Financial Management Handbook

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Gower
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OVERVIEW

The efficient use of a company's resources is essential to its growth. These resources take many forms: employees, buildings, machinery and stocks, but all involve expenditures of funds for purchase and operation. The ultimate resource that is being employed is the funds of the company. This section deals with four aspects of using funds: capital investment, coping with inflation, working capital management and international money management.

What are the common features of decisions on using funds to purchase resources for the company? Any of these decisions involves an expenditure to create the resource: new buildings or equipment, better trained personnel, new markets through investment in a sales force or marketing organisation. These expenditures anticipate benefits that should arise in the future: the profit contribution from sales from new capacity, the increased productivity of a more skilled workforce, the increased revenues from new markets.

How should such decisions be evaluated from a financial standpoint? The financial resource that is being committed is cash. Cheques are written to purchase the new buildings and machinery and to pay employees. Only when the cash is paid does the company lose the use of its funds. Similarly, the expected benefits should be evaluated in terms of cash flows. If a sale is made, but the cheque is not received for six months, the financial return occurs when the cash flow from the cheque arrives, because the funds are not there for the company to use until that time. Thus the financial costs and benefits should be evaluated in terms of current and expected cash flows.

These cash flows will often differ from accounting profits. The most
important difference is the use by accountants of depreciation to spread the costs of capital resources over their lives. If a machine is purchased, the cheque must usually be written for the entire purchase price. This cash flow is a financial cost to the company at the time the machine is purchased, and the company loses the use of funds representing the entire purchase price. In exchange the company receives a machine, which its managers hope will produce sufficient cash flow in the future to compensate for the loss of these funds. The depreciation in the profit statement does not represent a cash flow and is not therefore relevant to the decision being made.

The passage of time means that we should expect to receive interest on our money. Offered £10 one year from now in exchange for £5 now, we would compare this with the interest we could earn by putting our £5 in the bank. The 100 per cent return we are offered compares favourably with the, say, 10 per cent opportunity cost of lending the money to the bank. A good decision in this case involves comparing the rate of return on the ‘project’ with the rate our money could earn elsewhere.

How much better off does this project make us? To answer this question we must consider the financing arrangements. Suppose we can borrow the £5 at 10 per cent per annum interest to make the investment. In one year we must pay back £5.50, which will leave £4.50 out of the ultimate £10 payment. This is called the net future value of the project, because it represents the net amount by which we will be better off at the final date once we have allowed for the financing costs. This is useful information, but what we really want to know is how much better off we are now. To answer this, suppose we borrow against the entire £10 at 10 per cent. We could borrow £9.09 on this basis, and pay off the loan with the £10 proceeds from our project. Of the £9.09 we must invest £5, but the other £4.09 represents the true gain or profit from the project. This amount is known as the net present value and tells us the value now of making this particular investment.

Uncertainty and inflation affect this decision in several ways. If we are not sure of receiving exactly £10, how should we make the decision? The procedure we followed before was to compute the amount of finance we could raise with the £10 payoff and compare this with the £5 investment to get the net present value. Now the payoff is not certain, so we need to estimate its most likely or expected value. For instance, if the payoff could be £10 or £8 with equal chance, the expected payoff is £9. The rate at which we could raise money to finance the project would also differ. To finance risky ventures investors require higher rates of return. The rate required now might be 20 per cent. In that case, against the £9 expected proceeds, we could raise (9/1.20) = £7.50. The net present value of the project has fallen to £2.50. Uncertainty means that we must use expected payoffs and a higher rate of return.

Inflation also affects payoffs and required rates of return. The interest rate tends to increase when inflation increases, so that we must earn higher returns to beat putting our money into the bank. But the expected cash flows from a project will be affected by inflation. These cash flows may consist of sales proceeds minus labour and material costs. The selling price, wage costs and raw material prices will all be expected to change over time at rates that partly reflect general inflation. As inflation escalates, projected future cash flows from a project should also increase, but so will the rate of return required to finance the project.

Part Two begins with a detailed explanation by Tessa Ryder Runton, Jack Broyles and Ian Cooper of the techniques and organisation required for effective capital investment planning (Chapter 2). They develop the notion of an opportunity cost of funds and explain how this cost of capital can be computed for a company. Testing the viability of capital investments consists of comparing the return from a project with the return required by the company on projects of that sort. Various techniques for doing this are described, including the discounted cash flow method. The chapter then explains how risk can be incorporated into capital investment planning, using techniques such as sensitivity and probability analysis. The authors then place this technical material in an organisational context, discussing the capital investment decision process and the problem of ex-post evaluation of capital investment decisions.

The next chapter, by Ian Cooper (Chapter 3), is concerned with incorporating considerations of inflation into financial decision-making. It begins by showing the impact of inflation on the cash flows from a project and on the cost of capital. The chapter then shows how the principles of effective funds usage can be extended to cope with inflation and changes in relative prices and concludes with the treatment of special tax issues that are heavily affected by inflation, such as stock relief and delays in tax payments.

In the chapter by Geoffrey Clarkson (Chapter 4) the important area of working capital management is addressed. The same notions of profitability apply here, but with additional special techniques for
OVERVIEW

Financial measurement is an essential ingredient in all commercial activities in a market economy. Thus the challenge of financial management lies in the interdependence of finance and all other activities in the firm. Financial management encompasses not only the treasury function, that is, raising capital and the management of working capital and of capital investment, but also the controllership function involving the operation of a financial control system which aims to depict the financial aspect of all the firm's planned and actual activities. This means that as well as being a financial specialist, a financial manager may need to be a management systems generalist. Financial information systems must be articulated with operational information systems in sales and marketing, production, physical distribution, personnel, and so on. Hence, when discussing control, one should consider companies and their various parts as systems and sub-systems (systems within systems.)

Part Three of this handbook deals with these control aspects of financial management. Broadly speaking, control requires that objectives be established, that actual outcomes be measured and compared to objectives, and that actions be taken to avoid any major divergences between expected outcomes and objectives. For the financial manager, the relevant aspects of objectives and outcomes are the financial ones, that is, in the last analysis, cash flows. Certain financial objectives and outcomes can be, and often are, also expressed in terms of profits, which are perhaps best considered as cash flows which have been smoothed by removing two kinds of fluctuations:

1. Fluctuations due to the operation of the working capital cycle;
on the operation of the management system as a whole. As described in
the chapter on Internal Auditing by Harry Scholefield and P. C.
Elliott, it constitutes an off-line or second-level appraisal activity
designed to evaluate the adequacy, efficiency and effectiveness of the
company’s on-line or first-level control subsystems (Chapter 9).
Internal Audit, then, is not part of financial control as exercised by the
Financial Manager; rather, it is complementary to it.

Thus, the four chapters deal with the principles which govern the
design and operation of financial control systems in business
organisations. Certain important system requirements tend, however,
to be specific to particular kinds of business (retailing, for example, as
compared with manufacturing or transport); others may be specific to
certain areas of the business (marketing, production, etc.).

Such situation-specific requirements are potentially vast in number.
Part Three does not aim to cover the control requirements of particular
types of business or, in detail, of particular areas in a business; rather,
the aim is to deal with those principles and approaches which apply to a
wide range of business situations.

2 Fluctuations due to the lumpy nature of expenditure on fixed
assets.

How far this kind of smoothing contributes to the usefulness of the
information will depend on the circumstances in which it is being used.
It should be recognised that because the financial control system works
by abstracting the financial aspects of the firm’s activities, a degree of
abstraction is essential to the system. An excessive degree of
abstraction is, however, a common failing in accounting systems.

To achieve control, a management system has two interrelated kinds
of systemic requirements: an information system or systems, and a
system of responsibilities or management organisation. These
requirements are the subject of Richard Wilson’s chapter ‘Reporting
and Responsibilities’ (Chapter 6). Within this overall system, the
budget control sub-system is concerned particularly with the
expression of operational objectives in financial terms, and the
comparison of financial outcomes (profits and cash flows) with these
objectives. This forms the subject of Alan Leaper’s chapter ‘Budgets
and Budgetary Control’ (Chapter 7).

Both the establishment of objectives and the measurement of
financial outcomes require information subsystems which provide
knowledge of the costs of the organisation’s final outputs (products)
and of intermediate outputs (goods and services produced and used
within the organisation in the production of those final outputs). These
subsystems for Costing and Internal (or Transfer) Pricing are the
subject of Chapter 8 by H. W. Calvert and Simon Archer.

Finally, the Internal Audit subsystem is intended to provide a check
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In Part Four we discuss both the conceptual problems and the practical issues associated with raising finance for companies. Financing can be classified broadly under the headings of debt and equity, and in this introduction we shall summarise the relative advantages of debt and equity in the capital structure, the importance of financial planning and the methods of raising finance for quoted and unquoted companies.

When making a choice between debt and equity financing one should be aware that there is no theoretical case for the notion that the cost of debt is different from the cost of a company's equity. That the cost of debt and equity could be the same is not obvious since these costs take different forms. To the dividend costs of equity one must add capital gains. To the interest payments on debt one must add the implicit cost of debt. The implicit cost of debt is reflected in the impact of additional debt on the cost of equity. Financial gearing increases risk per pound of equity, as equity is replaced by debt in the capital structure. The increased equity risk increases the cost of equity, which takes the form of dividends and capital gains required by shareholders as a reward for risk taking.

Modigliani and Miller (1958), (1), in a number of famous propositions showed that the true pre-tax cost of debt and equity is the same in a competitive capital market because the operational risks of the underlying assets are not changed by the method of financing. They showed why arbitrage would ensure that investors would not pay more for an operating cash flow partially financed by equity. Miller (1977), (2), later claimed that the same result holds after tax. Thus financial management should not imagine that there are any strong theoretical
grounds for expecting an economic advantage to be gained from the choice between equity and debt financing. The theory, however, is incomplete, as pointed out by Paul Marsh in Chapter 14. Other factors such as convenience, flotation costs and the risk of liquidation arising from the possibility of default must govern the balance between equity and debt in the capital structure of the company.

What is the implication of the equality of cost between debt and equity after tax for the weighted average cost of capital (WACC)? For the purpose of illustration suppose we begin with a company which has no debt. The cost of equity capital for such a company simply reflects the risk and required rate of return for the assets of the company (including its growth opportunities or goodwill). Now let us introduce some debt into the capital structure. The after-tax interest cost of the debt may appear low, but it does not alter the weighted average cost of capital according to the Miller argument. The increased gearing increases the cost of equity (expected dividends and capital gains per pound of equity) just sufficiently to keep the weighted average cost of capital the same as it would have been if there had been no debt financing. In other words the cost of capital reflects only the required rate of return on the company’s underlying operations and does not reflect the particular way those operations may have been financed. The financial community is not giving anything away and does not bless companies with extra debt any more than companies with less debt.

Unless one knows how to alter the cost of equity to reflect the extra cost per pound of equity due to gearing, one cannot calculate the weighted average cost of equity correctly. The purpose of obtaining the WACC is to try to determine a discount rate for an asset that is independent of the particular way the asset might be financed. A more useful way of determining this discount rate was discussed by Tessa Ryder Runton in Chapter 2. The required rate of return is merely the shareholder’s personal rate of interest after tax plus a premium for the systematic risk of the individual asset.

While the existing theory of finance provides little guidance as to the optimum capital structure of a company, many practical guidelines are available to help management maintain a sensible and prudent balance between equity and debt finance. Since borrowing entails legal obligations to pay interest and to repay principal, borrowing incurs a risk of reorganisation or liquidation in the event of default. In an industry characterised by highly variable and uncertain cash flows, borrowing can entail greater financial risk than in less volatile industries. Thus a study of industry debt ratios can provide useful rules of thumb for the capital structure of a company in the same industry. A more sophisticated approach involves the projection of future sources and uses of funds for the company including funds required for dividends, interest and repayment of debt. A sensitivity analysis of sales revenues, costs, working capital and capital investment requirements under alternative scenarios of business conditions can indicate whether conditions are likely to occur which might cause the company to default given a planned level of debt financing. Prudent financial managers keep the burden of interest payments and repayment of loan capital within the bounds of the company’s expected ability to pay under a variety of possible business conditions.

Arrangements for sufficient finance must be provided to ensure not only the continued financial viability of the firm under the most adverse circumstances but also to ensure that all likely options to invest in worthwhile growth can be exercised as profitable opportunities emerge in the course of time.

In Chapter 10 R. L. Mansbridge discusses the methods and importance of financial planning to determine the implications of operational plans, capital investments, acquisitions and divestments on the future financing requirements of the firm. Financial plans based on alternative scenarios of possible future economic conditions and investment opportunities provide the framework within which appropriate financing requirements can be determined. If there are sufficiently likely scenarios of future economic events and opportunities for which the sources of internally generated funds fall short of projected uses, then arrangements are required for external financing to meet the additional cash requirements.

When internal funds from retained earnings, liquidations, and other sources temporarily fall short of requirements, the company’s bankers represent a natural source of short term funds. Overdraft facilities to cover foreseeable short term requirements can readily be agreed in advance if the company has cultivated a continuing close relationship with its bankers. For longer term requirements banks now offer term loan financing up to about ten years, usually at variable rates of interest if the company’s total borrowing does not exceed prudent levels for the industry.

In Chapter 11 Michael Clipsham discusses how to identify the need for bank assistance, methods of presenting a case for finance to a bank,
and the nature of security usually required for bank loans. The chapter also provides a useful rundown of eleven types of finance offered by the commercial banks including, for example, leasing and export financing. The close relationship which a bank can maintain with its corporate customers through a variety of banking services means that banks can provide flexible and easily accessible financing facilities without the high flotations costs which would be associated with the sale of small issues of the company's securities.

An increasingly important form of term debt financing is equipment leasing. Lease financing now accounts for approximately 12 per cent of capital investment in the United Kingdom or about one quarter of new external financing. Since the title to the leased asset remains with the lessor, lease financing makes it possible for tax paying lessors to pass on some of the financial benefits of capital allowances to non-tax-paying lessees in the form of lower rental payments. For companies which have insufficient expected taxable profits to take full advantage of capital allowances, properly structured leases can provide one of the cheapest sources of finance. Colin Young defines in Chapter 12 the precise tax benefits available to certain companies through lease financing and describes methods of structuring leases to maximise these benefits.

If a combination of bank borrowing and lease financing cannot be expected to meet the company's future requirements for funds fully, then a public issue of either debt or equity may be required. Occasionally, a company may wish to make a public issue of debt securities. These may take the form of unsecured Loan stock or of Debentures which are secured on specific assets and therefore rank before unsecured loan stock in terms of entitlement to interest and repayment in liquidation. Interest on most corporate borrowing is allowable for tax, but the market for corporate debt is relatively inactive in the UK. The relative lack of corporate debt issues in the UK is often ascribed to vigorous competition from public sector borrowing, which makes the cost of debt issues relatively high compared to other forms of debt.

Elroy Dimson in Chapter 13 describes the various methods of making a new issue of securities including public issues by prospectus, offer for sale, placings, offer for sale by tender, public issue by tender and a Stock Exchange introduction. Securities other than debt which might be issued are preference shares (often considered as a class of debt with fixed dividend payments but without the benefit of tax deductibility for the dividends), or various classes of equity or ordinary share capital. Finally, warrants can be issued (usually in conjunction with other securities) giving the holder the right to purchase a specified number of ordinary shares from the company at stated prices during specified periods of years.

Next to undistributed income and bank borrowing the largest single source of funds to quoted companies results from the issue to existing shareholders of 'rights' to subscribe to a specified number of additional ordinary shares at a stated price within a limited period of weeks. To help ensure that the issue will be fully subscribed the rights price is fixed below the current market price of the shares. Furthermore underwriters are usually employed, who effectively insure the success of the issue by agreeing to purchase any shares remaining unsold. Since the rights are issued to existing shareholders proportionally to the number of shares already held, existing shareholders can maintain the proportion of ownership that they have in the company simply by exercising their rights. Alternatively they may sell the rights. Paul Marsh in Chapter 14 explains why rights issues do not dilute the value of existing shareholdings, why rights issues rarely fail and how to quantify the insurance benefits that underwriters provide.

Chapter 14 also indicates the likely flotations costs of rights issues including administrative, legal and underwriting costs. These costs undoubtedly explain why companies prefer to use internal sources of funds and bank borrowing when possible, and issue securities almost exclusively to raise large tranches of long term finance.

To summarise, the choice of financing is determined in practice by industry norms, limitations prescribed in a company's Articles of Association, convenience, term of requirement, taxes and flotations costs. The choice, amount and timing of funds raised from various sources must be planned within the context of projected sources and uses, indicating both the needs for funds and the ability to pay the cash costs of funds under various possible future business conditions. The chapters in Part Four provide a comprehensive review of the main external sources of funds available to companies in the UK.

REFERENCES

OVERVIEW

A company must be aware of the financial environment in which it operates. This environment consists of its shareholders and bankers, the tax and regulatory authorities and other companies.

Shareholders and bankers supply capital, and the company needs to maintain good relationships with them to ensure an adequate flow of investment funds. Maintaining these relationships entails publishing relevant up-to-date information so that investors can value their company, decide whether to subscribe new funds and monitor the use of assets.

The ultimate sanction that the capital market can apply is a company takeover and the replacement of senior management. Thus, mergers and acquisitions form important aspects of the financial environment, both for companies seeking to grow by this method and for those wishing to avoid being taken over.

The tax regime under which the company operates has a large impact on the cash flows resulting from financial decisions. Effective use of the tax laws to minimise the cash drain on the company requires that the tax impact of all decisions be understood and incorporated into the decision-making process.

These three aspects of the financial environment: presentation of information in accounts, mergers and taxation are covered by this section. Chapter 15 by George Thomson explains the regulations concerning disclosure in company accounts. These requirements form the basis for external financial reporting, but there may be good reason to disclose more than the minimum required. The kinds of extra information that are likely to prove most helpful, and the agreements
for providing such details are explored and explained. So is the recent requirement to present inflation-adjusted accounting information, which is the major change in this area in recent years.

Since investors use company accounts for three major purposes: valuation, portfolio decisions, and monitoring asset use, the information provided must be appropriate to these ends. Valuation and portfolio decisions require more than just raw accounting information. Somehow, information on the company's position in its product markets, strategic plans and operating performance, has to be communicated, in addition to the dry numerical data.

This additional requirement is achieved by a mixture of formal and informal contacts with the investment community, of which the published accounts are merely the tip of the iceberg. Given the high cost of raising funds when relationships with investors are poor, and the threat of takeover if the situation deteriorates too much, effort spent on keeping investors informed is an important part of good financial management.

Although investors can refuse to provide companies with new funds when asked, many concerns manage to operate for long periods of time by using retained earnings and not making rights issues. Such companies are not immune to external financial markets, however, since their share prices may fall to such a level that it becomes attractive for another company to purchase a majority of the shares and gain control of the assets. The other side of this coin is that a company with a very high share rating resulting from able management can gain control of more assets by merger or acquisition.

In Chapter 16 Julian Franks analyses in detail the various motivations that are put forward for mergers and acquisitions: managerial skills, economies of scale, new product opportunities and valuation differences. In addition to these operational motivations, several purely financial incentives are sometimes suggested. Dr Franks shows that some of these may not be such powerful reasons for merging as is often stated. In particular, diversification through merger is not likely to benefit shareholders much, since they can diversify their own portfolios.

Even when there is a legitimate reason for merging, care must be taken that the premium paid does not exceed the synergistic benefits of the merger. Dr. Franks describes the various techniques that are applied in analysing acquisition opportunities. Finally, he examines the profitability record of past mergers, to indicate whether they have achieved the expected gains, and, if so, how these gains have been split between acquirors and acquirees.

The final chapter of Part Five, Chapter 17, by Raymond Ashton, covers the taxation of corporations in the UK. Almost all financial decisions have an impact on the amount of tax paid, and this must be included in the financial evaluation of the decisions. For instance, the hundred per cent initial allowance on certain kinds of industrial capital expenditure means that profitable companies reduce their effective initial cost to only 48 per cent of the cost of these assets. The other 52 per cent comes from a reduction in the corporation tax payment for that year. Similarly, the tax deductability of interest payments means that the value of projects that are financed partially by debt is increased by the value of this tax saving as discussed in Chapter 2.

Clearly, an understanding of the way that corporations are taxed is essential to good financial management. Dr. Ashton describes in detail the way that the tax system operates with respect to corporations. The most important aspect is the definition and taxation of corporate income, including the effects of allowances, grants and charges on income. Part of this corporation tax liability is offset by Advance Corporation Tax on dividends and this is also explained in detail.

The UK corporate tax system involves delays in payments which depend on the year end of the company concerned. Such delays are very valuable when interest rates are high, and Dr. Ashton shows how to work out the timing of the payments. Finally, he describes three additional features of the corporate tax system which can have a major impact on some companies; overseas tax, stock relief and value added tax.

Many corporations do not pay corporation tax, and it might be argued that such companies can ignore the tax impact of their decisions. This is fallacious, since companies which have unused tax losses are wasting opportunities to save money. The most common ways of taking advantage of unused tax losses are merging with or acquiring a profit-making company, sale and leaseback of assets from profit-making companies, or reduction of interest payments through retiring debt.

In these and other ways, understanding the financial environment is crucial to good financial decisions. These three aspects: taxation, mergers and financial reporting cover relationships with the tax authorities and the financial markets, the two most important external financial influences on companies. Mismanagement in these areas can
be hazardous to the separate existence of a company, but good external relations ensure a continued flow of capital to support the growth and development of a soundly based and progressive organisation.