

1. Introducing Finance

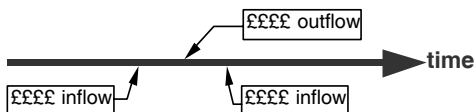
The main objective of this book is to introduce and familiarise the reader with the financial management of the business enterprise. This involves learning the **language** of finance, the **environment** in which finance takes place, as well as a number of **methods** of financial analysis. Additionally, a number of finance theories are discussed on the basis that understanding them will enhance the ability to make financial decisions. Some of the theories have yet to find a consensus among financial economists, and thus there are several views that need to be considered.

While my aim is to make the subject matter “user friendly”, there is a certain amount of technical material that cannot be avoided. Nonetheless, mathematical material has been kept to a discreet minimum, and even those with “mathematics-phobia” should be able to glean much more than the gist of the argument!

For many people the words finance and money are equivalent. However, such thinking can obscure the real insights that finance has to offer. While money is an object that enhances trade, finance is a field involved with decision-making concerning the use of money and credit; it is simultaneously an art and a science. Like all economic decision-making, finance involves a weighing-up of benefits against costs, and is therefore very much a sub-field of economics. Cost in economics refers to the concept of **opportunity cost**: “the cost of the next best alternative foregone”. Thus, cost does not simply mean what has been paid for a given commodity, but rather what else might have been purchased instead. While in many cases both benefits and costs can be measured in monetary terms, this is not always possible, and there is increasing effort being made by finance experts to find methods to estimate or “proxy” non-monetary valuations. Costs and benefits for which no market valuation is available are often referred to as **externalities**. Their measurement or valuation is especially important for investments being

undertaken by the public sector or those which are likely to have a significant social or environmental impact (which might be positive or negative).

It is important to think of finance as an economic phenomenon that occurs **in time**. For any economic agent—such as an individual, a business, or government—the timing of inflows of funds and outflows of funds will not automatically balance. Almost everyone who has been a student has had to experience the problem of bills needing to be paid when the grant (or loan) for the current period has run out. Finance might be thought of as the art of bringing fund inflows and outflows into some kind of balance. On these grounds finance may best be considered visually, occurring along a time-line:



Visualisation of the flows of funds can also be made by proper use of a computer spreadsheet:

Time period	0	1	2	3	4
Cash inflows			£3,000	£5,000	£6,000
Cash outflows	(£10,000)	(£1,000)	(£500)	(£500)	(£500)
Net cash flow	(£10,000)	(£1,000)	£2,500	£4,500	£5,500

1.1 The Stuff of Finance

Ultimately, finance is about making decisions. **Personal finance** deals with making individual and family financial decisions: where to save, what type of insurance or pension scheme meets a person's requirements, and so on. This book focuses on **corporate finance**, which deals with financial decision-making within the context of the firm. The same principles we discuss apply equally to the not-for-profit firm. Other areas of finance might include investment management, or financial markets and institutions.

Although there may be an element of the abstract, financial theory aims to provide financial decision-makers with better tools. Better tools make for better decisions. Equally, finance can also help decision-makers understand better the environment within which they operate. A good financial manager needs both to understand the markets and institutions with which they are dealing, as well as the driving forces which bring about changes to the financial system.

While finance today is essentially a well-defined area, the subject matter has changed over time. It would not be an exaggeration to suggest that before the twentieth century finance was largely about the study of banking, and the relationship of the firm to its bank. The start of the twentieth century saw the beginning of a secular growth of other, non-bank financial intermediaries as well as an ever-increasing turnover and expansion of financial markets, and this brought about a change in perspective. For most of the first half of the twentieth century finance remained largely a descriptive, institutional subject, more the precinct of legal minds than economists. However, by the 1950s things had begun to change, and finance as we know it today was beginning to take shape.

From the work of Joel Dean [1951] real investment appraisal (**capital budgeting**, covered in Chapter Six) began to develop, and with it the use of mathematical techniques for financial analysis and decision-making. With the seminal work of Harry Markowitz [1952, 1958] on financial investment appraisal (**portfolio theory**, covered in Chapter Seven), the subject matter of finance really took off, becoming both more technical and more insightful. This is a trend which has continued up to the present day and seems likely to continue for the foreseeable future. This is especially so given the current vogue for establishing models for the pricing of derivatives. Those involved in constructing such models are often referred to as “rocket scientists”, as they often come from a strongly numerate background in physics, for example. However, it is worth noting that it is often several years before developments in finance theory are taken up by practitioners. Thus, there are still areas of finance theory that have yet to be exploited in practice.

1.2 The Firm

1.2.1 What is a firm?

According to the dictionary, a firm may be defined as “a partnership for the undertaking of business” and also “the business itself”. In common usage the words “firm”, “business”, “company”, “organisation” and even “concern” are often used interchangeably. The phrase “enterprise” is also used, but typically to imply an ambitious firm, perhaps with a (somewhat) cavalier attitude towards risk. For our purposes we need to be more rigorous, and define a firm on either a legal basis or on a functional or economic basis.

A firm might be regarded as a set of legal relationships between the various components (**stakeholders**) of which it is comprised. These relationships are typically expressed in contractual form, either explicitly or implicitly perhaps via custom. Thus, the firm will have a contractual relationship with its shareholders and another contractual relationship with its employees, whether they are in a management role or labour. The firm has a relationship with its customers and suppliers, usually defined by the contractual terms of the sales invoice. Firms have contractual agreements with those who fund them by way of loans, embodied in the loan agreement. A firm also has a contractual relationship with the state: implicitly through abiding by the rule of law and more explicitly if the firm is a corporation (see Section 1.2.3). Multinational companies (MNCs) will have such relationships with several governments, depending on the countries in which the MNC operates.

The firm may be seen by way of its functions. This approach is often referred to as the firm being a “black box”, in which inputs or resources are converted into outputs for sale:



Economists refer to the inputs as “factors of production”. The primary factors are land (including extractive and natural resources),

labour (of all kinds, including entrepreneurial), and capital (meaning **real capital**, or productive equipment, rather than **financial capital**). Increasingly, capital has come to include **human capital**, which encompasses human knowledge and the wisdom to employ that knowledge (“technology” in its broadest context).

This is diagrammatically equivalent to the economist’s production function, which says that the level of output of a firm, q , is a function of the level of its inputs:

$$q = f(g, l, k)$$

where g = land, l = labour, and k = capital. The level of output, q , will form the firm’s sales volume, with anything unsold going into inventory. Thus, q depends upon customer demand for the firm’s products. The labour input, l , consists of the hours worked by labour and management, which in turn will be partly dependent upon their levels of remuneration. Given that labour is a significant stakeholder in the firm, the welfare (utility) of labour is significantly dependent upon the well-being of the firm. Additionally, labour remuneration often consists of a share options component, giving labour a shareholder stake in the firm.

The purchase of land and capital is funded from a mix of debt funding (e.g. from banks, bondholders, etc; see Chapter Four) and equity funding (from shareholders; see Chapter Five). Indeed, the value of the firm is the sum of its debt and equity funding:

$$V = B + S$$

where V = the value of the firm, B = the value of debt, and S = the value of equity. The immediate implication would seem to be that the value of the firm is independent of the mix of debt funding to equity funding. Whether or not this is the case is one of the issues we shall examine in Chapter Nine.

1.2.2 *The objective of the firm*

Microeconomists typically suggest that a firm tries to maximise its profits (subject to the costs imposed by the production function). However, the question remains as to whether pursuit of **profit**

maximisation would act to increase the well-being (welfare or utility) of the firm's owners, the shareholders. While it is true that different shareholders typically have different individual welfare preferences, if the management of the firm seeks to increase the value of shareholder wealth then that would act to increase the overall welfare of shareholders *in toto*. Thus, the true objective for the firm should be the maximisation of shareholder wealth. This would mean acting to maximise the value of the firm as measured by the price of each share.

1.1.2.1 Profit maximisation or wealth maximisation?

Economics textbooks which argue that the objective of the firm is to maximise profits are taking a simplified “single-period” view of the firm's operations. However, **value maximisation**—the maximisation of the value of the firm, or the maximisation of shareholder wealth—is a broader objective than profit maximisation. Indeed, value maximisation encompasses profit maximisation! For single-period analysis, the two methods are equivalent. For multi-period analysis, value maximisation is preferable.

Firstly, profits are essentially short-run. They are typically measured on an annual or semi-annual basis. While the accrual of profits serves to enhance the value of the firm, the maximisation of current profits may involve undertaking activities that actually jeopardise future profits. One example might be that of a firm improving its current profits by reducing maintenance spending on its capital equipment. This would very likely shorten the useful length of the equipment's lifetime, and mean a significant increase in future expenditure on capital; a case of “penny wise, pound foolish”. To maximise value, the firm must take into account the long-run future stream of profits.

Secondly, profit maximisation fails to take into account **risk**. For example, in considering two possible investment projects, a firm operating under the goal of pure profit maximisation would undertake whichever project offered the highest expected future profits, even if that project meant having to take levels of risk that might be considered unacceptable. It might be the case that a lower-risk alternative offers a more robust, if smaller, level of profits, which is more acceptable to shareholders. As we shall see, value explicitly incorporates risk, so value

maximisation takes account of risk in a way that profit maximisation does not.

In summary, value maximisation offers a sounder basis for decision-making than profit maximisation. It better describes the true objective of the firm, and provides a logical basis for optimal decision-making based on rigorous analytical procedures. Nonetheless, empirical evidence suggests that firms in the United Kingdom often adopt other objectives. A major postal questionnaire study of the financial objectives of 208 large UK firms was conducted in both 1980 and 1986 by R. H. Pike and T. S. Ooi [1988]. With a response rate from senior finance executives in excess of 70 per cent, and with 5 indicating “very important” and 1 “unimportant”, their results can be summarised as follows:

Table 1: The Relative Importance of Financial Objectives

Objective	1980	1986
Short-term (1–3 years)		
Profitability (e.g., percentage rate of return on investment)	4.28	4.61
Profits or earnings (i.e., a profit target)	4.01	4.41
Long-term (3+ years)		
Growth in sales	3.18	2.97
Growth in earnings per share	2.83	4.38
Growth in shareholders’ wealth	3.07	4.06

This shows quite clear evidence of a British penchant for “short-termism”, although there appears to be a growing realisation of the importance of longer-term goals, indicated by the increasing importance attached to EPS growth and shareholders’ wealth growth. It should also be noted that this evidence is quite consistent with results obtained from similar studies for both the United Kingdom and the United States.

1.3 Corporate Structure

1.3.1 Sole proprietorship

Once upon a time, the sole proprietorship (or **sole trader**) was known as the “one-man firm”. Under this form of organisation, the firm *is* a single individual, and there is no legal distinction between the firm as an entity

and the owner. That is to say, the firm has **unlimited liability**, and the assets of the owner can be called upon to meet the obligations of the firm. Because the firm is not a separate legal entity, it will not be subject to corporate taxation. However, the owner will be subject to personal income taxes on the firm's earnings, and the personal assets of the owner could be taken to pay off the firm's debts.

Because of its unlimited liability, it is unlikely that the sole proprietorship will be able to attract sizeable amounts of external funding. In part, this is due to the limited resources a sole proprietor typically has by way of collateral. It is often the case that as the business of the sole proprietorship grows, the owner will eventually seek to incorporate. Because the existence of the firm depends on the identity of its owner, the lifespan of the sole proprietorship depends on the lifespan of the owner.

Because a sole proprietorship means that the firm is the owner, there is a natural tendency to think of the firm as having no other employees. This is not necessarily the case, although in practice it quite often is.

1.3.2 Partnership

A partnership occurs whenever two or more persons associate for the purpose of conducting business. The partnership agreement may be oral or it may take a more formal basis. The profits of a partnership are taxed as personal income, usually on a *pro rata* basis. Not all partners need contribute financial resources; it is possible for some partners to be included because of the nature of the skills they bring to the venture. It is on this basis that some accountants and lawyers have established partnerships in the United Kingdom. Partners in such professions often work their way up through the ranks, and ultimately are rewarded by being made a partner in the company.

Nowadays, it is possible for some partners to be included in the partnership agreement with limited liability. However, under such a **limited partnership**, there still must be some general partners who have unlimited liability.

Under the partnership agreement, the partners share *pro rata* in the profits of the company. They are also both jointly and separately liable to make good any losses, and are personally liable for any debts the

company incurs. The death or withdrawal of a partner, or a new partner coming into the business, results in the cessation of the existing partnership and the creation of a new one. For a partnership to work well, it is important to set up the partnership agreement to avoid potential conflicts. Terms and conditions for distribution of assets upon dissolution may be included in the agreement. One example is that it has become common practice for each partner to carry life assurance, with the other partners named as beneficiaries.

In February 1997, the British government proposed the introduction of **limited liability partnerships** (LLPs). These came into being on 6 April 2001 under the Limited Liability Partnerships Act 2000 and Regulations 2001. This legislation allowed for the creation of a new corporate entity with the flexibility of a partnership allied with limited liability status. An LLP provides the benefits of limited liability but allows its members the flexibility of organising their internal structure as a traditional partnership. The LLP is a separate legal entity and, while the LLP itself will be liable for the full extent of its assets, the liability of the members will be limited. Disclosure requirements for LLPs are similar to those of a company: financial information filed is equivalent to that of limited companies, including annual accounts.

1.3.3 *Limited companies*

A limited company (or **corporation**) is a separate legal entity from its owners and managers. Some would argue that a limited company is an “artificially created legal person”. The owners of the corporation—known as **shareholders**—hold shares according to the proportion of the company they own. In the event of the company going bankrupt, any individual owner’s liability is limited to their stake in the company as measured by the value of their shares. Personal assets may not be taken to pay off the company’s debts; the company’s liabilities are said to be limited.

The benefit of limited liability is that all profits and gains accrue to the shareholders. Any firm which is incorporated (i.e. has limited liability) is subject to corporate taxation. Shares in corporations are typically transferable from one individual to another.

Because a corporation does not depend on who its shareholders are, its lifespan can far exceed those of its shareholders. Indeed, the lifespan of a corporation may be considered indefinite. At each corporation's Annual General Meeting, the shareholders elect a Board of Directors (who might also be shareholders) to run the company on their behalf. As a company grows in size, the management of a corporation may become increasingly divorced from its ownership; i.e. the directors may choose to employ others ("managers") to administer the day-to-day affairs of the company. According to Companies House publication *CHN 15: Notes for Guidance: Directors and Companies House*,

A director is appointed to manage the affairs of a company in accordance with its articles of association and the law generally. . . .

Every company director has a personal responsibility to ensure that certain statutory documents are delivered to the Registrar of Companies as and when required by the Companies Act.

Failure to file documents such as accounts or annual returns with Companies House on time is a criminal offence, which can lead to a fine of up to £5,000, and ultimately the disqualification of a director.

Setting up a limited company in the United Kingdom is relatively straightforward, and can be done directly or via a Company Formation Agency. Most of the major Company Formations Agencies in the United Kingdom advertise in the weekly publication *Exchange and Mart*. However, individuals who have already been in business—perhaps as a sole proprietor—often incorporate using their accountants or lawyers as the formation agent. This is typically more costly, and in many cases the lawyer or accountant will simply employ a Company Formation Agency to do the work and add a margin on to the bill they send their client.

Directly or otherwise, application for incorporation is made to the Registrar of Companies, based at Companies House. Providing that the name of the firm is not already on The Register and that the proposed directors are not barred from being directors, the incorporation will be completed in about a week. A certificate of incorporation indicating the company number will be issued by Companies House. Documents known

as the Memorandum and Articles of Association set out the rights and obligations of the firm. In essence, these form a contract between the corporation and the state. Corporations are required to file accounts annually with Companies House. All information held at Companies House is available to the general public, sometimes for a nominal fee, often free. This can be accessed via telephone, or by using the on-site computer terminals. Alternatively, an online service is offered, providing remote access to the Companies House system from a modem-linked personal computer. Available via the Internet at www.companieshouse.gov.uk, the site offers on-line registration, company searches, a list of disqualified directors, brochures and documentation and much more.

Similar arrangements for setting up a corporation exist in most countries. In the USA, where each state has its own laws, many businesses prefer to incorporate in Nevada or Delaware, where the regulatory burden is considered less onerous.

(Private) Limited Company

This refers to a corporation whose shares are not freely transferable. Shareholders may transfer (sell) their shares to a third party, but usually only with the express permission of the corporation. Private limited companies are required to use the phrase “**Limited**” or “**Ltd**” after the company name in all of their documentation. In the United States, the term “Inc.” or “Incorporated” is used.

Public Limited Company (plc)

A public limited company is a corporation whose shares may be directly purchased from an existing shareholder without the permission of the company. Public limited companies are required to use the phrase “plc” after the company name in all of their documentation. Note that there is a distinction between **public limited companies** (plcs) and **listed companies**: while a listed company must be a plc, not all plcs are listed on the London Stock Exchange.

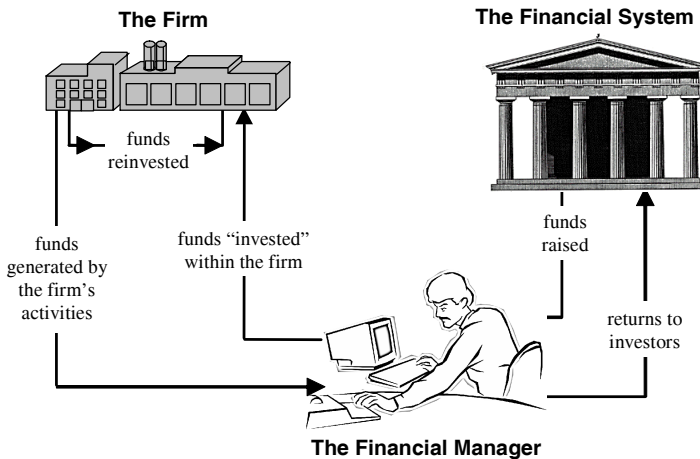
In order for a plc to become listed there are a number of requirements which it must first meet. Chief among these is the minimum capital requirement; it is unusual for a company with a capitalisation of less than £10 million to seek a listing. Additionally, for a company to gain a full

listing in the stock exchange at least 25 per cent of its shares must be in public hands.

1.4 The Finance Function

The phrase **finance function** is often used to indicate that part of the firm concerned with the firm's financial affairs. The finance function may also be referred to as the financial department, or the firm's financial managers.

Given that the objective of the firm is to maximise the value of the firm (thereby maximising shareholder wealth), we can say that **the main function of financial management is to plan for, acquire, and utilise funds in such a way that shareholder wealth is maximised**. In order to fulfil such a role, the financial manager must have a keen knowledge and sound understanding of both the firm and the financial system. This can be summarised in the following diagram:

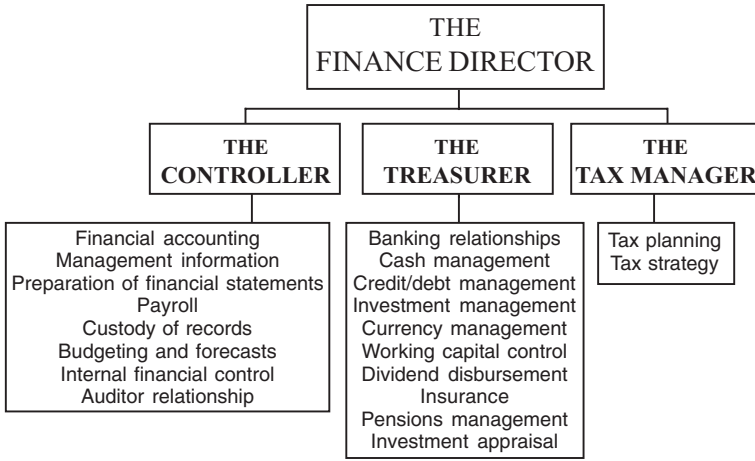


Particularly in larger firms, the functions of the Financial Manager (Financial Director or CFO—Chief Financial Officer) are often divided into (at least) two major areas of responsibility:

Treasurer Responsible for the acquisition and custody of funds

Controller Responsible for accounting, reporting and control

Additionally, the Control function is often sub-divided to include a separate function with responsibility for taxation issues, which have a particularly significant impact on firms operating across national boundaries. This division can best be understood diagrammatically:



1.5 Principals and Agents

In the early days of the industrial revolution, the firm was usually managed by those who owned it, much like the small family-run business of today. Because the modern corporation tends to be a large, complex organisation, a divorce has arisen between those who own the firm (shareholders) and those who run it (managers, typically the Board of Directors). In the modern corporation, it is the task of management—the **agents**—to administer the firm on behalf of its owners—the **principals**. This is known as an **agency relationship**. In the past, it was often assumed that there was no divergence of interests between the firm's owners and managers, but increasingly this does not seem to be the case. A conflict of interest between those who own the firm and those who manage it appears to be the norm rather than the exception. There is a tendency for managers to make decisions that may be in their own interest but not in the interest of shareholders or consistent with the risks bondholders accepted when they purchased their stake in the company.

Such conflicts give rise to additional costs, known as **agency costs**. These costs, which are not easily measured in monetary terms, represent opportunities which have been foregone as a result. For example, while management might consider a corporate aircraft useful, it might not be in the shareholders' interest. One way of minimising these costs is to turn agents into principals. This can occur when the directors of a company are also shareholders (a primary aim of the use of employee share options). There are four key areas of agency cost:

- Costs of minimising the incentives for management to act contrary to the interests of shareholders
- Costs of monitoring the actions of management
- Bonding costs to protect shareholders from managerial dishonesty
- Opportunity costs of lost profits due to complex organisational structures, which limit managerial decision-making flexibility

Further, there may be a conflict of interest between the firm's managers and its labour force. Thus within the firm's operations there may be a three-way conflict of interest. Further conflicts of interest may arise as a result of the firm's sources of financing. Investors can provide funds to a firm via debt or via equity. Bondholders—a shorthand term including any providers of debt to the firm—are likely to be affected in a different way by the firm's decisions than shareholders, leading to a conflict of interest between these groups. The key area of conflict concerns the appetite of these groups for risk. Because shareholders wish to see their wealth maximised *ceteris paribus* (other things being equal), they would prefer management to leverage their returns via prudent risk-taking. Alternatively, bondholders are primarily interested in the company doing enough to ensure that they receive their payments of interest (and repayment of principal in the longer run), which may involve a lower risk strategy. It may also be the case that conflicts of interest occur between groups of shareholders, or between groups of bondholders.

In recent years, an expanding body of literature has developed, investigating the various issues pertaining to conflicts of interest between

a firm's various constituents or **stakeholders**. The seminal work in this area is probably the 1976 paper by M. C. Jensen and W. H. Meckling, which gave rise to the distinction between **maximising** behaviour and **satisficing** behaviour: the former indicating behaviour with the objective of maximising the value of the firm (or shareholder wealth), the latter indicating behaviour whereby management does "just enough" to keep shareholders content.

1.5.1 Maximising versus satisficing

Economic theory is built on the assumption that individuals are rational maximisers. The usual objective is for individuals to act to maximise their well-being subject to the constraints which are imposed by limited wealth or income. Economists typically use the concept of **utility** as a measure of an individual's well-being or welfare. Utility is largely a subjective measure: the individual decides what is in their best self-interest. However, this does not mean that individuals act in a purely selfish manner; there is a vast difference between acting in one's own interest and acting selfishly. It may well be in an individual's self-interest to donate funds to charity, or to consider how their actions impinge on others above their own immediate requirements. Self-interest usually includes the notion that most individuals prefer less risk to more, *ceteris paribus*; that is to say, individuals are normally **risk-averse**. Self-interest also implies that an individual prefers to receive a given sum of money now rather than in the future, *ceteris paribus*.

Maximising involves optimisation of a given objective: it implies striving for the best possible outcome. On the other hand, satisficing behaviour involves a willingness to settle for less than the best possible outcome. Jensen and Meckling established that a manager with fractional ownership (including zero ownership) might become inclined to adopt satisficing behaviour, rather than seeking to maximise the wealth of all shareholders. This imposes an agency cost on the shareholders. The increasing use of perquisites (perks) is sometimes cited as a symptom of satisficing behaviour. Increasingly shareholders are trying to structure the remuneration of directors to ensure maximising rather than satisficing behaviour.

1.5.2 Management goals

In the modern corporation, managers are employed to act on behalf of the shareholders. It has been argued, however, that managers may substitute their own goals in place of the objectives of the shareholders, who wish to see their own wealth maximised. As well as perks, managers may seek to pay themselves large salaries and other forms of remuneration—such as pensions and share options—regardless of the performance of the company. Recent publicity has highlighted strong shareholder concern about directors’ remuneration, an issue often referred to in the press as “fat cats’ pay”. In the United Kingdom, this issue is occasionally highlighted by “shareholder revolts” at company AGMs. In some cases, the revolts have been brought about by larger, institutional investors, while in others groups of individual, small shareholders have been moved to actively voice their concerns. In the United Kingdom in 1995, the Greenbury Committee—chaired by Sir Richard Greenbury, chairman of Marks and Spencer—published a code of conduct on executive pay for corporations. A study carried out by PIRC, the corporate governance consultancy, suggested that in 1996 many companies were still in contravention of the Greenbury guidelines, especially in respect of the length of directors’ contracts and long-term investment plans (L-tips). The issue of corporate governance is one which continues to test the minds and imaginations of both regulators and the regulated, yet the solution seems never to get closer. A case of two steps forward, one step backwards, and *vice versa* on occasion!

Managers may also have an agenda of “empire building”, whereby they try to enhance their status through promotion or the pursuit of “status goals” such as the numbers of staff or the size of budget for which they are responsible. Because these goals focus only on part of the firm’s operation, they may be inconsistent with the goal of shareholder wealth maximisation.

Finally, because managers depend on their position for their livelihood, they might well take a satisficing, more risk-averse view of the company’s activities than would suit the shareholders. Shareholders have the option of diversifying away some of their risk by holding a portfolio of shares in different companies (see Chapter Seven).

1.5.3 *Shareholders' goals*

The main aim of any shareholder is to promote his or her individual well-being, usually in terms of the wealth that accrues. For shareholders, this increased wealth can take the form of income by way of dividends, and also capital gains through increases in the price of the shares. Capital gains may be **realised** (when the shares are actually sold) or unrealised, in which case they are “paper increases” in the shareholder’s wealth. Capital gains can also be negative, when they then become known as capital losses.

Depending upon their individual preferences, some shareholders will seek to maximise their wealth through capital gains, while others may be more interested in the stream of dividend payments that a company offers. Institutional investors, such as pension funds and insurance companies, are a prime example of the latter, using the regular dividends they receive to meet their outgoings, such as pension payments. Investors who seek to make capital gains in the short-term from newly-issued shares are referred to as “stags”. Issues of shares in the newly-privatised utilities during the 1980s were often offered at bargain-basement prices, leading to a great deal of successful stagg activity.

Whether investors are interested in capital gains or dividends, these can only arise ultimately from a company being successful (profitable) in the longer-run. That is to say, the interests of shareholders can be met only if the company is successfully adding value. Because this requires the investor to take a view on what the future holds for the company, it is considered to be speculative activity. It therefore requires a higher degree of risk-aversion on the part of the investor than if they were to hold bonds, for example.

1.5.4 *Bondholders' goals*

Although the term “debtholder” would be more appropriate and certainly more accurate, “bondholder” is the traditional term for any entity which has lent funds to the firm, regardless of whether or not bonds (marketable or otherwise) have been issued. Thus, a bank which has extended a loan to a firm would come under this classification.

By their very nature, bondholders are more risk averse than shareholders. Bondholders have usually opted for a certain return by way

of regular interest payments on the funds they have lent to the firm. Shareholders have opted for the greater uncertainty of dividends and/or possible capital gains. It therefore follows that bondholders will typically prefer the firm to undertake less risky investments than would be preferred by shareholders.

1.5.5 Other stakeholders' goals

In addition to those who have a capital stake in the company, by way of debt or equity, there is a broader group of stakeholders whose activities directly affect the successful running of the firm. It may well be the case that the goals of these other stakeholders conflict with those of the shareholders, in whose interest the firm is supposed to be run. Additionally, there are stakeholders with a more tenuous connection to the company, but who still have an interest in its well-being. In no particular order, these other stakeholders include:

customers: without whom the company has no *raison d'être*. There is a direct connection between a company that can successfully offer customers the products they desire over time, and one that successfully achieves value maximisation.

workers: those who are employed to undertake the actual work of production within a company. History is replete with examples of conflicts between the workforce and the management of a company. However, it also needs to be noted that management are also part of the company's workforce.

suppliers: for a company to operate successfully it requires stability from its suppliers, in terms of price and quality of product, ability to deliver, and the supplier's existence. Suppliers include those who provide such necessities as raw materials (to a manufacturer, for example) and distributors, as well as those who provide indispensable services to the firm. These would include the company's accountants, any legal services required, as well as those who offer peripheral services such as local caterers offering lunch facilities.

the local community: firms have to operate within the local community, and to abide by local culture, customs, and taxation. Local infrastructure, such as transportation, is required for a firm's labour force to be able to get to and from work, and for the firm to be able to take delivery of raw materials and deliver its products to the customer.

government: the (national) government provides infrastructure and the laws within which firms operate. Firms have to operate within national laws of contract and other legal property rights, as well as having to comply with the laws on taxation.

society “at large”: increasingly society places pressures on the way in which firms operate, through changing acceptable public standards (on the environment, for example), or via pressure groups, which seem to play an ever-increasing role in changing societal norms and standards.

1.5.6 *In summary*

All of the above suggests that, in the real world, managers may not operate in the best interests of shareholders. However, this is not to say that shareholders are powerless. There are a number of devices which can be utilised by shareholders to ensure that management comply with pursuit of the goals of shareholders:

directors: because the board of directors are elected by the shareholders, they can be terminated if the latter are dissatisfied with their performance. However, experience suggests that this is more likely in theory than in practice.

contracts: judicial arrangements for compensation and remuneration to management can be written into their contracts. Increasingly, use is made of performance-related measures, such as share options.

takeovers: if a firm is considered to be sound with the exception of its management, it is liable to be considered ripe for a takeover bid.

In the event of a takeover, the existing management would be sacked and replaced. Thus, the fear of takeover acts as an incentive for managers to pursue actions which will positively impact the share price, thereby maximising shareholder wealth.

labour market competition: this works in a similar yet localised way to the fear of takeover, and has been used by well-paid managers as an explanation of their compensation packages. Put simply, there is a labour market for management, in the same way as there is a market for any other form of labour. Poor managers will be readily replaced by better managers. Those firms willing to pay the most will be able to attract the best management. That there is a global market for top management is one of the arguments put forward (in the United Kingdom) to justify large executive compensation packages. Nonetheless, there is some evidence to suggest that there is some degree of segmentation of national markets for executives. Thus, while the argument for market competition seems to hold for a very large economy like the United States, the evidence for the United Kingdom seems to be more questionable.

1.6 Finance versus Accounting

To many people the terms “accounting” and “finance” are synonymous. Although there is a strong symbiosis, there is a distinct difference between these two fields. Nonetheless, in smaller firms, the functions of “finance” and “accounting” may well both be performed by the same person or group of people. To some degree one could argue that “finance” is what is performed by the **treasury** function, and “accounting” is performed by the **control** function, based on the diagram on page 13. There is strong anecdotal evidence suggesting that accountants tend to over emphasise the closeness between accounting and finance, while financial economists tend to emphasise the distinction. This can be seen at first hand when observing the appointments columns for financial positions, which in the United Kingdom are largely advertisements for qualified accountants. In larger firms where there is increasingly a division of labour within the finance

function, this might not be a good thing given the divergence of the skill-sets between finance professionals and accountants.

Primarily, accounting is responsible for financial record-keeping, and hence the provision of information by which sound financial decisions can be made. Thus, accounting offers both a stewardship and accountability function. Accounting is the means by which records of the firm's financial activities are recorded and audited to ensure that the best possible (legitimate) use is made of the firm's resources. One major way this is done is via the production of financial reports—"the accounts". According to the United Kingdom's Accounting Standards Committee [1975], the object of these financial reports is

... to communicate economic measurements of, and information about resources and performance of the reporting entity useful to those having reasonable rights to such information.

Thus, financial reports are one means by which the principals—shareholders—can check on the actions of their agents—the management. They also allow debt-holders and other stakeholders, as well as various analysts, to gain some insight into what the firm has been doing. The accounts are also the basis on which the firm is subject to taxation.

Finance, on the other hand, refers to the making of financial decisions. If financial managers are to make sound decisions, they require the best possible (financial and other) information. Thus, finance may be seen as a decision-making structure built on the foundations of sound accounting. Indeed, the past is really the only true guide we have to the future, however imperfect. Nonetheless, because the kind of information contained within financial reports is primarily for reporting purposes, it is not necessarily the same kind of information that financial managers require for making decisions.

For example, financial accounts are normally prepared on an accruals basis. For valuations to be calculated, finance requires cash flows. Earnings per share and cash flow per share are not the same thing, as the former will typically include monies which have yet to flow into or out of the firm. Indeed, it is possible to find a company which appears profitable but is in fact suffering from negative cash flows.

There is also the question of “window dressing” or “creative accounting”. By adopting certain types of accounting policies, firms try to give the impression that their business is in better shape than it is in reality to maintain investor confidence; sometimes they try to make the firm appear worse off to avoid paying taxes! Profits—the “bottom line”—are derived based on a series of assumptions, usually those provided by the Accounting Standards Committee, and increasingly the standards laid down by the London-based International Accounting Standards Committee (IASC). Nonetheless, there remains much inconsistency, to the extent that some cynics still argue that corporate accounts are largely a work of fiction. Providing a company adopts a consistent policy for accounting, it is possible to compare its year-on-year performance, although comparison with other firms (who may have different accounting policies) may be spurious.

We now move on to consider in greater detail the various issues we have addressed in this chapter. Remember, however, that the journey is at least as important as the destination.