further finance. A well-known example of the effect of limited liability occurred in 2002 with the collapse of **ITV Digital plc**. This company was established as a joint venture by **Carlton** and **Granada**, two media businesses. ITV Digital failed as a result of the reluctance on the part of the public to subscribe for its broadcasts. When this happened, its shareholders, Carlton and Granada, were able to ignore the claims of those owed money by ITV Digital, principally the English Nationwide Football League clubs (members of the three divisions below the Premiership) with whom ITV Digital had a contract. This was because of the separate entity status of ITV Digital.

The position of a shareholder with regard to limited liability does not depend upon whether the shares were acquired by taking up an issue from the company or as a result of buying them from an existing shareholder.

Formation of a limited company

Creating a new company is a very simple operation, which can be carried out cheaply (costing about £100) and with little effort on the part of those wishing to form the company (the promoters).

Formation basically requires that the promoters make an application to a UK government official, the Registrar of Companies (Department for Business, Innovation and Skills). The application must be accompanied by several documents, the most important of which is a proposed set of rules or constitution for the company defining how it will be administered. These rules are contained in two documents known as the Memorandum of Association and the Articles of Association.

All of the documentation becomes public once the company has been formally registered. A file is opened at Companies House in Cardiff, on which are placed the various documents; the file is constantly available for examination by any member of the public who wishes to see it. It can be, and increasingly is, accessible online.

Recognition of companies

Limited companies are required to use the words (or abbreviations) 'Limited' (Ltd) or 'Public Limited Company' (plc) after their name in all formal documentation to warn those dealing with the company that its members' liability is limited.

'Limited' is used by private limited companies. These are basically the smaller, family-type companies, which have certain rights on the restriction of transfer of their shares. This is to say that holders of the majority of the shares in a private limited company have the power to stop minority shareholders from disposing of their shares in the company, should the majority choose to exercise that power. Public companies are typically the larger companies with more widespread share ownership. Of the 3.6 million UK limited companies, fewer than 7,000 are public ones – about one company in about 500 is a public one (source: www.companieshouse.gov.uk).

Transferability

As a separate legal entity, the company does not depend on the identity of its shareholders for its existence. Transfer of shares by buying and selling or by gift is therefore possible. Thus a part, even all, of the company's ownership or equity can change hands without it necessarily having any effect on the business activity of the company.

As we have seen, many companies arrange for their shares to be 'listed' on a recognised stock market (like the LSE, Wall Street of the Shanghai Stock Exchange). Listing means that the stock market concerned is willing to act as a marketplace that members of the investing public can use to buy or sell shares in the company concerned. Listing is beneficial to the company because it will find it easier to attract potential shareholders where they are confident that there is a market where they can dispose of their shares, as and when they wish.

Of the nearly 7,000 public limited companies in the UK, about 29 per cent are listed by the LSE (London Stock Exchange, 2016).

We shall consider the role of the LSE in more detail in Chapters 8 and 9.

Since it can continue irrespective of precisely who the shareholders happen to be at any given moment, the company can in theory have a perpetual lifespan, unlike its human counterparts.

Shareholders and directors

The shareholders (or members, as they are often known) are the owners of the company. Company profits and gains accrue to the shareholders and losses are borne by them, up to a maximum of the amount of their investment in the company. The shareholders, at any particular time, need not be the original shareholders, that is, those who first owned the shares. Transfers by sale or gift (including legacy on death) lead to shares changing hands.

For a variety of sound practical reasons, the shareholders delegate the day-to-day management of the company to the directors. The directors may or may not themselves

own some shares in the company. Shareholders elect directors in much the same way as citizens elect their representatives in a parliamentary democracy. They may also fail to re-elect them if the directors' performance is judged by shareholders to be unsatisfactory. Usually, one-third of the directors retire from office each year, frequently offering themselves for re-election. Typically, each shareholder has one vote for each share owned. Where a company has a large number of shareholders, a particular individual holding a large number of shares, even though well short of a majority of them, can wield tremendous power. The board of directors is the company's top level of management, therefore owning enough shares to control the board's composition is substantially to control the company.

In small companies, the shareholders may all be directors.

Accountability of directors

The law imposes a duty on directors to report annually, both to the shareholders and, to some extent, to the world at large, on the performance of the company's trading and on its financial position.

Each year, directors are required to prepare (or to have prepared on their behalf) a report for the shareholders. The minimum contents of the report are prescribed by International Financial Reporting (Accounting) Standards, which have the weight of UK law. In practice this minimum content is often exceeded. The report consists principally of an income statement (or profit and loss account), a statement of financial position (or balance sheet) and a statement of cash flows. These financial statements are subject to audit by an independent firm of accountants, whose main role is to express an opinion on the truth and fairness of the view shown by the financial statements. The auditors' expression of opinion is attached to the annual report.

A copy of the report (containing the financial statements) must be made available to each shareholder. A copy must also be sent to the Registrar of Companies for insertion in the company's file. This file must be available to be inspected by anyone wishing to do so. Virtually all major companies place a copy of their annual report on their website. In addition, large companies tend to send copies of the report to financial analysts and journalists. The annual report is a major, but not the only, source of information for interested parties, including existing and prospective shareholders, on the progress of the company. Companies whose shares are listed on the LSE are required by its rules to publish summarised financial statements each half-year (also usually available on the companies' websites). In practice, most large companies, from time to time, issue information over and above that which is contained in the annual and half-yearly reports.

The nature of the financial statements and how those statements can be interpreted are discussed in Chapter 3.

1.5 Corporate governance and the role of directors

In recent years, the issue of **corporate governance** has generated much debate. The term is used to describe the ways in which companies are directed and controlled. The issue of corporate governance is important because, with larger companies, those who own the company (that is, the shareholders) are usually divorced from the day-to-day control of the business. The shareholders employ the directors to manage the company