FINANCIAL MANAGEMENT
FOR DECISION MAKERS

NINTH EDITION

Peter Atrill

FINANCIAL MANAGEMENT

FOR DECISION MAKERS

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**

FINANCIAL MANAGEMENT FOR DECISION MAKERS

NINTH EDITION

Peter Atrill

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

PEARSON EDUCATION LIMITED
KAO Two
KAO Park
Harlow CM17 9SR
United Kingdom
Tel: +44 (0)1279 623623
Web: www.pearson.com/uk

First published 1997 (print)
Second edition published 2000 (print)
Third edition published 2003 (print)
Fourth edition published 2006 (print)
Fifth edition published 2009 (print)
Sixth edition published 2012 (print)
Seventh edition published 2014 (print and electronic)
Eighth edition published 2017 (print and electronic)
Ninth edition published 2020 (print and electronic)

© Peter Atrill 1997, 2012 (print)
© Peter Atrill 2014, 2017, 2020 (print and electronic)

The right of Peter Atrill 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/.

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

This publication contains copyright material of the IFRS® Foundation in respect of which all rights are reserved. Reproduced by Pearson Education Ltd with the permission of the IFRS Foundation. No permission granted to third parties to reproduce or distribute. For full access to IFRS Standards and the work of the IFRS Foundation please visit http://eifrs.ifrs.org

The International Accounting Standards Board®, the IFRS Foundation, the authors and the publishers do not accept responsibility for any loss caused by acting or refraining from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

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: 978-1-292-31143-2 (print)
978-1-292-31146-3 (PDF)
978-1-292-31145-6 (ePub)

British Library Cataloguing-in-Publication Data

Library of Congress Cataloging-in-Publication Data
Names: Atrill, Peter, author.
Title: Financial management for decision makers / Peter Atrill.
Description: Ninth edition. | Harlow, England ; New York : Pearson, 2020. | Includes bibliographical references and index. | Summary: "This book has been written for those wishing to achieve a broad understanding of financial management at either undergraduate or postgraduate/post-experience level. It is aimed primarily at students who are studying financial management as part of their course in business, management, accounting, economics, computing, or some other area. The book should also be suitable for those not engaged in formal study but, nevertheless, need to understand financial management to help manage their business"-- Provided by publisher.
Identifiers: LCCN 2019033692 | ISBN 9781292311432 (hardback) | ISBN 9781292311456 (epub)
Subjects: LCSH: Accounting. | Decision making.
Classification: LCC HF5636 .A8843 2020 | DDC 658.15--dc23
LC record available at https://lccn.loc.gov/2019033692

10 9 8 7 6 5 4 3 2 1
24 23 22 21 20

Front cover image: © Singora/Shutterstock

Print edition typeset in 9.25/13 pt Helvetica Neue LT W1G by SPi Global
Print edition printed and bound in Slovakia by Neografia

NOTE THAT ANY PAGE CROSS REFERENCES REFER TO THE PRINT EDITION

Contents

Preface	**xiii**
Publisher's acknowledgements	**xiv**

1 The world of financial management — 1

Introduction	1
Learning outcomes	1
The finance function	2
Structure of the book	4
Modern financial management	4
Why do businesses exist?	6
Balancing risk and return	14
Behaving ethically	16
Protecting shareholders' interests	18
Shareholder involvement	23
Summary	30
Key terms	32
References	32
Further reading	32
Critical review questions	32

2 Financial planning — 33

Introduction	33
Learning outcomes	33
Planning for the future	34
The role of projected financial statements	35
Preparing projected financial statements	36
The sales forecast	36
Preparing the projected statements: a worked example	37
Projected cash flow statement	38
Projected income statement	42
Projected statement of financial position (balance sheet)	44
Per-cent-of-sales method	47
Long-term cash flow projections	51
Projected financial statements and decision making	54
Taking account of risk	56
Financial planning and gearing	58
Financial gearing	58

Operating gearing 67
Combined gearing effect 73
Summary 77
Key terms 79
Further reading 79
Critical review questions 79
Exercises 80

3 Analysing and interpreting financial statements 89

Introduction 89
Learning outcomes 89
Financial ratios 90
Financial ratio classifications 90
The need for comparison 92
Calculating the ratios 94
A brief overview 95
Profitability 96
Efficiency 103
Relationship between profitability and efficiency 109
Liquidity 111
Financial gearing 113
Investment ratios 116
Financial ratios and the problem of overtrading 124
Key performance indicators 125
Trend analysis 126
Using ratios to predict financial failure 127
Limitations of ratio analysis 132
Summary 136
Key terms 137
References 138
Further reading 138
Critical review questions 138
Exercises 139

4 Making capital investment decisions 147

Introduction 147
Learning outcomes 147
The nature of investment decisions 148
Investment appraisal methods 150
Accounting rate of return (ARR) 151
Payback period (PP) 156
Net present value (NPV) 160
Why NPV is better 167
Internal rate of return (IRR) 168
Some practical points 173
The main methods summarised 177
Investment appraisal in practice 178

Investment appraisal and strategic planning 180
The investment appraisal process 181
Investment decisions and human behaviour 187
Summary 188
Key terms 189
References 190
Further reading 190
Critical review questions 190
Exercises 191

5 Making capital investment decisions: further issues 199

Introduction 199
Learning outcomes 199
Investment decisions when funds are limited 200
Comparing projects with unequal lives 205
The ability to delay 208
The problem of inflation 208
The problem of risk 210
Sensitivity analysis 211
Scenario analysis 219
Risk preferences of investors 220
Risk-adjusted discount rate 223
Expected net present value (ENPV) 225
Event tree diagrams 228
Risk and the standard deviation 232
The standard deviation and the normal distribution 236
The expected value–standard deviation rule 237
Simulations 237
Measuring probabilities 240
Portfolio effects and risk reduction 241
Summary 249
Key terms 251
Further reading 251
Critical review questions 252
Exercises 252

6 Financing a business 1: sources of finance 257

Introduction 257
Learning outcomes 257
Sources of finance 258
External sources of finance 258
External sources of long-term finance 259
Attitudes towards the level of borrowing 272
External sources of short-term finance 282
Long-term versus short-term borrowing 287
Internal sources of finance 288
Internal sources of long-term finance 289

Internal sources of short-term finance 290
Summary 296
Key terms 297
Further reading 298
Critical review questions 298
Exercises 299

7 Financing a business 2: raising long-term finance 305

Introduction 305
Learning outcomes 305
The Stock Exchange 306
Stock market efficiency 311
Are the stock markets really efficient? 316
Share issues 322
Long-term finance for the smaller business 330
Business angels 337
Government assistance 339
The Alternative Investment Market (AIM) 340
Summary 346
Key terms 347
References 347
Further reading 348
Critical review questions 348
Exercises 348

8 The cost of capital and the capital structure decision 353

Introduction 353
Learning outcomes 353
Cost of capital 354
Weighted average cost of capital (WACC) 371
Specific or average cost of capital? 375
Limitations of the WACC approach 376
Cost of capital – some evidence 377
The capital structure debate 378
Gearing and signalling 388
Summary 390
Key terms 391
References 392
Further reading 392
Critical review questions 392
Exercises 393

9 Making distributions to shareholders 399

Introduction 399
Learning outcomes 399

Paying dividends 400
Dividend distributions in practice 402
Dividend policy and shareholder wealth 404
The importance of dividends 410
Factors determining the level of dividends 416
Dividend policy and management attitudes: some evidence 420
Dividend smoothing in practice 422
What should managers do? 423
Alternatives to cash dividends 424

Summary 434
Key terms 436
References 436
Further reading 436
Critical review questions 437
Exercises 437

10 Managing working capital 441

Introduction 441
Learning outcomes 441
What is working capital? 442
The scale of working capital 443
Managing inventories 446
Inventories management models 453
Managing trade receivables 460
Managing cash 471
Managing trade payables 478

Summary 482
Key terms 484
Further reading 484
Critical review questions 484
Exercises 485

11 Measuring and managing for shareholder value 491

Introduction 491
Learning outcomes 491
The quest for shareholder value 492
Creating shareholder value 492
The need for new forms of measurement 493
Net present value (NPV) analysis 495
Managing the business with shareholder value analysis 502
Implications of SVA 503
Economic value added (EVA®) 504
EVA®-based ratios 508
EVA® in practice 509
EVA® and SVA compared 511
EVA® or SVA? 512

Market value added (MVA) 514
The link between MVA and EVA® 517
Limitations of MVA 518
Total shareholder return (TSR) 518
Criticisms of the shareholder value approach 522
Measuring the value of future growth 523
Shareholder value and directors' rewards 524
Summary 532
Key terms 534
References 534
Further reading 534
Critical review questions 535
Exercises 535

12 Business mergers and share valuation 539

Introduction 539
Learning outcomes 539
Mergers and takeovers 540
Merger and takeover activity 540
The rationale for mergers 541
Wealth-enhancing motives for mergers 542
Other motives for mergers 546
Forms of purchase consideration 548
Merger synergies – a case study 551
Mergers and financial outcomes 552
Who benefits? 555
The merger puzzle 558
Ingredients for successful mergers 559
Rejecting a takeover bid 559
Due diligence 563
Protecting shareholders and the public 564
Mergers and conglomerates 564
Restructuring a business: divestments and demergers 565
The valuation of shares 569
Summary 585
Key terms 587
References 587
Further reading 588
Critical review questions 588
Exercises 588

13 International aspects of financial management 597

Introduction 597
Learning outcomes 597
The internationalisation of business 598
Internationalisation and risk reduction 599

Internationalisation and shareholders' wealth 599
Foreign exchange 600
A theoretical explanation of relative exchange rates 603
Foreign exchange markets and market efficiency 604
Problems of internationalisation 605
Dealing with transaction risk 606
Economic risk 615
Translation risk 618
International investment appraisal 620
International investment at the portfolio level 623
International investment and agency cost 623
Summary 624
Key terms 627
References 627
Further reading 627
Critical review questions 627
Exercises 628

Appendix A Present value table 631
Appendix B Annual equivalent factor table 633
Appendix C Solutions to self-assessment questions 635
Appendix D Solutions to critical review questions 649
Appendix E Solutions to selected exercises 659

Glossary of key terms 685
Index 695

Companion Website

For open-access **student resources** specifically written to complement this textbook and support your learning, please visit **www.pearsoned.co.uk/atrill**

Lecturer Resources

For password-protected online resources tailored to support the use of this textbook in teaching, please visit **www.pearsoned.co.uk/atrill**

Preface

This book has been written for those wishing to achieve a broad understanding of financial management at either undergraduate or postgraduate/post-experience level. It is aimed primarily at students who are studying financial management as part of their course in business, management, accounting, economics, computing, or some other area. The book should also be suitable for those not engaged in formal study but, nevertheless, need to understand financial management to help manage their business.

As there are several excellent books on financial management already published, it is reasonable to ask why another book is needed in this area. Many of the available books are too detailed and demanding to provide a suitable introduction to the subject. They are often around a thousand pages in length and contain mathematical formulae that many find daunting. This book assumes no previous knowledge of financial management (although a basic understanding of financial statements is required) and every attempt has been made to make the writing as accessible as possible. Each topic is introduced carefully and there is a gradual building of knowledge. In addition, mathematical formulae have been kept to a minimum.

The book rests on a solid foundation of theory but the main focus throughout is its practical value. It is assumed that readers are primarily concerned with understanding financial management in order to make better financial decisions. The title of the book reflects this decision-making focus.

The book is written in an 'open learning' style. That is, it tries to involve the reader in a way not traditionally found in textbooks. Throughout each chapter there are activities and self-assessment questions to attempt. The purpose of these is to help check understanding of the points being made and to encourage the reader to think around particular topics. The open learning style has been adopted because, I believe, it is more 'user friendly'. Irrespective of whether the book is being used as part of a taught course or for independent study, the interactive approach employed makes it easier to learn.

As it is likely that most readers will not have studied financial management before, the use of technical jargon has been kept to a minimum. Where technical terminology is unavoidable, I try to provide clear explanations. As a further aid, all key terms are highlighted in the book and then listed at the end of each chapter with a page reference to enable rapid revision of the main concepts. All key terms are listed alphabetically with a short definition in the glossary, which can be found towards the end of the book.

In writing the ninth edition, I have taken account of helpful comments and suggestions made by lecturers, students and other readers. To improve clarity, I have rewritten some sections and have added further diagrams. To improve coverage, I have expanded certain topics including share valuation and behavioural finance, and have added a completely new chapter dealing with the international aspects of financial management. This new chapter, which was co-written with my colleague Eddie McLaney, covers topics such as foreign exchange markets, foreign investments and exchange rate risk. I have also introduced additional activities throughout to enhance the interactive nature of the text. Finally, to help deepen understanding, I have replaced some of the review questions and end-of-chapter exercises with others that are a little more challenging.

I do hope that you will find the book both readable and helpful.

Peter Atrill
April 2019

Publisher's acknowledgements

Text

5 Elroy Dimson: Dimson, E. (1995) *Assessing the Rate of Return*, Financial Times Mastering Management series, supplement issue no. 1, p. 13. © Professor E. Dimson 1995, reproduced with permission of the author. All rights reserved; **10–11 Retail Gazette:** Sabharwal, V. (2016) 'Sports Direct falls out of FTSE 100', www.retailgazette.co.uk, 2 March; **11 Ferguson plc:** Ferguson plc, Annual Report and Accounts 2018, p.13; **11 Permanent TSB Group Holdings plc:** Permanent TSB Group Holdings plc, www.permanenttsbgroup.com, accessed 26 November 2018; **11 Imperial Minerals plc:** Imperial Minerals plc, *Corporate Governance*, www.imperialminerals.com, accessed 26 November 2018; **11 DiamondCorp Plc:** Diamond Corporation plc, www.diamondcorpplc.uk, accessed 26 November 2018; **11 Just Group plc:** The chairman of Just Group plc, a financial services group; **14 The Financial Times Ltd:** Kay, J. (2012) Forget how the crow flies, *Financial Times*, 17 January, p. 21. © The Financial Times Limited 2019. All Rights Reserved; **16 The Financial Times Ltd:** Rose, H. (1995) *Tasks of the Finance Function*, Financial Times Mastering Management Series, supplement issue no. 1, p. 11. © The Financial Times Limited 2019. All Rights Reserved; **17 Sage Group:** *Code of Ethics*, Sage Group plc, www.sage.com, accessed 26 November 2018. **17–18 John Wiley & Sons:** Carvalho, A. and Areal, N. (2016) 'Great Places to Work®: resilience in times of crisis', *Human Resource Management*, vol. 55, no. 3, pp. 479–98; **18 Vodafone plc:** *Code of Ethics*, Vodafone plc, accessed 13 February 2019 www.vodafone.com; **23–24 Crown copyright:** *Ownership of UK Quoted Shares 2016*, Table 4, Office for National Statistics, 29 November 2017. Office for National Statistics licensed under the Open Government Licence v3.0; **26 The Financial Times Ltd:** Extract from Mooney, A. (2018) Shareholder rebellions over high pay double in a year, ft.com, 29 August. © The Financial Times Limited 2019. All Rights Reserved; **28–29 FIL Limited:** Extract from (2018) *Responsible Investment Policy Fidelity International*, February, p. 4; **29 Terry Smith:** Smith, T. (2015) 'Shareholder value is an outcome not an objective', *Financial Times*, 6 February. © Terry Smith 2015, reproduced with permission of the author. All rights reserved; **30 McKinsey & Company:** Joseph Cyriac, Ruth De Backer, and Justin Sanders, *Preparing for bigger, bolder shareholder activists*, March 2014, p.1, McKinsey & Company; **35 Trinity Mirror plc:** *Adapted from Audit and Risk Committee Report*, Trinity Mirror plc, Annual Report 2017, p. 44; **42 The Financial Times Ltd:** Johnson, L. (2013) The most dangerous unforced errors, ft.com, 9 July. © The Financial Times Limited 2019. All Rights Reserved; **55 Parker Scott:** KPMG (2016) Forecasting with confidence, KPMG, p. 41; **56–57 Kindred Group plc:** Kindred Group plc, www.kindredgroup.com/investors, accessed 16 November 2018; **57–58 Next plc:** Adapted from Next plc, Annual Report and Accounts, January 2018, pp. 33–34; **62 The Financial Times Ltd:** Thorpe, D. (2018) Gearing helps Schroders Income Growth trust outperform, ftadvisor.com, 9 November 2018. © The Financial Times Limited 2019. All Rights Reserved; **67 Warren E. Buffet:** Adapted from Buffet, W. (2011) Shareholders Letter, Berkshire Hathaway Inc., www.berkshirehathaway.com,

26 February, p. 22; **99 European Commission:** Figures taken from Eurostat database, Gross return on capital employed, before taxes, of non-financial corporations, http://ec.europa.eu/eurostat/tgm/ July 2019; **102–103 Nextplc.co.uk:** Next plc, Results for the year ended January 2018, p. 7, www.nextplc.co.uk; **106–107 The Financial Times Ltd:** Ralph, O. (2018) Longer customer payment terms spark corporate fears, ft.com, 2 May. © The Financial Times Limited 2019. All Rights Reserved; **110 Pearson Education:** From Accounting and Finance for Non-specialists, 7th edn., FT/Prentice Hall (Atrill P. and Mclaney E. 2010) p. 206, © Pearson Education Ltd, reproduced with permission; **115 CSIMarket, Inc:** Diagram compiled from information in CSIMarket.com. Interest coverage screening https://csimarket.com/screening/ accessed 13 December 2018; **117 The Financial Times Ltd:** Extracts from Beioley, K. (2018) UK dividends look unsustainable, investors warned, ft.com, 13 April. © The Financial Times Limited 2019. All Rights Reserved; **118–119 Terry Smith:** Smith, T. (2014) 'How investors ignored the warning signs at Tesco', ft.com, 5 September. © Terry Smith 2014. Reproduced by permission of the author. All Rights Reserved; **121–122 The Financial Times Ltd:** Based on information extracted from Financial Times, 7 March 2019, p. 24. © The Financial Times Limited 2019. All Rights Reserved; **125–126 easyJet plc:** easyJet Annual Report and Accounts 2018, p. 21; **134 Aurum Press Ltd:** Extract from Aris, S., (1998) *Arnold Weinstock and the Making of GEC*, Aurum Press, published in *The Sunday Times*, 22 February 1998, p. 3; **148 L.E.K. Consulting:** Adapted from: 'Biotech Economics and Valuation' Massachusetts Biotechnology Council and L.E.K. Consulting, August 2009, p. 3. Reprinted with permission from L.E.K. Consulting. L.E.K. Consulting is a registered trademark of L.E.K. Consulting, LLC. All other products and brands mentioned in this document are properties of their respective owners. © 2016 L.E.K. Consulting, LLC. All rights reserved; **156 Penguin Books:** G. Gigerenzer *Reckoning with Risk*, Penguin, 2002; **160 Associated British Foods plc:** Associated British Foods plc, 2018 Annual Report, p. 26; **168 The Financial Times Ltd:** Extract from Raval, A. and Crooks, E. (2018) BP bet big on shale for its US comeback, ft.com, 16 August. © The Financial Times Limited 2019. All Rights Reserved; **180 The Financial Times Ltd:** Extract from Platt, E., Fontanella-Khan, J. and Garrahan, M. (2018) Disney ups the ante in Fox fight with new $71.3bn offer, ft.com, 20 June. © The Financial Times Limited 2019. All Rights Reserved; **186 CIMA:** Adapted from figure in 'Management accounting tools for today and tomorrow', CIMA, July 2009, p.18; **202 Independent Project Analysis, Inc:** N. Nandurdikar *Is Bigger Always Better? An Examination of the Relationship Between Reservoir Size and Profitability Index in Deepwater*, Independent project Analysis, www.ipaglobal.com, 20 August 2015; **204 Indiana University of Pennsylvania:** Cohen, G. and Yagil, J. (2007) 'A multinational survey of corporate financial policies', *Journal of Applied Finance*, vol. 17(1); **219–220 Iamgold Corporation:** Based on information *in Feasibility Study for Côté Gold Yields Significantly Improved Project Economics* (2018). http://www.iamgold.com, 1 November; **240 The Financial Times Ltd:** Kay, J. (2013) A story can be more useful than maths, *Financial Times*, 26 February. © The Financial Times Limited 2019. All Rights Reserved; **244 The Financial Times Ltd:** Extract from Arnold, M. (2017) *Rothschild's diversification strategy starts to pay off Franco-British investment bank's revenues grew 11% to €1.8bn in year to March*, ft.com. 14 June. © The Financial Times Limited 2019. All Rights Reserved; **246–247 Multinational Finance Society:** Kent Baker, H., Dutta, S. and Saadi, S. (2011) 'Corporate finance practices in Canada: where do we stand?' *Multinational Finance Journal*, vol. 15, pp 157–92; **261 Rentokil Initial plc:** www.rentokil-initial.com, accessed 5 February 2019; **263 Berkshire Hathaway Inc:** Buffett, W. (2011) Shareholder letter, Berkshire Hathaway Inc, www.berkshirehathaway.com, 26 February, p. 22; **265 ITV plc:** Investors, ITV plc, www.itvplc.com, accessed 7 February 2019; **266–267 The Financial Times Ltd:** Scraggs, A. (2018) Convertible bonds surge highlights late stage of credit

cycle, ft.com, 8 June. © The Financial Times Limited 2019. All Rights Reserved; **267–268 Standard & Poor's Financial Services LLC:** Table adapted from Standard & Poor's Ratings Definitions, www.standardandpoors.com, 20 November 2014; **269 Ryanair Holdings plc:** Ryanair Holdings plc, Annual Report 2018, www.ryanair.com, pp.163–4; **270 South West Water Ltd:** South West Water Ltd, Annual Report and Financial Statements 2018 note 19, p. 132; **274–275 The Financial Times Ltd:** Murphy, H. (2018) Debt at UK listed companies soars to record high, ft.com, 2 July. © The Financial Times Limited 2019. All Rights Reserved; **276 Finance & Leasing Association:** Annual Review 2018, The Finance and Leasing Association, www.fla.org.uk, p. 14; **278 easyJet plc:** Adapted from easyJet plc, Annual Report and Accounts 2018, p. 19; **279 The Financial Times Ltd:** Extracts from Morris, S. and Evans, J. (2018) Goldman agrees sale and leaseback of new London HQ, ft.com, 22 August. © The Financial Times Limited 2019. All Rights Reserved; **280 Stagecoach Group plc:** Stagecoach Group plc, Annual Report 2018, note 13, p. 102; **286 ABFA:** Chart constructed from data published by the Asset Based Finance Association, 2013–2017, www.abfa.org.uk; **292–293 The Financial Times Ltd:** Bounds, A. (2018) UK small businesses face average £9,000 bill to recover late payments, ft.com, 10 December. © The Financial Times Limited 2019. All Rights Reserved; **306 HarperCollins:** Graham, B. (2003) *The Intelligent Investor*, Harper Business, p.141; **306 Warren E. Buffet:** Warren Buffett quoted in www.investorwords.com, accessed 15 February 2019. **310 The Financial Times Ltd:** Extracts from Hodgson, C. and Evans, J. (2018) Intu share price soars on report of being taken private, ft.com, 5 October. © The Financial Times Limited 2019. All Rights Reserved; **316 Michael Jensen:** Professor Michael Jensen, 1978; **317–318 The Financial Times Ltd:** Tett, G. (2018) Extracts from Listed companies are less short-termist than previously thought, ft.com, 4 October. © The Financial Times Limited 2019. All Rights Reserved; **321 The Financial Times Ltd:** Extracts from Thorpe, D. (2018) Woodford predicts stock market bubble will burst this year, FT Advisor, 2 January. © The Financial Times Limited 2019. All Rights Reserved; **325 The Financial Times Ltd:** Extracts from Morris, S. and Hodgson, C. (2018) Kier's emergency rights issue taken up by only 38% of shareholders, ft.com, 20 December. © The Financial Times Limited 2019. All Rights Reserved; **329 The Financial Times Ltd:** Extracts from Megaw, N. and Jenkins, P. (2019) *Metro Bank raises more than expected in discounted share placement* ft.com, 16 May. © The Financial Times Limited 2019. All Rights Reserved; **330 London Stock Exchange plc:** Based on figures in Table 3 of Main Market Statistics covering the six-year period ending 31 December 2017, London Stock Exchange, www.londonstockexchange.com; **333 British Private Equity & Venture Capital Association:** (2018) Report on investment activity 2017, British Private Equity and Venture Capital Association, www.bvca.co.uk, p. 8; **340 London Stock Exchange Group plc:** Adapted from information on London Stock Exchange website, www.londonstockexchange.com; **342–343 The Financial Times Ltd:** Barrett, C. (2015) AIM – 20 years of a few winners and many losers, *Financial Times/ft.com*, 19 June. © The Financial Times 2019. All Rights Reserved; **344 British Business Bank Plc:** British Business Bank 2017/18 (2018), 'Small business finance markets (February)', Figure B.16, p. 25; **361 Credit Suisse Group Ag:** Dimson, E., Marsh, P. and Staunton, M. (2018) *Credit Suisse Global Investment Returns Yearbook 2018*, Figure 3, p. 35. Credit Suisse Research Institute; **363 Reuters:** Compiled from information taken from www.reuters.com, accessed 3 February 2016; **376 Aswath Damodaran:** Extracts from table in Damodaran A. *Useful Data Sets Costs of Equity and Capital,* www.stern.nyu.edu accessed 12 January 2019; **382 Merton Miller:** Merton Miller; **388 Pennon Group Plc:** Extracts from Pennon Group plc Annual Report and Accounts 2018, p. 112; **401 Halma plc:** Extracts from Financial calendar, Halma plc, www.halma.com accessed 21 January 2019; **402 Aswath Damodaran:** Chart compiled from data in Damodaran, A. *Useful Data Sets*, http://www.stern.

nyu.edu, accessed 23 January 2019; **403 Deutsche Bank AG:** Servaes, H. and Tufano, P. (2006) ‘The theory and practice of corporate dividend and share repurchase policy’, Deutsche Bank AG and Global Association of Risk Professionals, February, p. 26; **409–410 Warren E. Buffet:** Buffett, W. (2013) Shareholders Letter, Berkshire Hathaway Inc., www.berkshirehathaway.com, 1 March, pp. 19–21; **414 Telegraph Media Group:** Extracts from Armstrong, A. (2017) Tesco to signal comeback with return to dividend, *Daily Telegraph*, 30 September; **416 ASOS plc:** Asos plc, Annual Report and Accounts 2018, p. 23; **418 The Financial Times Ltd:** Extracts from Buck, T. (2017) Uniper offers investors cash to fend off hostile takeover, ft.com, 7 December. © The Financial Times Limited 2019. All Rights Reserved; **421 Springer:** Chart compiled from Baker, H., Powell, G. and Theodor Veit, E. (2002), ‘Revisiting managerial perspectives on dividend policy’, *Journal of Economics and Finance*, vol. 26, no. 3, pp. 267–83; **424–426 The Financial Times Ltd:** Murphy, H. (2018) Scrip payments save European groups £55bn over 3 years, ft.com. 30 April. © The Financial Times Limited 2019. All Rights Reserved; **429–430 Berkshire Hathaway Inc:** Buffett, W. (2016) Shareholders Letter, Berkshire Hathaway Inc., www.berkshirehathaway.com, p.7. www.berkshirehathaway.com/; **433 The Financial Times Ltd:** Adapted from Palladino L. and Edmans A. (2018) Should the US rein in buybacks’, ft.com, 9 December. © The Financial Times Limited 2019. All Rights Reserved; **445–446 PWC:** Compiled from information in Navigating uncertainty: PwC’s annual global working capital study, 2018/19 www.pwc.com. **449–451 The Financial Times Ltd:** Romei, V., Rovnik, N. and Bounds, A. (2019) UK manufactures stockpile goods at fastest pace in 27 years, ft.com, 1 February. © The Financial Times Limited 2019. All Rights Reserved; **464 My Credit Controllers:** Extracts from Elmes, S. (2018) Payment practices of large companies, www.mycreditcontrollers.co.uk 12 March; **468 Sky Plc:** Sky plc (2018) Annual report, p. 102; **470 Satago Ltd:** Renwick, S. (2014) ‘Top 7 late payment excuses’, www.satago.com, 17 July; **471 Berkshire Hathaway Inc:** Buffet, W. (2018) Shareholders Letter, Berkshire Hathaway Inc, www.berkshirehathaway.com/ p. 6; **477–478 PWC:** Compiled from information in PwC Navigating Uncertainty: Working Capital Study 2018/19, www.wpc.com. p.17; **508 Stock Analysis on Net:** Adapted from Stock Analysis on Net, www.stock-analysis-on.net, accessed 26 January 2019; **510 Association of International Certified Professional Accountants:** Adapted from figure in ‘Management accounting tools for today and tomorrow’, CIMA, 2009, p. 20; **510–511 John Wiley & Sons:** Adapted from Ehrbar, A. (1998) *EVA: The Real Key to Creating Wealth*, John Wiley & Sons; **513 Halma plc:** Halma plc, Annual Report and Accounts 2018, p. 99; **516–517 Stock Analysis on Net:** www.stock-analysis-on.net/ accessed 29 January 2019; **522–523 McKinsey & Company:** Extract from Goedhart, M., Koller, T. and Wessels, D. (2015) ‘The real business of business’, *McKinsey Quarterly*, March; **526, 529 KPMG AG:** *KPMG’s Guide to Directors Remuneration 2017*, KPMG LLP www.kpmg.com p. 24 and 25. By permission of KMPG LLP; **528 KPMG AG:** Figure compiled from information in KPMG (2018) *Guide to Directors’ Remuneration 2017*, p. 59; **535 Stagecoach Group plc:** Stagecoach Group plc, Group Income Statement, Annual Report 2018, www.stagecoach.com.p.76; **541 Crown copyright:** Mergers and acquisitions involving UK companies, Quarter 3, Summary of Acquisitions and Mergers in the UK by other UK companies, Table 8, Office for National Statistics, www.ons.gov.uk, 4 December 2018; **543–544 Proactive Investors:** Adapted from ‘Statement of Merger Benefits’, Greencore plc, www.proactiveinvestors.co.uk, 24 January 2011; **545 The Linde Group:** Based on information in Linde and Praxair Sign Business Combination Agreement to Become a Leading Industrial Gas Company, 1 June 2017.www.lindepraxairmerger.com; **548 Berkshire Hathaway Inc:** Buffett, W. (1981) Shareholders Letter, Berkshire Hathaway Inc., www.berkshirehathaway.com; **549–550 Berkshire Hathaway Inc:** Adapted from W. Buffett (2010) Shareholders Letter, Berkshire Hathaway Inc., www.berkshirehathaway.com, 26 February, p. 16; **558 The Financial Times Ltd:** Extract from

Fontanella-Khan, J. (2018) Goldman Sachs tops $100m fees in fees from Fox-Disney deal, ft.com,27 June. © The Financial Times Limited 2019. All Rights Reserved; **558–559 Berkshire Hathaway Inc:** Buffett, W. (1981), Shareholders Letter, Berkshire Hathaway Inc. www.berkshirehathaway.com; **561–562 The Financial Times Ltd:** Adapted from Daneshkho, S. and Barber, L. (2017) Paul Polman: how I fended off a hostile takeover bid, ft.com, 3 December. © The Financial Times Limited 2019. All Rights Reserved; **562 John Wiley & Sons:** Gaughan, P. (2002) *Mergers, Acquisitions, and Corporate Restructurings*, 3rd edition John Wiley & Sons Inc. p. 27; **565 Berkshire Hathaway Inc:** Buffett, W. (2014) Shareholders Letter, Berkshire Hathaway Inc., www.berkshirehathaway.com, p. 30; **566 The Financial Times Ltd:** Adapted from (2018) Divestment of Swiftbrook in Packaging Division, Company announcements, ft.com, 31 July 2018. © The Financial Times Limited 2019. All Rights Reserved; **568 The Financial Times Ltd:** Extract from Jackson, T (2011) Logic of corporate shrinkage asserts itself, *Financial Times*, 4 September © The Financial Times Limited 2019. All Rights Reserved. **581–582 Swiss Finance Institute:** (2016) Mukhlynina L. and Nyborg K. *The Choice of Valuation Techniques in Practice: Education versus Profession,* Swiss Finance Institute Research Paper Series, 16–36; **582–583 John Wiley & Sons:** Goedhart, M., Koller, T. and Wessels, D. (2015) *Valuation: Measuring and Managing the Value of Companies*, 6th edition John Wiley & Sons Inc; **584 CFA Institute:** Adapted from Fabozzi .F, Focardi S. and Jonas C. (2017) *Equity Valuation: Science, Art or Craft?* CFA Institute Research Foundation, p.14; **599 Eddie McLaney:** Fig 15.1 from McLaney: *Business Finance* 11th edition Pearson Education, reprinted with permission from Eddie McLaney; **605 HSBC Bank:** Information contained in: Risk management survey (2018), HSBC. www.gbm.hsbc.com; **615 ASOS plc:** Extract from Asos plc, 2018 Annual Report, p. 113; **619 Associated British Foods plc:** Extract from Associated British Foods plc, 2018 Annual Report, p. 148; **621 Tesco PLC:** Extract from Tesco plc, 2018 Annual Report, p. 24; **622 Eddie McLaney:** Fig 15.2 from McLaney: Business Finance 11th edn, Pearson Education, reprinted with permission from Eddie McLaney.

Chapter 1

THE WORLD OF FINANCIAL MANAGEMENT

INTRODUCTION

In this first chapter, we shall look at the role of the finance function within a business and the context within which financial decisions are made. This should help to set the scene for subsequent chapters. We begin by identifying the tasks of the finance function and how they relate to the tasks of managers. We then go on to consider the objectives that a business may pursue.

Modern financial management theory assumes that the primary objective of a business is to maximise the wealth of its shareholders. We shall examine this and other possible objectives for a business to understand why shareholder wealth maximisation is considered the most appropriate. There is always a danger, however, that businesses will adopt too narrow a focus in pursuit of this objective. We shall see that, for a business to survive and prosper over the long term, it must be pursued in a way that takes account of the surrounding environment. This requires managers to behave in an ethical manner and to be sensitive to the interests of the various groups that have a stake in the business.

Simply stating that a business's primary objective is shareholder wealth maximisation will not automatically cause this to happen. There is always a risk that managers will pursue their own interests at the expense of shareholders' interests. This is often referred to as the *agency problem*. We end the chapter by considering how this problem may be managed through regulation and through the active involvement of shareholders.

Learning outcomes

When you have completed this chapter, you should be able to:

- Discuss the role of the finance function within a business.
- Identify and discuss possible objectives for a business and explain the advantages of the shareholder wealth maximisation objective.
- Explain how risk, ethical considerations and the needs of other stakeholders influence the pursuit of shareholder wealth maximisation.
- Describe the agency problem and explain how it may be managed.

THE FINANCE FUNCTION

Put simply, the finance function within a business exists to help managers to manage. To understand how the finance function can achieve this, we must first be clear about what managers do. One way of describing the role of managers is to classify their activities into the following categories:

- *Strategic management.* This involves developing aims and objectives for a business and then formulating a strategy (long-term plan) to achieve them. Deciding on an appropriate strategy will involve identifying and evaluating the various options available. The option chosen should be the one that offers the greatest potential for achieving the aims and objectives developed.
- *Operations management.* To ensure that things go according to plan, managers must exert day-to-day control over the various business functions. Where events do not conform to earlier plans, appropriate decisions and actions must be taken.
- *Risk management.* The risks faced by a business must be identified and properly managed. These risks, which are many and varied, arise from the nature of business operations and from the way in which the business is financed.

As we can see from Figure 1.1, these three management activities are not separate and distinct. They are interrelated, and overlaps arise between them. When considering a particular strategy, for example, managers must also make a careful assessment of the risks involved and how these risks may be managed. Similarly, when making operational decisions, managers must try to ensure they fit within the strategic (long-term) plan that has been formulated.

The figure shows the three overlapping roles of management.

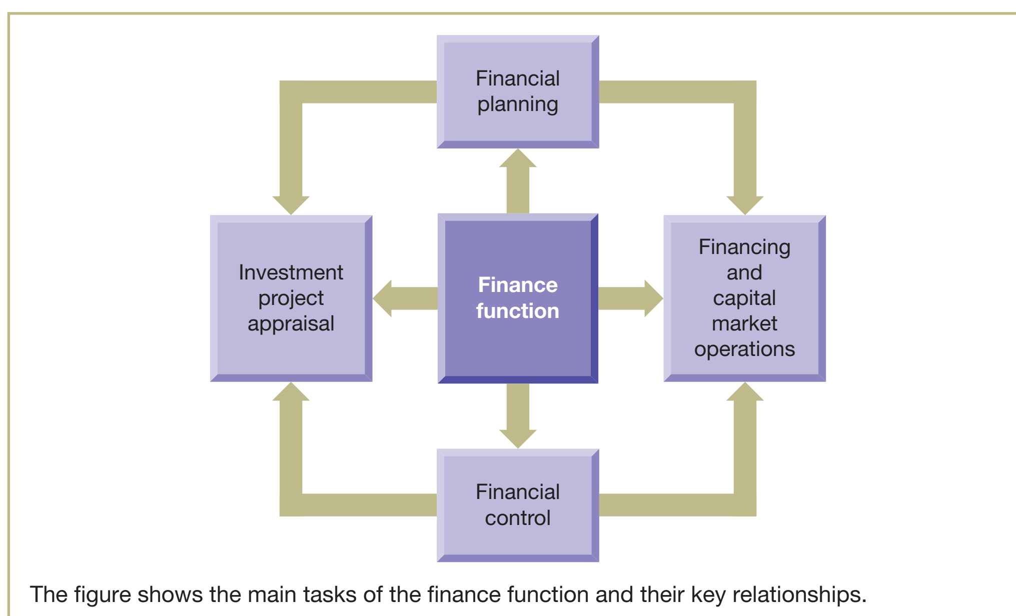
Figure 1.1 The role of managers

The finance function is concerned with helping managers in each of the three areas identified. This is achieved by undertaking various key tasks, which are set out in Figure 1.2 and described below.

- *Financial planning.* It is vital for managers to assess the potential impact of proposals on future financial performance and position. They can more readily evaluate the implications of their decisions if they are provided with estimates of financial outcomes. These can often take the form of projected financial statements, such as projected cash flow statements and projected income statements.
- *Investment project appraisal.* Investment in new long-term projects can have a profound effect on the future prospects of a business. By undertaking appraisals of the profitability

and riskiness of investment project proposals, managers can make informed decisions about whether to accept or reject them. These appraisals can also help in prioritising investment projects that have been accepted.

- *Financing decisions.* Investment projects and other business activities have to be financed. The various sources of finance available need to be identified and evaluated: each will have its own characteristics and costs. When evaluating different sources, consideration must be given to the overall financial structure of the business. An appropriate balance must be struck between long- and short-term sources of finance and between the contribution of shareholders (owners) and that of lenders. Not all of the finance required may come from external sources: some may be internally generated. An important source of internally generated finance is profits, and the extent to which these are reinvested within the business, rather than distributed to the owners, requires careful consideration.
- *Capital market operations.* New finance may be raised through the capital markets, which include stock markets and banks. Managers will often seek advice and guidance on how finance can be raised through these markets, how securities (shares and loan capital) are priced, and how the markets are likely to react to proposed investment and financing plans.
- *Financial control.* Once plans are implemented, managers must ensure that things stay on course. Here, regular reporting of information on actual outcomes, such as the profitability of investment projects, levels of working capital and cash flows, can play a vital role. This can help monitor performance and detect when corrective action is needed.



The figure shows the main tasks of the finance function and their key relationships.

Figure 1.2 The tasks of the finance function

Links between the tasks of managers and those of the finance function, which have just been discussed, are many and varied. Strategic management, for example, may require an input from the finance function on issues relating to financial planning, investment project appraisal, financing and capital market operations. Operations management may require an input on issues relating to financial planning, investment project appraisal, financing and financial control. Risk management may require an input on issues relating to all of the finance function tasks identified above.

STRUCTURE OF THE BOOK

This book considers each of the tasks of the finance function in some detail. In Chapter 2, we begin by examining how financial plans are prepared and the role of projected financial statements in helping managers assess likely future outcomes. We then go on to consider how risks and returns to shareholders are affected by the way in which a business is financed and by the cost structure that it adopts.

In Chapter 3, we consider how financial statements can be analysed and interpreted. We discuss, in some detail, techniques that can be applied to the financial statements to help assess various aspects of financial health. These techniques are also used in short-term financial planning decisions, such as the control of working capital, as well as for long-term financing decisions, such as the issue of shares. We shall, therefore, encounter these techniques again in later chapters.

Chapters 4 and 5 are concerned with the appraisal of investment projects. This is a vitally important area as investment decisions can have far reaching financial consequences. In these two chapters, we examine the main methods employed to assess the viability of investment proposals. We also discuss how risk may be taken into account when evaluating investment projects and how, once implemented, projects may be monitored and controlled.

Chapters 6 to 9 are concerned with various aspects of the financing decision. We begin by identifying the main sources of finance available and the role and efficiency of capital markets. We then go on to examine the cost of each of the main sources of finance and to discuss whether the financing decision has any effect on shareholder wealth. Finally, we consider the decision concerning whether to retain or to distribute profits to shareholders. We identify the key factors to be taken into account when making this decision as well as the issues surrounding the form that any distribution might take.

In Chapter 10, we discuss the importance to a business of managing its working capital effectively. We then go on to examine the key elements of working capital (inventories, receivables, cash and payables) and describe the various techniques available for controlling each element.

In Chapter 11, we consider the main methods available for measuring shareholder wealth and for promoting its creation. We begin by discussing the limitations of conventional methods and then continue by discussing newer, alternative, methods that may be employed. Finally, we consider how managerial rewards may be aligned to the goal of creating shareholder wealth.

In Chapter 12, we examine the rationale for mergers and takeovers. We also consider how they may be financed and who benefits from this form of business activity. The chapter concludes by looking at ways in which shares in a business may be valued. This is relevant for merger and takeover decisions as well as for other purposes. This chapter draws on our understanding of topics covered in earlier chapters such as investment appraisal, financing methods and capital market operations.

Finally, in Chapter 13, we consider the international aspects of financial management. In this modern era, many businesses have an international reach. This goes beyond buying and selling goods and services and will often involve investing and financing activities. Engaging in international operations is accompanied by various financial risks. In this chapter, we identify these risks and discuss how they may be managed.

MODERN FINANCIAL MANAGEMENT

In the early years of its development, financial management was really an offshoot of accounting. Much of the early work was descriptive, and arguments were based on casual observation rather than on any clear theoretical framework. Over the years, however, financial

management became increasingly influenced by economic theories and the reasoning applied to particular issues has become more rigorous and analytical. Indeed, such is the influence of economic theory that modern financial management is often viewed as a branch of applied economics.

Economic theories concerning the efficient allocation of scarce resources have been taken and developed into decision-making tools for management. This development of economic theories for practical business use has usually involved taking account of both the time dimension and the risks associated with management decision making. An investment decision, for example, must look at both the time period over which the investment extends and the degree of risk associated with the investment. This fact has led to financial management being described as the *economics of time and risk*. Certainly, time and risk will be recurring themes throughout this book.

Economic theories have also helped us to understand the importance of **capital markets**, such as stock markets and banks, to a business. Capital markets have a vital role to play in bringing together borrowers and lenders. They also help investors to select the type of investment that best meets their risk requirements and to evaluate the performance of businesses through the prices assigned to their shares.

Real World 1.1 is an extract from an article by Professor Dimson of London Business School. It neatly sums up how time, risk and capital markets are at the centre of modern financial management.

Real World 1.1

Finance on the back of a postage stamp

The leading textbooks in finance are nearly 1,000 pages long. Many students learn by making notes on each topic. They then summarise their notes. Here is one student's summary of his Finance course: Time is money . . . Don't put all your eggs in one basket . . . You can't fool all the people all of the time.

- The idea that time is money refers to the fact that a sum of money received now is worth more than the same sum paid in the future. This gives rise to the principle that future cash flows should be discounted, in order to calculate their present value.
- You can reduce the risk of an investment if you don't put all your eggs in one basket. In other words, a diversified portfolio of investments is less risky than putting all your money in a single asset. Risks that cannot be diversified away should be accepted only if they are offset by a higher expected return.
- The idea that you can't fool all of the people all of the time refers to the efficiency of financial markets. An efficient market is one in which information is widely and cheaply available to everyone and relevant information is therefore incorporated into security prices. Because new information is reflected in prices immediately, investors should expect to receive only a normal rate of return. Possession of information about a company will not enable an investor to outperform. The only way to expect a higher expected return is to be exposed to greater risk.

These three themes of discounted cash flow, risk and diversification, and market efficiency lie at the very heart of most introductory finance courses. Each of these themes will be considered in this book.

Source: Dimson, E. (1995) *Assessing the Rate of Return*, Financial Times Mastering Management series, supplement issue no. 1, p. 13. © Professor E. Dimson 1995, reproduced with permission of the author. All rights reserved.

WHY DO BUSINESSES EXIST?

A key assumption underpinning modern financial management is that businesses exist to create wealth for their shareholders. This has provoked much debate and so is worth exploring in some detail. Shareholders are considered of paramount importance because they effectively own the business and therefore bear the residual risk. During the good times they benefit, but during the bad times they must bear any losses. Furthermore, if the business fails and its remaining assets are distributed, the shareholders' claim against those assets goes to the bottom of the pile. The claims of other 'stakeholders', such as employees, customers, lenders and suppliers, are given legal priority over those of shareholders. These other stakeholders may also have the added advantage of being able to protect themselves against the risk of losses.

Activity 1.1

Can you think of any way in which:

(a) a lender, and
(b) a supplier

could take steps to avoid the risk of loss, even though the business with which they are dealing is in financial difficulties and may even fail?

Lenders can insist that the business offers adequate security for any loans that they provide. This may allow assets to be seized to pay off amounts due in the event of a default in interest or loan repayments. Suppliers can insist on being paid in advance for the goods or services provided.

Note that shareholders have a residual claim on the wealth generated by a business, while other stakeholders, such as employees, lenders and suppliers, normally have a fixed claim. In other words, shareholders receive whatever remains after other stakeholders have received the fixed amounts due to them. Having a residual claim means that shareholders have an incentive to increase the size of their claim by ensuring that the business undertakes new and risky ventures. Entrepreneurial activity is therefore encouraged, which can benefit all those connected with the business. Stakeholder groups with a fixed claim on the business do not have the same incentive as that of shareholders. Providing the business can meet their claims, this will normally be enough. (To minimise their risks, they might even prefer the business to avoid new ventures.)

Wealth maximisation

We have just seen that a business is assumed to exist to create wealth for its shareholders. We can be more precise, however, by saying that a business is assumed to pursue the goal of **shareholder wealth maximisation**. Within a market economy, shareholders provide funds to a business in the expectation that they will receive the maximum possible increase in wealth for the level of risk involved. When we use the term 'wealth' in this context, we are referring to the *market value of the ordinary shares*. The market value of these shares will, in turn, reflect the future returns that shareholders are expected to receive *over time* from the shares and the level of risk that must be faced. It is important to emphasise that the assumed goal is not to

maximise shareholders' returns over the short term, but rather to generate the highest possible returns over the long term.

Wealth maximisation or profit maximisation?

Instead of seeking to maximise shareholder wealth, a business may seek to maximise profit. In broad terms, profit represents the surplus generated by a business during a period and so it is tempting to conclude that the maximisation of profit will ultimately lead to the maximisation of shareholder wealth. Unfortunately, things aren't quite so straightforward.

The goal of profit maximisation is rather vague and fails to capture all aspects of shareholder wealth. Various difficulties lay in the path of attempts to implement this goal including:

- *Lack of precision*: the term 'profit' is imprecise and different measures of both profit and profitability exist. They include:
  - operating profit (that is, profit before interest and tax)
  - profit before tax
  - profit after tax
  - profit available to shareholders per ordinary share
  - profit available to shareholders as a percentage of ordinary shareholders' funds invested.

These measures do not always move in lockstep. An injection of new share capital, for example, may increase profit after tax but may lead to a decrease in profit available to shareholders per ordinary share. Different profit measures may, therefore, provide a different narrative of financial performance.

- *Lack of objectivity*: the profit measures mentioned cannot be objectively determined. They are all influenced by the particular accounting policies and estimates employed, such as those relating to depreciation, inventories and bad debts. They are also vulnerable to manipulation by managers wishing to present a particular picture of financial health to investors.
- *Time period*: the period over which profit should be maximised is unclear. This is a serious flaw as conflict can occur between short-term and long-term profit maximisation. It is possible, for example, to maximise short-term profits at the expense of long-term profits.

Activity 1.2

How might the managers of a business increase short-term profits at the expense of long-term profits? Try to think of at least two ways.

Managers may reduce operating expenses, and so increase short-term profits, by:

- reducing research and development expenditure
- cutting staff training and development
- buying lower-quality materials
- reducing marketing expenditure
- cutting quality control mechanisms.

The methods identified, however, may undermine the long-term competitiveness and performance of the business.

- *Risk*: the goal of profit maximisation takes no account of the risks involved. Shareholders, however, are normally very concerned with risk. To protect their investment, they may shy away from high-risk projects even though they have the potential to generate large profits.
- *Opportunity cost*: suppose that managers decide to reinvest current profits in order to boost future profits. This policy may well be consistent with the goal of profit maximisation, but what if the returns on profits reinvested were lower than those that shareholders could achieve from investing in a similar business with similar levels of risk? It would mean that by reinvesting the profits, rather than distributing them, shareholders are being prevented from maximising their wealth.

The weaknesses just mentioned do not apply to the goal of shareholder wealth maximisation. It is more precise and, as we shall see in later chapters, takes account of both risk and the opportunity cost of shareholders' funds.

Do managers really have a choice?

Within a market economy there are strong competitive forces at work to ensure that failure to maximise shareholder wealth will not be tolerated for long. Competition for funds provided by shareholders and competition for managers' jobs should ensure that the interests of the shareholders prevail. If the managers of a business do not provide the expected increase in shareholder wealth, shareholders have the power to replace the existing management team with a new team that is more responsive to their needs. Alternatively, the shareholders may decide to sell their shares in the business (and, perhaps, reinvest in other businesses that provide better returns in relation to the risks involved). The sale of shares in the business is likely to depress the market price of the shares, which management will have to rectify in order to avoid the risk of takeover. This can be done only by pursuing policies that are consistent with the needs of shareholders.

Real World 1.2 below concerns a recent failed takeover bid and its consequent effect on the target business. It neatly illustrates some of the points raised above.

Real World 1.2

A lesson quickly learned

The failed attempt by Kraft Heinz, the US food business to take over Unilever, the Anglo-Dutch business, can be viewed as a case study in what happens when a business loses sight of the importance of maximising shareholder value. Prior to the failed bid, the chief executive of Unilever, Paul Polman, was an outspoken critic of the shareholder value approach. Instead, he demonstrated a concern for environmental, social and corporate governance issues as a means of promoting the interests of all stakeholders.

The takeover bid came as a shock to the Unilever board, despite growing evidence that shareholder returns were disappointing when compared with those of the business's main rivals. Once the bid had been withdrawn, the board recognised that things could not simply carry on as before. It, therefore, announced a 12 per cent increase in dividends as well as a share buyback programme. It doubled planned cost cuts to two billion euros by 2020, to boost profit margins, and announced a strategic review of business operations to find ways 'to accelerate delivery of value for the benefit of our shareholders'. The overall effect of these

initiatives was to cause the share price to rise to the Kraft Heinz bid price, thereby making Unilever a less attractive takeover target to prospective bidders.

Sources: Based on information in Vermaelen T. (2017) Unilever: *Why firms should maximise shareholder value,* https://knowledge.insead.edu/blog/insead-blog/unilever-why-firms-should-maximise-shareholder-value-5336 27 February; A.Edgecliffe-Johnson (2018) *Unilever chief admits Kraft Heinz bid forced compromises* ft.com, 27 February; P. Jarvis (2017) *Unilever reviewing options for change after Kraft Heinz bid fails* chicagotribune.com, 22 February.

It should be mentioned that managers are usually encouraged to maximise shareholder wealth through their remuneration arrangements. Financial incentives are normally on offer to help align the interests of the managers with those of the shareholders. These incentives, which are often linked to share price performance, may take the form of bonus payments and awards of shares in the business.

Criticisms of shareholder wealth maximisation

Critics of the shareholder wealth maximisation objective believe that many of the problems of modern business can be laid at its door. It has been argued, for example, that the relentless pursuit of this objective will lead businesses to implement measures such as cost cutting, redundancies and forcing suppliers to lower prices. These measures can be carried to a point where serious conflict can arise between the various stakeholders (shareholders, employees, suppliers and so on) associated with a business. As a result, the business becomes weakened and incapable of exploiting profitable opportunities.

While the kind of behaviour mentioned may well occur, it is difficult to see how it would be consistent with the goal of maximising shareholder wealth.

Activity 1.3

Can you see why?

As mentioned earlier, shareholder wealth maximisation is a long-term goal and the sort of behaviour described would only undermine the achievement of this goal.

A further criticism made is that, by making shareholders the dominant group, other stakeholders will feel like second-class citizens and so will not fully engage with the business. Shareholder wealth maximisation cannot be achieved if other stakeholders are unhappy with their lot. Discontented staff can lead to low productivity and strikes. Discontented suppliers can lead to the business being given lower ordering priority and receiving slower deliveries in the future. In both cases, the wealth of shareholders will be adversely affected. At the very least, this means that the needs of other stakeholders must be considered if shareholder wealth maximisation is to be successfully pursued.

A final criticism is that shareholder wealth maximisation encourages unethical behaviour. In a highly competitive environment, managers are under huge pressure to produce the returns that shareholders require. To achieve these returns, they may be tempted to act in unethical ways.