

A blue-tinted photograph of a city skyline with various skyscrapers, reflected in a body of water. The text 'PART 1' is overlaid on the right side of the image.

PART 1

Corporate finance

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Introduction to Part I

Part I of this book is about corporate finance, which is concerned with the effective use of financial resources in creating corporate value. It looks at the financial environment in which businesses operate, their financial aims and objectives, and includes a wide range of strategic financial management techniques related to financial decision-making. These include, for example, capital investment, capital structure, working capital, the management of financial risk, financial planning, and international operations and investment. It also considers the ways in which compliance with various corporate governance guidelines broadly support the achievement of business objectives in determining the responsibilities and accountability of company directors and their relationships with shareholders and other stakeholders.

In Chapter 1, Fig. 1.1 provides the framework of strategic corporate finance on which this book is based. The topics included in each of the shaded areas in Fig. 1.1 are covered in Chapters 1 to 12, except for financial strategy, which is covered in Chapters 13 to 18 in Part II of this book.

Part I is concerned primarily with the creation of corporate value and its translation into shareholder value. Part II of this book is about the use of appropriate financial strategies, as distinct from business strategies. This looks at what companies may do to ensure not only the creation of corporate value, but also that the performance of the business is reflected in the maximisation of shareholder value. Companies may do all the right things in terms of creating value from investments in value-creating projects. However, if this performance is not translated into and reflected in optimal shareholder value through dividend growth and an increasing share price then the primary objective of the business – maximisation of shareholder wealth – is not being achieved.

The providers of the capital for a business, its shareholders and lenders, require appropriate returns on their investments from dividends, interest, and share price increases, commensurate with the levels of risk they are prepared to accept associated with the type of businesses and industrial sectors in which they invest. The directors or managers of a company have the responsibility for pursuit of the objective of shareholder wealth maximisation. Faced with different types and levels of risk at each stage in a company's development, directors' responsibilities include therefore not only ensuring that value is added to the business, that is corporate value, through making 'real' investments in projects that return the highest possible positive net present values of cash flows, but also ensuring that appropriate financial strategies are adopted that reflect this in the value created for shareholders, that is shareholder wealth.

These 'real' investment types of decision and their financing are dealt with in Part I. Part II looks at how companies are exposed to varying levels of financial risk at each of the different stages in their development, and in response to these how they may apply the techniques dealt with in Part I. Part II also considers how the creation of corporate value by companies at each stage of their development may then be reflected in increased shareholder value through the use of appropriate financial strategies and exploitation of market imperfections. We will explore how different financial strategies may apply at different stages in the development of a company.

Shareholder value is provided in two ways, from increases in the price of shares and the payment of dividends on those shares. In Part II we look at the ways in which strategic financial decisions may be made relating to the levels of:

- investment in the assets of the business, and the types of assets
- most appropriate methods of funding – debt or equity
- profit retention
- profit distribution
- gearing, or capital structure of the business,

with the aim of maximisation of shareholder wealth through creation of shareholder value consistent with levels of perceived risk and returns required by investors and lenders.

To provide a framework for Part II in which to consider these decisions we will use a simplified, theoretical 'business life cycle' model, the BLC, which describes the stages through which businesses may typically progress from their initial start-up through to their ultimate decline and possible demise. The financial parameters particular to each stage of this simplified business life cycle will be identified and appropriate financial strategies will be discussed that may be used to exploit the specific circumstances in order to create shareholder value.

Chapter 1 looks at the financial environment in which businesses operate and their financial aims and objectives. This chapter provides the framework of strategic corporate finance on which this book is based.

Chapter 2 considers the objectives of businesses. Businesses raise money from shareholders and lenders to invest in assets, which are used to increase the wealth of the business and its owners. The underlying fundamental economic objective of a company is to maximise shareholder wealth.

In Chapter 3 we provide an introduction to corporate governance, a topic that is becoming increasingly important, as the responsibilities of directors continue to increase. We look at the ways in which compliance with the various corporate governance guidelines broadly support the achievement of the aims and objectives of companies in determining the responsibilities and accountability of company directors and their relationships with shareholders and other stakeholders. The burden lies with management to run businesses in strict compliance with statutory, regulatory, and accounting requirements, so it is crucial that directors are aware of the rules and codes of practice that are in place to regulate the behaviour of directors of limited companies.

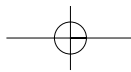
Chapter 4 considers how businesses make decisions about potential investments that may be made, in order to ensure that the wealth of the business will be increased. This is an important area of decision-making that usually involves a great deal of money and relatively long-term commitments. It therefore requires appropriate techniques to ensure that the financial objectives of the company are in line with the interests of the shareholders.

Chapter 5 examines the relationship between risk and return and how diversification may be used to mitigate and reduce risk. It considers the impact of diversification and looks at the portfolio theory developed by Markowitz.

Chapter 6 considers the way in which a company's average cost of capital may be determined from the costs of its various types of capital financing. The average cost of a company's capital is an important factor in determining the value of a business. In theory the minimisation of the combined cost of equity, debt, and retained earnings used by a company to finance its business should increase its value. The average cost of a company's capital may also be used as the discount rate with which to evaluate proposed investments in new capital projects. Chapter 6 considers whether an optimal capital structure is of fundamental importance to its average cost of capital and looks at the various approaches taken to determine this.

Chapter 7 deals primarily with long-term, external sources of business finance for investment in businesses. This relates to the various types of funding available to a business, including the raising of funds from the owners of the business (the shareholders) and from lenders external to the business. Chapter 7 closes with an introduction to the fast-growing area of Islamic banking and Islamic finance.

Chapter 8 is headed *Financial analysis*. The three main financial statements provide information about business performance. Much more may be gleaned about the performance of the business through further analysis of the financial statements, using financial ratios and other techniques, for example trend analysis, industrial and inter-company analysis. Chapter 8 looks at the analysis and interpretation of the published accounts of a business. It uses the Report and Accounts for the year ended 31 March 2007 of Johnson Matthey plc to illustrate the type of financial and non-financial information provided by a major UK public company. The chapter closes with a look at some of the measures that approximate to cash flow, for example earnings before interest, tax, depreciation, and amortisation (EBITDA), and economic value added (EVA), that may be used to evaluate company performance.

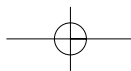
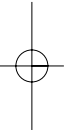


Chapter 9 deals with the way in which businesses, as part of their strategic management process, translate their long-term objectives into financial plans. This chapter includes consideration of the role of forecasting, financial modelling, and planning for growth.

In Chapter 10 we look at one of the sources of finance internal to a business, its working capital, and the impact that its effective management has on cash flow, profitability, and return on capital. Working capital comprises the short-term assets of the business, stocks (or inventory), trade debtors, and cash and claims on the business, trade creditors. This chapter deals with how these important items may be more effectively managed.

We are now living in a global economy in which businesses trade internationally and also may exist in a number of countries. In Chapter 11 the implications of internationalisation are discussed with regard to companies' involvement in overseas operations, directly and indirectly, and considers the appraisal and financing of international investments.

Chapter 12 looks at financial risk faced by businesses resulting from the variation in interest rates, and currency exchange rates, from one period to another. We consider the different ways in which these risks may be approached by companies, and the techniques that may be used to manage such risks. Finally, the use of derivatives is discussed together with examples of their use by companies (and their misuse, which we have seen over the past ten years or so).



Chapter

1

The financial environment

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LEARNING OBJECTIVES



Completion of this chapter will enable you to:

- ✓ Outline the framework of corporate finance and its link with financial strategy.
- ✓ Illustrate the different types of business entity: sole traders, partnerships, private limited companies, public limited companies.
- ✓ Explain the role of the finance function within a business organisational structure.

- ▶ Explain the nature and purpose of financial statements.
- Consider the issues of accountability and financial reporting.
- Describe what is meant by accounting and corporate finance.
- Outline how the corporate finance function is managed to meet business objectives.
- Explain the underlying principles of corporate finance.

Introduction

This chapter explains why finance is such a key element of business life. For aspiring finance directors, finance managers, and accountants, and those of you who may not continue to study finance and accounting, the underlying principles of finance are important topics. A broad appreciation will be useful not only in dealing with the subsequent text, but also in the context of the day-to-day management of a business.

The chapter begins by explaining how the discipline of corporate finance was established and developed. It provides the framework on which each of the subsequent chapters is based. It also explains the links between corporate finance and strategy, and how the financial models and techniques covered in the first part of the book are used in the adoption of appropriate financial strategies by companies at different stages in their development.

The owners or shareholders of the range of business entities may be assumed to have the primary objective of maximisation of their wealth. Directors of the business manage the resources of the business to meet shareholders' objectives. Directors and managers are responsible for running businesses, and their accountability to shareholders is maintained through their regular reporting on the activities of the business.

The finance function plays a crucially important part in all organisations. Its responsibilities include both accounting and corporate finance, the latter relating to the management and control of the financial resources at its disposal. The effective management of corporate finance is essential in ensuring that the business meets its prime objective of maximisation of shareholder wealth. This chapter closes by introducing the fundamental concepts and principles of corporate finance.

A large number of financial terms are used throughout this book, the definitions of which may be found in the glossaries of key terms at the end of each chapter.

Corporate finance and financial strategy

The business environment comprises companies that have just started up or are in various stages of their development. Each has its own reason for being in business and each has its own financing requirements. In the early part of the 20th century when new industries and technologies were emerging there was a growing requirement for new financing, particularly from external sources. This requirement saw increasing interest in various types of securities, particularly equity shares, and also led to the establishment of finance as a discipline separate from economics, in which it had its origins.

The growth in equity shareholdings increased (and continued to increase up to the present day) but confidence was drastically dented during the economic depression and as a result of

the financial scandals of the 1930s. As bankruptcy became a real possibility more attention began to be focused on companies' liquidity and financial structure, and there was a need for increased disclosure of financial information and its analysis. The 1940s saw an increase in financial analysis of cash flow, planning, and methods of control. In the 1950s capital budgeting emerged together with the financial management of assets, and an awareness of how financial decision-making impacted on the value of businesses. This all led to the establishment of the discipline of corporate finance in the early 1960s supported by the publication of a number of academic papers on topics such as the capital markets, and share prices, which had previously been considered only in the areas of economics and statistics.

Corporate finance continues to be developed from its beginnings at the start of the 20th century, as do the techniques used in the management of corporate finance, and with an increasing emphasis on international aspects of trade, investment and financing. This book covers all the main areas of corporate finance and its management (financial management).

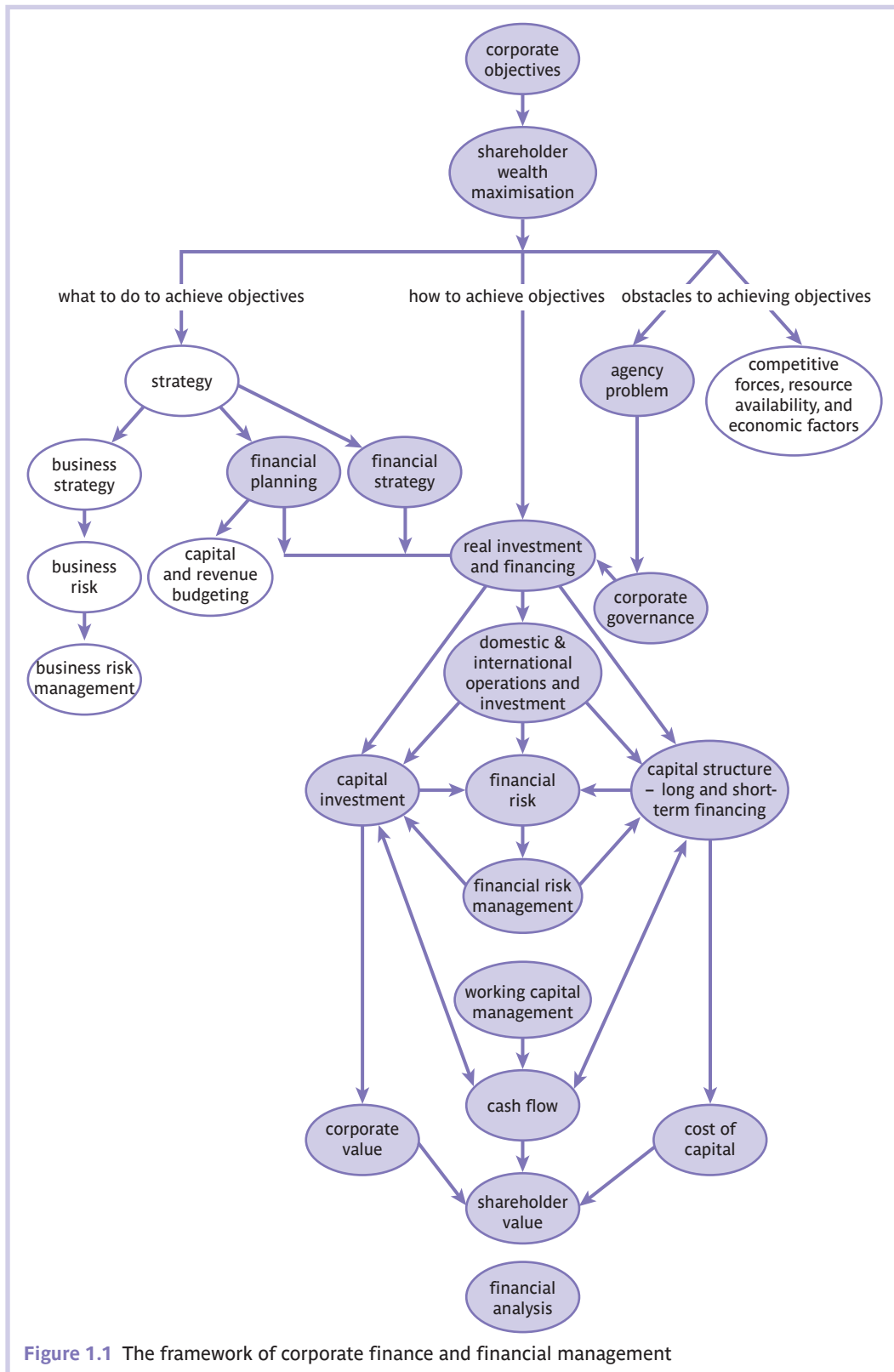
Let's consider each of the elements of the chart in Fig. 1.1, which provides the framework on which this book is based. It is not strictly a flow chart but contains the topics, roles, and techniques covered in this book (and the relationships between them), which are represented by the elements of the chart that are shaded.

Corporate objectives (see Chapter 2) are formulated by a business, in alignment with its underlying mission and company policy, and may include for example profit maximisation, or market share maximisation. Its mission is the company's general sense of purpose or underlying belief. Its policy is a long-lasting, usually unquantified, statement of guidance about the way in which the company seeks to behave in relation to its stakeholders. A company normally has social and environmental responsibilities, responsibilities to its employees, and responsibilities to all its other stakeholders. However, this should not be inconsistent with its primary responsibility to its shareholders. We are assuming that the aim of a business is to add value for its shareholders with the primary objective of maximising shareholder wealth. Shareholder wealth comprises the dividends paid to shareholders on the shares they hold, and the gains achieved from the increase in the market price of their shares.

The directors of a business are appointed by the shareholders to manage the business on their behalf. The directors are responsible for developing appropriate strategies that determine *what* the company is going to do to achieve its objectives, with the primary aim of maximising shareholder wealth. A strategy is a course of action that includes a specification of resources required to achieve a specific objective; it is *what* the company needs to do long term to achieve its objectives, but it does not include *how* to achieve them.

A company's strategy includes its business strategy, which establishes the type of business, its location, its products and services, its markets, its use of resources, and its growth objectives. These areas are assessed with regard to the risks associated with them for which appropriate risk management techniques may be put in place. The company's business strategy is quantified for the long term (typically three years, five years, or ten years) through its financial planning function (see Chapter 9). The short term is quantified in the company's six-monthly or yearly budgets.

A company's strategy also includes financial strategy. This book links corporate finance and financial management with financial strategy. Chapters 1 to 12 discuss the various aspects, models, and hypotheses relating to the discipline of corporate finance, and the techniques and methods used in the financial management of a business. Chapters 13 to 18 deal with the various stages in the development of a business from its initial start-up, each chapter considering the most appropriate financial strategies that may be adopted by companies, with regard to their current stage of development. 'Most appropriate financial strategies' means those financial



strategies that result in the optimisation of the value of the business, with the aim of maximising shareholder wealth. An example of such a strategy is a company that may buy insurance to cover the risks relating to the achievement of its commercial objectives. The cost of the insurance premiums means that the short-term profits of the company are reduced, but the long-term value of the business to the shareholders will be increased because of the removal of uncertainty about the company's future earnings.

At the heart of corporate finance is *how* the company will achieve its objectives, and specifically its financial objective of maximisation of shareholder wealth. The first part of this relates to the allocation and use of financial resources for real capital investment (see Chapter 4) in, for example, new product development, land and buildings, and plant and equipment (as distinct from the popular meaning of investment in securities, stocks, and shares). The second part relates to the financing of such investments, which may be internal to the company from the retained earnings of the business or from improvements in its management of working capital (see Chapter 10) or from external financing. External financing broadly comprises loans and equity share capital provided to companies by investors and which may be acquired and traded in capital markets like, for example, the London Stock Exchange (see Chapter 7).

Capital investments may be made by companies in their own domestic countries, but companies are also now becoming increasingly involved in international operations and investment (see Chapter 11), and international financing (see Chapter 7). Domestic and international investment, and domestic and international financing all face various types of risk (see Chapter 5), including financial risk, the management of which is discussed in Chapter 12.

If good decisions are made by a company's managers and directors, which result in value-adding investments then corporate value will be increased and reflected in increased cash flow. It is crucially important to appreciate that it is cash flow (in real terms) and not profits, which reflects the true value of a business. If good decisions are made with regard to financing then the capital structure of the company will result in the cost of capital of the company being at a level that will also enhance its corporate value (see Chapter 6). However, an increase in corporate value may not necessarily result in an increase in shareholder value. That will depend partly on how much of the cash flow that has been generated is used to pay out dividends (or retained for future investment), and partly in the increase (or not) in the share price. The share price will depend on the market's perception of the financial health of the business, and the demand for and level of trading in the company's shares. The analysis of the financial performance and the financial position of a business is considered in Chapter 8.

In theory, the creation of value through adoption of appropriate strategies, and making the right decisions, looks simple and straightforward. In practice, there are of course many obstacles in the way to prevent a company from achieving its objectives. There are competitive forces in most markets from existing companies, from new entrants to the market, and from substitute and alternative products and services. There may be pressures on revenues, costs, and profitability from powerful customers or groups of customers who may demand lower selling prices, or higher levels of quality or service for the same price. There may be pressures on costs and profitability from suppliers or groups of suppliers who may increase prices or control the supply of materials, components, or services. There may be constraints in terms of market demand, availability of materials and people, knowledge, technology, legislation, taxation, import tariffs, social and environmental responsibilities, and media and political pressure.

In addition to the predominantly external obstacles to achieving corporate objectives outlined above, there may also be a major internal obstacle, which is called the agency problem (see Chapter 2). As we have said, the shareholders appoint the directors to manage the company on

their behalf. The primary role of the directors is to make decisions and manage the business consistent with the objective of maximisation of shareholder wealth. The agency problem is concerned mainly with situations in which there is a lack of goal congruence between the directors and shareholders of a company, and the decisions of the directors are not aligned with the requirements of the shareholders. The most serious examples of this have been seen in the numerous cases of fraud and corporate excesses over the past 20 years, which have been extensively reported in the financial press. In the UK, the USA, and many other countries throughout the world the concern about financial reporting and accountability and the effect of such financial scandals resulted in the development of various codes of corporate governance (see Chapter 3). Corporate governance is broadly the system by which companies are directed and controlled, and how directors report on the activities and progress of companies to their shareholders.

In the section above we have been talking about businesses and companies in general with regard to corporate finance and financial strategy. Many of the financial techniques covered in this book relate primarily, although not exclusively, to medium-sized and large limited companies. However, it is useful to consider all the various types of business entity that exist and exactly what we mean by a **private limited company (Ltd)** and a **public limited company (plc)**, which is all discussed in the next section.

Types of business entity

Business entities are involved either in manufacturing (for example, food and automotive components) or in providing services (for example, retailing, hospitals, or television broadcasting). Such entities include profit-making and not-for-profit organisations, and charities. The main types of entity and the environments in which they operate are represented in Fig. 1.2. The four main types of profit-making organisations are explained in the sections that follow.

The variety of business entities can be seen to range from quangos (quasi-autonomous non-government organisations) to partnerships to limited companies.

Sole traders

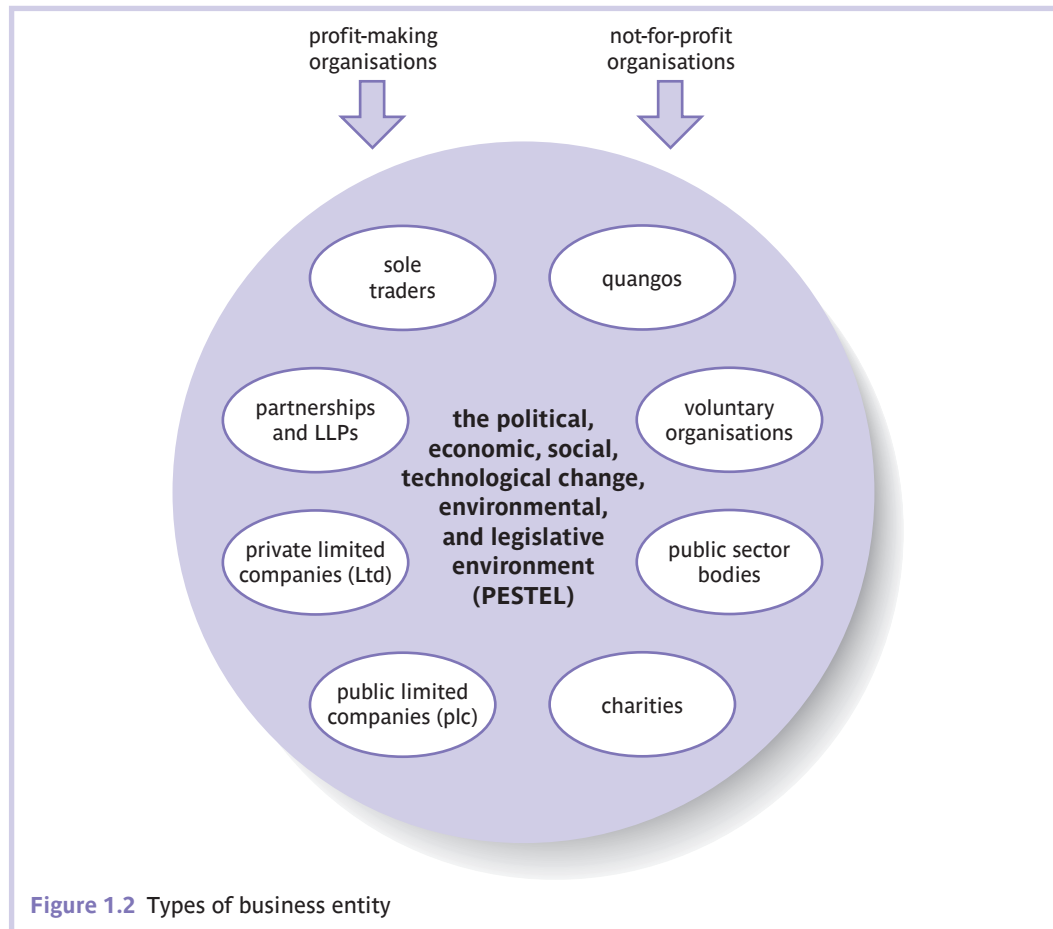
A sole trader entity is applicable for most types of small business. It is owned and financed by one individual, who receives all the profit made by the business, even though more than one person may work in the business.

The individual sole trader has complete flexibility regarding:

- the type of (legal) activities in which the business may be engaged
- when to start up or cease the business
- the way in which business is conducted.

The individual sole trader also has responsibility for:

- financing the business
- risk-taking
- decision-making
- employing staff
- any debts or loans that the business may have (the responsibility for which is unlimited, and cases of financial difficulty may result in personal property being used to repay debts).



A sole trader business is simple and cheap to set up. There are no legal or administrative set-up costs as the business does not have to be registered since it is not a legal entity separate from its owner. As we shall see, this is unlike the legal position of owners, or shareholders, of limited companies who are recognised as separate legal entities from the businesses they own.

Accounting records are needed to be kept by sole traders for the day-to-day management of the business and to provide an account of profit made during each tax year. Unlike limited companies, sole traders are not required to file a formal report and accounts each year with the **Registrar of Companies**. However, sole traders must prepare accounts on an annual basis to provide the appropriate financial information for inclusion in their annual tax return for submission to HMRC (Her Majesty's Revenue and Customs).

Sole traders normally remain quite small businesses, which may be seen as a disadvantage. The breadth of business skills is likely to be lacking since there are no co-owners with which to share the management and development of the business.

Partnerships

Partnerships are similar to sole traders except that the ownership of the business is in the hands of two or more persons. The main differences are in respect of how much money each of the partners puts into the business, who is responsible for what, and how the profits are to be

shared. These factors are normally set out in formal partnership agreements, and if the partnership agreement is not specific then the provisions of the Partnership Act 1890 apply. There is usually a written partnership agreement (but this is not absolutely necessary) and so there are initial legal costs of setting up the business.

A partnership is called a firm and is usually a small business, although there are some very large partnerships, for example firms of accountants like PriceWaterhouseCoopers, and the retailer John Lewis. Partnerships are formed by two or more persons and, apart from certain professions like accountants, architects, and solicitors, the number of persons in a partnership is limited to 20.

A partnership:

- can carry out any legal activities agreed by all the partners
- is not a legal entity separate from its partners.

The partners in a firm:

- can all be involved in running the business
- all share the profits made by the firm
- are all jointly and severally liable for the debts of the firm
- all have unlimited liability for the debts of the firm (and cases of financial difficulty may result in personal property being used to repay debts)
- are each liable for the actions of the other partners.

Accounting records are needed to be kept by partnerships for the day-to-day management of the business and to provide an account of profit made during each tax year. Unlike limited companies, partnership firms are not required to file a formal report and accounts each year with the Registrar of Companies, but partners must submit annual returns for tax purposes to HMRC.

A new type of legal entity was established in 2001, the limited liability partnership (LLP). This is a variation on the traditional partnership, and has a separate legal identity from the partners, which therefore protects them from personal bankruptcy.

One of the main benefits of a partnership is that derived from its broader base of business skills than that of a sole trader. A partnership is also able to share risk-taking, decision-making, and the general management of the firm.

Limited companies

A limited company is a legal entity separate from the owners of the business, which may enter into contracts, own property, and take or receive legal action. The owners limit their obligations to the amount of finance they have put into the company by way of the share of the company they have paid for. Normally, the maximum that may be claimed from shareholders is no more than they have paid for their shares, regardless of what happens to the company. Equally, there is no certainty that shareholders may recover their original investment if they wish to dispose of their shares or if the business is wound up, for whatever reason.

A company with unlimited liability does not give the owners, or members, of the company the protection of limited liability. If the business were to fail, the members would be liable, without limitation, for all the debts of the business.

A further class of company is a company limited by guarantee, which is normally incorporated for non-profit-making functions. The company has no share capital and has members

rather than shareholders. The members of the company guarantee to contribute a predetermined sum to the liabilities of the company, which becomes due in the event of the company being wound up.

The legal requirements relating to the registration and operation of limited companies is contained within the Companies Act 1985 as amended by the Companies Act 1989. Limited companies are required to be registered with the Registrar of Companies as either a private limited company (Ltd) or a public limited company (plc).

Private limited companies (Ltd)

Private limited companies are designated as Ltd. There are legal formalities involved in setting up a Ltd company which result in costs for the company. These formalities include the drafting of the company's Memorandum and Articles of Association (M and A) that describe what the company is and what it is allowed to do, registering the company and its director(s) with the Registrar of Companies, and registering the name of the company.

The shareholders provide the financing of the business in the form of share capital, of which there is no minimum requirement, and are therefore the owners of the business. The shareholders must appoint at least one director of the company, who may also be the company secretary, who carries out the day-to-day management of the business. A Ltd company may only carry out the activities included in its M and A.

Ltd companies must regularly produce annual accounts for their shareholders and file a copy with the Registrar of Companies, and therefore the general public may have access to this information. A Ltd company's accounts must be audited by a suitably **qualified accountant**, unless it is exempt from this requirement, currently (with effect from 30 March 2004) by having annual sales of less than £5.6m and a **balance sheet** total of less than £2.8m. The exemption is not compulsory and having no audit may be a disadvantage: banks, financial institutions, customers, and suppliers may rely on information from Companies House to assess credit-worthiness and they are usually reassured by an independent audit. Ltd companies must also provide copies of their annual accounts to HMRC and also generally provide a separate computation of their profit on which corporation tax is payable. The accounting profit of a Ltd company is adjusted for:

- various expenses that may not be allowable in computing taxable profit
- tax allowances that may be deducted in computing taxable profit.

Limited companies tend to be family businesses and smaller businesses with the ownership split among a few shareholders, although there have been many examples of very large private limited companies. The shares of Ltd companies may be bought and sold but they may not be offered for sale to the general public. Since ownership is usually with family and friends there is rarely a ready market for the shares and so their sale usually requires a valuation of the business.

Progress check 1.1

Which features of a limited company are similar to those of a sole trader?

Public limited companies (plc)



Public limited companies are designated as plc. A plc usually starts its life as a Ltd company and then becomes a public limited company by applying for registration as a plc and a listing of its shares on the Stock Exchange or the **Alternative Investment Market (AIM)**, and making a public offer for sale of shares in the company. Plcs must have a minimum issued share capital of (currently) £50,000. The offer for sale, dealt with by a financial institution and the company's legal representatives, is very costly. The formalities also include the redrafting of the company's M and A, reflecting its status as a plc, registering the company and its director(s) with the Registrar of Companies, and registering the name of the plc.

The shareholders must appoint at least two directors of the company, who carry out the day-to-day management of the business, and a suitably qualified company secretary to ensure the plc's compliance with company law. A plc may only carry out the activities included in its M and A.

Plcs must regularly produce annual accounts, a copy of which they must send to all their shareholders. They must also file a copy with the Registrar of Companies, and therefore the general public may have access to this information. The larger plcs usually provide printed glossy annual reports and accounts which they distribute to their shareholders and other interested parties. A plc's accounts must be audited by a suitably qualified accountant, unless it is exempt from this requirement by (currently) having annual sales of less than £5.6m and a balance sheet total of less than £2.8m. The same drawback applies to having no audit as applies with a Ltd company. Plcs must also provide copies of their annual accounts to HMRC and also generally provide a separate computation of their profit on which corporation tax is payable. The accounting profit of a plc is adjusted for:

- various expenses that may not be allowable in computing taxable profit
- tax allowances that may be deducted in computing taxable profit.

The shareholders provide the financing of the plc in the form of share capital and are therefore the owners of the business. The ownership of a plc can therefore be seen to be spread amongst many shareholders (individuals and institutions like insurance companies and pension funds), and the shares may be freely traded and bought and sold by the general public.

Progress check 1.2

What are the different types of business entity? Can you think of some examples of each?

Worked Example 1.1

Ike Andoowit is in the process of planning the setting up of a new residential training centre. Ike has discussed with a number of his friends the question of registering the business as a limited company, or being a sole trader. Most of Ike's friends have highlighted the advantages of limiting his liability to the original share capital that he would need to put into the company to

finance the business. Ike feels a bit uneasy about the whole question and decides to obtain the advice of a professional accountant to find out:

- (i) the main disadvantages of setting up a limited company as opposed to a sole trader
- (ii) if Ike's friends are correct about the advantage of limiting one's liability
- (iii) what other advantages there are to registering the business as a limited company.

The accountant may answer Ike's questions as follows:

Setting up as a sole trader is a lot simpler and easier than setting up a limited company. A limited company is bound by the provisions of the Companies Act 1985 as amended by the Companies Act 1989, and, for example, is required to have an independent annual audit. A limited company is required to be much more open about its affairs.

The financial structure of a limited company is more complicated than that of a sole trader. There are also additional costs involved in the setting up, and in the administrative functions of a limited company.

Running a business as a limited company requires registration of the business with the Registrar of Companies.

As Ike's friends have pointed out, the financial obligations of a shareholder in a limited company are generally restricted to the amount he/she has paid for his/her shares. In addition, the number of shareholders is potentially unlimited, which widens the scope for raising additional capital.

It should also be noted that:

- a limited company is restricted in its choice of business name
- if its annual sales exceed £1m, a limited company is required to hold an annual general meeting (AGM)
- any additional finance provided for a company by a bank is likely to require a personal guarantee from one or more shareholders.

Progress check 1.3

There are some differences between those businesses that have been established as sole traders and those established as partnerships, and there are also differences between private limited companies and public limited companies. What are these differences, and what are the similarities?

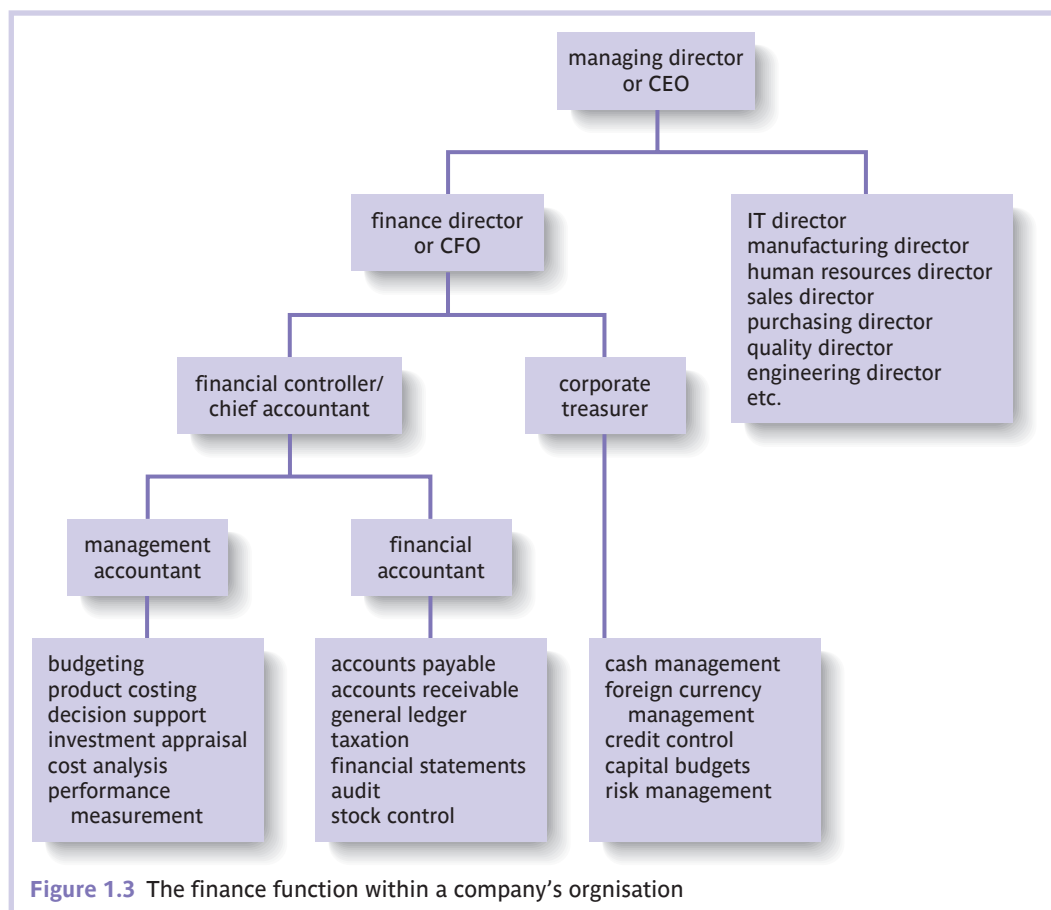
Throughout this book, when we talk about companies we are generally referring to limited companies, as distinct from sole traders and partnerships (or firms – although this term is frequently wrongly used to refer to companies). As we have discussed, limited liability companies have an identity separate from their owners, the shareholders, and the liability of shareholders is limited to the amount of money they have invested in the company, that is their shares in the company.

Ownership of a business is separated from its stewardship, or management, by the shareholders' assignment to a board of directors the responsibility for running the company. The directors of the company are accountable to the shareholders, and both parties must play their part in making that accountability effective.

Business organisational structures

The board of directors of a limited company includes a managing director (or CEO – chief executive officer), and a number of functional executive directors and may include one or more professionally qualified accountants, one of which may be the finance director. The directors of the company necessarily delegate to middle managers and junior managers the responsibility for the day-to-day management of the business. It is certainly likely that this body of managers, who report to the board of directors, will include a further one or more qualified accountants responsible for managing the finance function.

The traditional structure of the finance function in a medium to large sized company (see Fig. 1.3) splits responsibilities broadly between accounting and finance, both being the responsibility of the finance director (or CFO – chief financial officer). Accounting is managed by the financial controller (or chief accountant), and cash and corporate finance may be managed by a corporate treasurer (or financial manager), and they both report to the finance director. Historically, the IT function (information technology or data processing) has also been the responsibility of the finance director in the majority of companies. This is because the accounting function was the first major user of computers for payroll and then accounting ledgers, financial reporting, budgeting, financial information, etc. In most large companies the IT function, including communications generally, has become a separate responsibility under an IT



director. In the same way, the responsibility for the payroll function has moved away from the finance function to being the responsibility of the HR (human resources) director.

Accounting

The original, basic purposes of **accounting** were to classify and record monetary transactions and present the financial results of the activities of an entity, in other words the scorecard that shows how the business is doing. As the business and economic environment has become more complex the accounting profession has evolved, and accounting techniques have been developed for use in a much broader business context. To look at the current nature of accounting and the broad purposes of accounting systems we need to consider the three questions these days generally answered by accounting information:

- how are we doing, and are we doing well or badly? **a scorecard (like scoring a game of cricket, for example)**
- which problems should be looked at? **attention-directing**
- which is the best alternative for doing a job? **problem solving**

Although accountants and the accounting profession have retained their fundamental roles they have grown into various branches of the profession, which have developed their own specialisms and responsibilities.

The accounting system is a part of the information system within an organisation. Accounting also exists as a service function, which ensures that the financial information that is presented meets the needs of the users of financial information. To achieve this, accountants must not only ensure that information is accurate, reliable and timely, but also that it is relevant for the purpose for which it is being provided, consistent for comparability, and easily understood (see Fig. 1.4).

In order to be useful to the users of financial information, the accounting data from which it is prepared, together with its analysis and presentation, must be:

- accurate – free from error of content or principle
- reliable – representing the information that users believe it represents
- timely – available in time to support decision-making
- relevant – applicable to the purpose required, for example a decision regarding a future event or to support an explanation of what has already happened
- consistent – the same methods and standards of measurement of data and presentation of information to allow like-for-like comparison
- clear – capable of being understood by those for whom the information has been prepared.

Progress check 1.4

What are the main purposes of accounting?

The provision of a great deal of financial information is mandatory; it is needed to comply with, for example, the requirements of Acts of Parliament and HMRC. However, there is a cost of

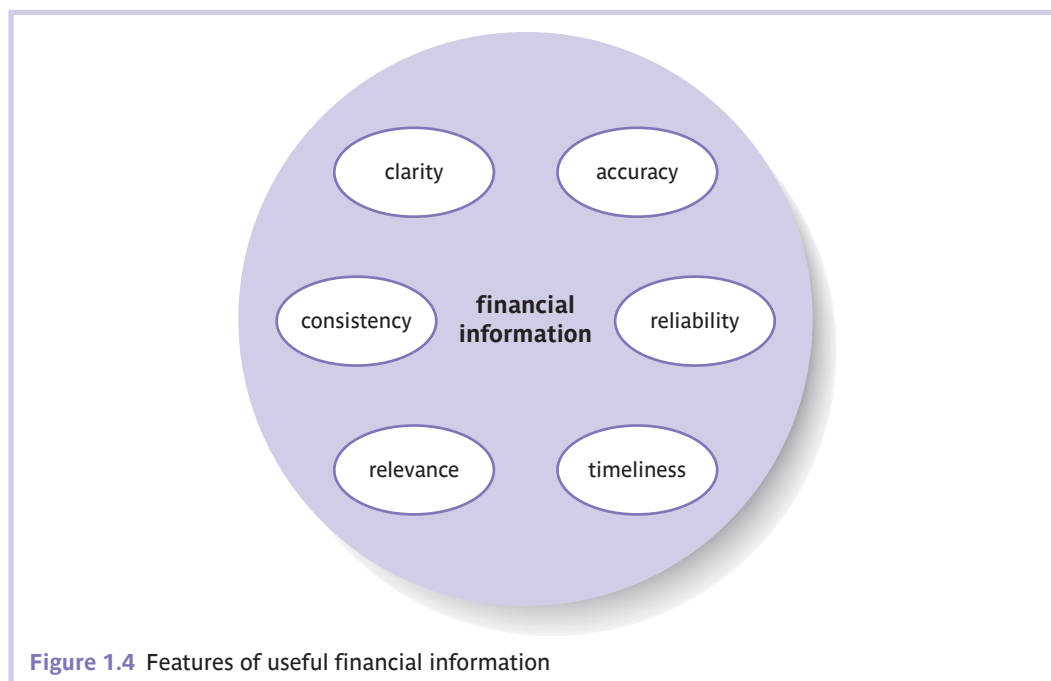


Figure 1.4 Features of useful financial information

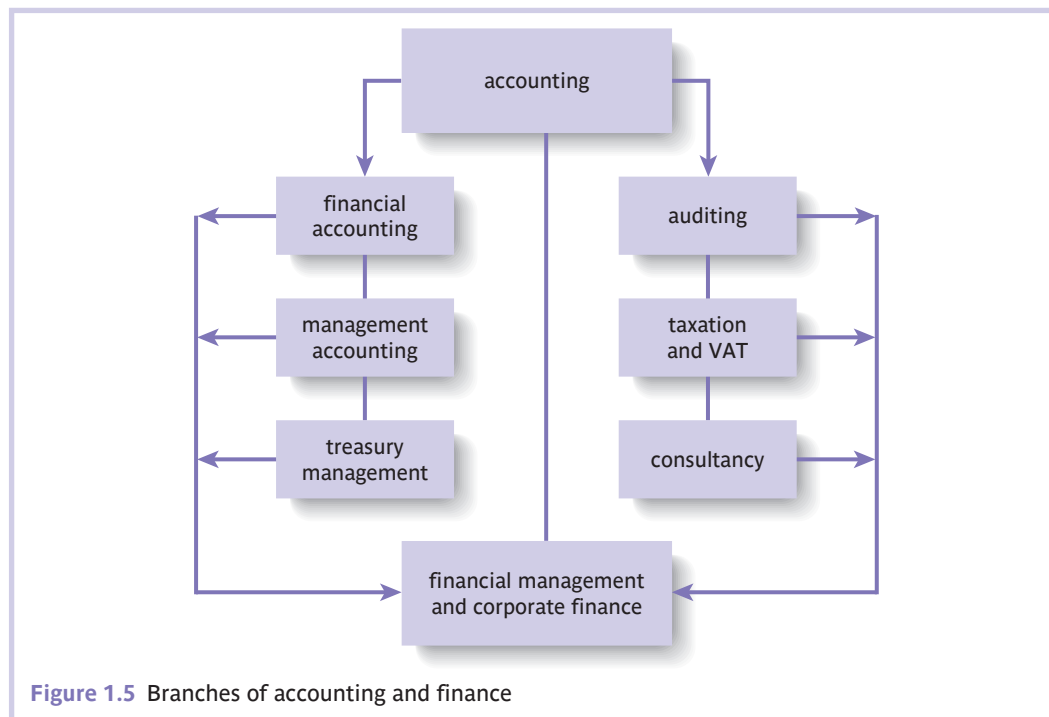
providing information that has all the features that have been described, which therefore renders it potentially useful information. The benefits from producing information, in addition to mandatory information, should therefore be considered and compared with the cost of producing that information to decide on which information is ‘really’ required.

- Accountants may be employed by accounting firms, which provide a range of accounting-related services to individuals, companies, public services, and other organisations. Alternatively, accountants may be employed within companies, public services, and other organisations. Accounting firms may specialise in **audit**, corporate taxation, personal taxation, VAT (value added tax), or consultancy (see the right hand column of Fig. 1.5). Accountants within companies, public service organisations etc., may be employed in the main functions of **financial accounting**, **management accounting**, and **treasury management** (see the left hand column of Fig. 1.5), and also in general management. Accounting skills may also be required in the area of **financial management** (or the management of corporate finance), which may also include treasury management. Within companies this may include responsibility for investments, and the management of cash and interest and foreign currency risk. External to companies this may include advice relating to mergers and acquisitions, and Stock Exchange **flotations**, or initial public offerings (IPOs).

Progress check 1.5

Does all accounting data provide useful financial information?

Financial accounting is primarily concerned with the first question answered by accounting information, the scorecard function. Taking a car-driving analogy, financial accounting makes



greater use of the rear-view mirror than the windscreen; financial accounting is primarily concerned with historical information.

Financial accounting is the function responsible in general for the reporting of financial information to the owners of a business, and specifically for preparation of the periodic external reporting of financial information, statutorily required, for shareholders. It also provides similar information as required for Government and other interested third parties, such as potential investors, employees, lenders, suppliers, customers, and financial analysts. Financial accounting is concerned with the three key **financial statements**: the balance sheet; **income statement** (or profit and loss account); **cash flow statement**. It assists in ensuring that financial statements are included in published reports and accounts in a way that provides ease of analysis and interpretation of company performance.

The role of financial accounting is therefore concerned with maintaining the scorecard for the entity. Financial accounting is concerned with the classification and recording of the monetary transactions of an entity in accordance with established **accounting concepts**, principles, **accounting standards** and legal requirements and their presentation, by means of income statements, balance sheets, and cash flow statements, during and at the end of an **accounting period**.

Within most companies, the financial accounting role usually involves much more than the preparation of the three main financial statements. A great deal of analysis is required to support such statements and to prepare information both for internal management and in preparation for the annual audit by the company's external **auditors**. This includes sales analyses, bank reconciliations, and analyses of various types of expenditure.

A typical finance department in a medium to large sized company has the following additional functions within the financial accounting role: control of **accounts payable** to suppliers (the purchase ledger); control of **accounts receivable** from customers (the sales ledger). The financial accounting role also includes the responsibility for the control of fixed assets, stock



control, and traditionally included responsibility for payroll, whether processed internally or by an external agency. However, a number of companies elect to transfer the responsibility for payroll to the personnel, or human resources department, bringing with it the possibility of loss of **internal control**.

The breadth of functions involved in financial accounting can require the processing of high volumes of data relating to purchase invoices, supplier payments, sales invoices, receipts from customers, other cash transactions, petty cash, employee expense claims, and payroll data. Control and monitoring of these functions therefore additionally requires a large number of reports generated by the accounting systems, for example:

- analysis of accounts receivable (debtors): those who owe money to the company – by age of debt
- analysis of accounts payable (creditors): those to whom the company owes money – by age of invoice
- sales analyses
- cheque and electronic payments
- records of fixed assets
- invoice lists.

Past performance is never a totally reliable basis for predicting the future. However, the vast amount of data required for the preparation of financial statements, and maintenance of the further subsidiary accounting functions, provides an indispensable source of data for use in another branch of accounting, namely management accounting. Management accounting is primarily concerned with the provision of information to managers within the organisation for product costing, planning and control, and decision-making, and is to a lesser extent involved in providing information for external reporting.

The functions of management accounting are wide and varied. Whereas financial accounting is primarily concerned with past performance, management accounting makes use of historical data, but focuses almost entirely on the present and the future. Management accounting is involved with the scorecard role of accounting, but in addition is particularly concerned with the other two areas of accounting, namely problem solving and attention directing. These include cost analysis, decision-making, sales pricing, forecasting, and budgeting.

Progress check 1.6

What roles are included within the accounting function?

Financial management

The discipline of corporate finance has its roots in economics, although it also uses many of the techniques used in accounting. Financial management (or the management of corporate finance) is broadly defined as the management of all the processes associated with the efficient acquisition and deployment of both short- and long-term financial resources. The financial management role assists an organisation's operations management to reach its financial objectives. This includes, for example, evaluation of investment opportunities, responsibility for treasury management, which is concerned with the management and control of cash, relationships with banks and other financial institutions, the management of interest rate and foreign currency

exchange rate risk, and credit control. The cashier function includes responsibility for cash payments, cash receipts, managers' expenses, petty cash, etc.

The management of an organisation generally involves the three overlapping and inter-linking roles of strategic management, risk management, and operations management. Financial management supports these roles to enable management to achieve the financial objectives of the shareholders. The corporate finance function assists in the way that financial results are reported to the users of financial information, for example shareholders, lenders, and employees.

The responsibility of the finance function for managing corporate finance includes the setting up and running of reporting and control systems, raising and managing funds, investment, the management of relationships with financial institutions, and the use of information and analysis to advise management regarding planning, policy, and capital investment. The overriding requirement of the corporate finance function is to ensure that the financial objectives of the company are in line with the interests of the shareholders, the prime objective being to maximise shareholder wealth.

The finance function therefore includes both accounting and corporate finance, which inevitably overlap in some areas. Financial management includes the management and control of corporate funds, in line with company policy. This includes the management of banking relationships, borrowings, and investment. Treasury management may also include the use of the various financial instruments, which may be used to hedge the risk to the business of changes in interest rates and foreign currency exchange rates, and advising on how company strategy may be developed to benefit from changes in the economic environment and the market in which the business operates.

Progress check 1.7

In what way does corporate finance and the financial management function use accounting information?

Worked Example 1.2

A friend of yours is thinking about pursuing a career in accounting and would like some views on the major differences between accounting and the management of corporate finance (financial management).

The following notes provide a summary that identifies the key differences.

Accounting: The financial accounting function deals with the recording of past and current transactions, usually with the aid of computerised accounting systems. Of the various reports prepared, the key reports for external users include the income statement, balance sheet, and the cash flow statement. In a plc, such reports must be prepared at least every six months, and must comply with current legal and reporting requirements.

The management accounting function works alongside the financial accounting function, using a number of the day-to-day financial accounting reports from the accounting system. Management accounting is concerned largely with looking at current issues and problems and the future in terms of decision-making and forecasting, for example the consideration of 'what if' scenarios during the course of preparation of forecasts and budgets. Management accounting outputs are mainly for internal users, with much confidential reporting, for example to the directors of the company.

► **Financial management:** The financial management function includes responsibility for corporate finance and the treasury function. Corporate finance includes the management and control of corporate funds, within parameters specified by the board of directors. The role includes the management of company borrowings, investment of surplus funds, the management of both interest rate and exchange rate risk, and giving advice on economic and market changes and the exploitation of opportunities. This function is not necessarily staffed by accountants. Plcs report on the treasury activities of the company in their periodic reporting and financial review.

The press extract below, which appeared in the *Daily Telegraph*, relates to the sale by Corus in February 2004 to St Modwen Properties of some of its surplus property, the former Llanwern steelworks site in Wales. They also revealed plans to invest more than £200m in the site over the next 10 years. The project would create 7,000 jobs and lead to a total end value of £750m, and they hoped to be on site towards the end of 2005. The acquisition of the Llanwern site was the fifth major land deal St Modwen completed with Corus, which retained a further 1,500 acres at Llanwern, including the operational steelworks. This illustrates some of the important applications of financial management, which include:

- planning activities, particularly with regard to restructuring of the business
- negotiations with bankers
- evaluation of investments in new steelworks.

Financial management in action

'Corus puts land up for sale to raise funds for rescue package',
by Edward Simkins and Mary Fagan

Corus, the troubled steel producer, is quietly marketing around 7,000 acres of surplus property in a bid to raise funds and streamline its business as it prepares for a radical restructuring of its UK operations.

Corus, formed through a merger of British Steel and Hoogovens of the Netherlands in 1999, requires around £250m to pay for redundancies and investments in its plan to turn around its ailing UK business.

Corus is unable to put a value on its surplus property because of the expensive cleaning up which some sites may require. Corus is legally liable to carry out the remediation work which can sometimes cost more than the value of the site.

Since the merger, Corus has cut around 10,000 jobs in the UK and is planning to cut a further 1,100 as it closes more unprofitable plants. The number of redundancies could rise by another 2,000 if its Teesside steel plant cannot be brought into profit.

However, the company intends to invest in modernising two or three steelworks in the UK in order to boost its output.

Earlier this month Corus announced that it had secured a new £800m debt facility, but the £250m needed for the UK restructuring is likely to come from either a rights issue or from fresh loans.

It is also planning to dispose of most of its US business after years of poor performance.

Philippe Varin, the new Corus chief executive who was appointed three months ago from the French aluminium producer Pechiney, has said the money is required 'the sooner the better'.

Despite selling several smaller portfolios earlier this year – including one to Threadneedle, the fund manager, for £48m in July – realising the value of its property portfolio is likely to be a slow process.

The company won planning permission in April to redevelop the 1,125 acre site of the former Ravenscraig steelworks in Scotland more than 11 years after the last steel was poured there.

© *Daily Telegraph*, 24 August 2003

Progress check 1.8

What are the main differences between accounting and corporate finance?

Financial statements

Limited companies produce financial statements for each accounting period to provide information about how the company has been doing. There are three main financial statements – balance sheet, income statement (or profit and loss account), and cash flow statement. Companies are obliged to provide financial statements at each year end to provide information for their shareholders, HMRC, and the Registrar of Companies.

Balance sheet

The balance sheet summarises the financial position of the business; it is a financial snapshot at a moment in time. It may be compared to looking at a DVD. In 'play' mode the DVD is showing what is happening as time goes by, second by second. If you press 'pause' the DVD stops on a picture. The picture does not tell you what has happened over the period of time up to the pause (or what is going to happen after the pause). The balance sheet is the financial position of the company at the 'pause' position. It is the consequence of everything that has happened up to that time. It does not explain how the company got to that position, it just shows the results of financial impacts of events and decisions up to the balance sheet date. The year end may be 31 December, but other dates may be chosen. A company's year end date is (normally) the same date each year.

The balance sheet comprises a number of categories, within the three main elements (see Fig. 1.6), which are labelled **assets**, **liabilities** and **shareholders' equity** (usually referred to as just equity). The balance sheet is always in balance so that:

$$\text{total assets (TA)} = \text{equity (E)} + \text{total liabilities (TL)}$$

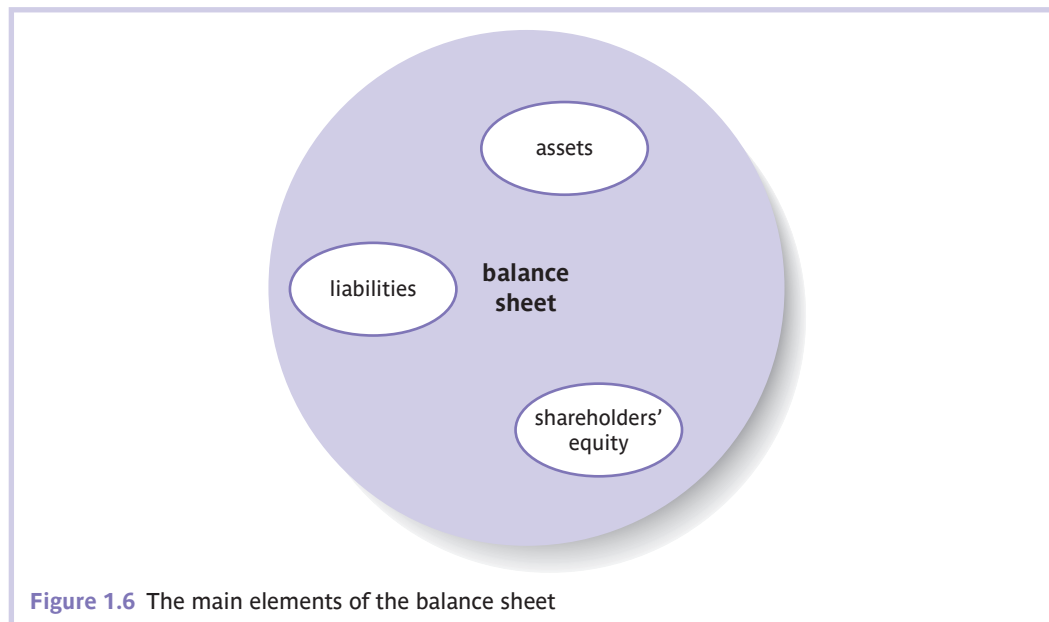


Figure 1.6 The main elements of the balance sheet

Flatco plc		
Balance sheet as at 31 December 2007		
Figures in £000		
Non-current assets		
Intangible		416
Tangible		1,884
Financial		<u>248</u>
		2,548
Current assets		
Stocks	311	
Debtors	573	
Prepayments	589	
Cash	<u>327</u>	
		<u>1,800</u>
Current liabilities (less than one year)		
Financial debt	50	
Creditors	553	
Accruals	<u>202</u>	
		<u>805</u>
Net current assets (working capital)		<u>995</u>
Total assets less current liabilities		3,543
less		
Non-current liabilities (over one year)		
Financial debt	173	
Creditors	<u>154</u>	
		327
less		
Provisions		<u>222</u>
Net assets		<u>2,994</u>
Capital and reserves		
Share capital		1,200
Share premium account		200
Retained earnings		<u>1,594</u>
		<u>2,994</u>

Figure 1.7 An example of a balance sheet

The balance sheet is a summary of all the accounts of the business in which the total assets equal the shareholders' equity plus total liabilities. Fig. 1.7 shows an example of a typical balance sheet for Flatco plc as at 31 December 2007.

Whereas the balance sheet is the financial snapshot at a moment in time – the 'pause' on the DVD – the two other financial statements, the income statement and cash flow statement, are the equivalent of what is going on throughout the accounting period – the 'play' mode on the DVD.

Valuation of assets

The question of valuation of assets at a specific balance sheet date arises in respect of choosing the most accurate methods relating to non-current assets (or fixed assets), stocks and debtors (and similarly creditors), which support the fundamental requirement to give a true and fair view of the business.

Companies must be very careful to ensure that their assets are valued in a way that realistically reflects their ability to generate future cash flows. This applies to both current assets such as stocks, and non-current assets such as land and buildings. The balance sheets of companies rarely reflect either the current market values of non-current assets, or their future earnings potential, since they are based on historical costs. During 2004, Marks & Spencer plc was facing a takeover bid from entrepreneur Philip Green. The directors of Marks & Spencer plc prepared to fight off the takeover bid on the basis that the offer price was a long way short of the true value of its assets. As a measure to protect it against takeover, Marks & Spencer then revalued its portfolio of freehold property, which the directors felt was worth £2bn more than stated in its balance sheet. Directors of companies must take care in recommending such valuation increases because they may reflect the impact of property price inflation, which may not be sustained, and ignore the future earning potential of the assets.

Differences between the methods chosen to value various assets (and liabilities) at the end of accounting periods may have a significant impact on the results reported in the income statement for those periods. Examples of this may be seen in:

- non-current assets and depreciation
- stocks valuations and cost of sales
- valuations of accounts payable and accounts receivable denominated in foreign currencies
- valuations of accounts receivable and provisions for doubtful debts.

The rules applicable to the valuation of balance sheet items are laid down in the Companies Act 1985, as amended by the Companies Act 1989. These rules allow companies to prepare their financial statements under the historical cost convention (the gross value of the asset being the purchase price or production cost), or alternative conventions of historical cost modified to include certain assets at a revalued amount or current cost.

Under alternative conventions, the gross value of the asset is either the market value at the most recent valuation date or its current cost: tangible non-current assets should be valued at market value or at current cost; non-current asset investments (for example, in subsidiary companies) are valued at market value or at any value considered appropriate by the directors; current asset investments (for example, in marketable non-associated companies) are valued at current cost; stocks are valued at current cost. If a reduction in value of any non-current assets is expected to be permanent then provision for this must be made. The same applies to investments even if the reduction is not expected to be permanent.

Non-current assets with finite lives are subject to depreciation charges. Current assets must be written down to the amount for which they could be disposed of (their **net realisable value**), if that value is lower than cost or an alternative valuation. It should be noted that provisions for reductions in value no longer considered necessary must be written back to the profit and loss account.

The valuation of assets is therefore an extremely subjective area. There is an element of choice between alternative valuation methods that may be adopted by businesses. As a consequence of that, different levels of profit may be reported by the same company through the use of alternative asset valuation methods. Profit is therefore an extremely subjective measure and because of this difficulties may arise in trying to provide consistent comparisons of the financial performance and financial position of companies even within the same industrial sectors.

If changes in accounting policies have been introduced, further inconsistencies arise in trying to provide a realistic comparison of just one company's performance between one

accounting period and another. The Companies Acts 1985/1989, accounting concepts, and the accounting standards (SSAPs and FRs) lay down certain rules for the valuation of balance sheet items.

Income statement (or profit and loss account)

The profit and loss account and income statement are two terms that really mean the same thing. Profit (or loss) may be considered in two ways, which both give the same result. The profit and loss account shows the change in the book value of the wealth of the business over a period. The book value of the wealth of the business is the amount it is worth to the owners, the shareholders. The accumulation of the total change in wealth since the business began, up to a particular point in time, is reflected within the equity section of the balance sheet under the heading retained profits. Using the DVD analogy, the profit and loss account measures the change in the balance sheet from one 'pause' to another. An increase in equity is a profit and a decrease in equity is a loss.

However, for measurement purposes, the income statement is considered with regard to the trading performance of the business (see Fig. 1.8). The profit and loss account calculates whether or not the company has made a profit or loss on its operations during the period, through producing and selling its goods or services. The result, the net earnings or **net profit** (or loss), is derived from deducting expenses incurred from revenues earned throughout the period between two 'pauses'.

The net profit or loss is reflected in the balance sheet of the business under the heading retained profits, which is part of 'shareholders' equity'. Figure 1.9 shows an example of a typical income statement for Flatco plc for the year ended 31 December 2007.

There are three main points to consider regarding the income statement and why it differs from a cash flow statement. First, revenues (or sales or income) and expenses (or costs

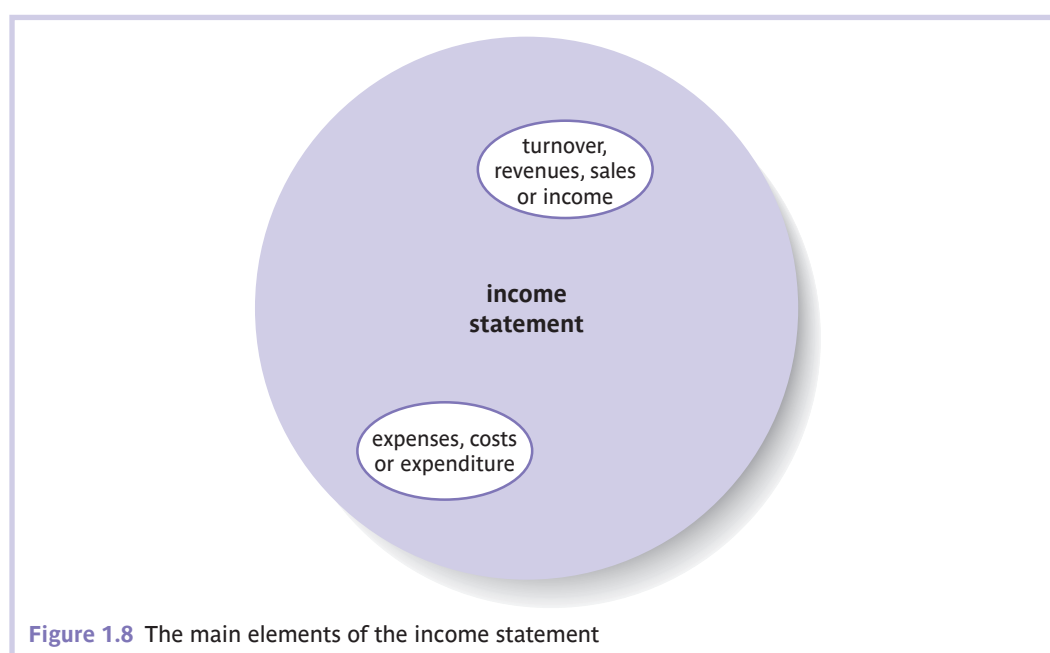


Figure 1.8 The main elements of the income statement

Flatco plc	
Income statement for the year ended 31 December 2007	
	£000
Turnover	3,500
Cost of sales	<u>(2,500)</u>
Gross profit	1,000
Distribution costs	(300)
Administrative expenses	<u>(250)</u>
	450
Other operating income	<u>100</u>
Operating profit	550
Income from other investments	<u>100</u>
Profit before interest and tax	650
Net interest	<u>(60)</u>
Profit before tax	590
Tax on profit on ordinary activities	<u>(50)</u>
Net profit (profit on ordinary activities after tax, or earnings, or net income)	540
Dividends	<u>(70)</u>
Retained profit for the financial year	<u>470</u>

Figure 1.9 An example of an income statement

or expenditure) are not necessarily received or paid in cash when the transactions occur, and stocks are not always used as soon as they are purchased. Sales are normally accounted for when goods or services are delivered and accepted by the customer. Cash will rarely be received immediately from the customer, except in businesses like high-street retailers and supermarkets; it is normally received weeks or months later.

Second, the income statement does not take into account all the events that impact on the financial position of the company. For example, cash paid for an investment in assets, and cash received from an issue of new shares in the company, or a loan to the company, will reduce or increase cash but they are neither revenue nor expenses.

Third, non-cash flow items, for example depreciation and provisions for doubtful debts, reduce the profit, or increase the loss, of the company but do not represent outflows of cash.

Therefore it can be seen that net profit is not the same as cash flow. A company may get into financial difficulties if it suffers a severe cash shortage even though it may have positive net earnings (or profit).

Cash flow statement

Between them, the balance sheet and income statement show a company's financial position at the beginning and at the end of an accounting period, and its financial performance in the profit or loss that has been achieved during that period.

The balance sheet and income statement do not show or directly analyse some of the key changes that have taken place in the company's financial position, for example:

- how much capital expenditure (for example, on equipment, machinery, and buildings) has the company made, and how did it fund the expenditure?

- what was the extent of new borrowing and how much debt was repaid?
- how much did the company need to fund new working capital (which includes, for example, an increase in debtors and stock requirements as a result of increased business activity)?
- how much of the company's funding was met by funds generated from its trading activities, and how much by new external funding (for example, from banks and other lenders, or new shareholders)?

Figure 1.10 shows the main elements of a cash flow statement and Fig. 1.11 is an example of a typical cash flow statement for Flatco plc for the year ended 31 December 2007.

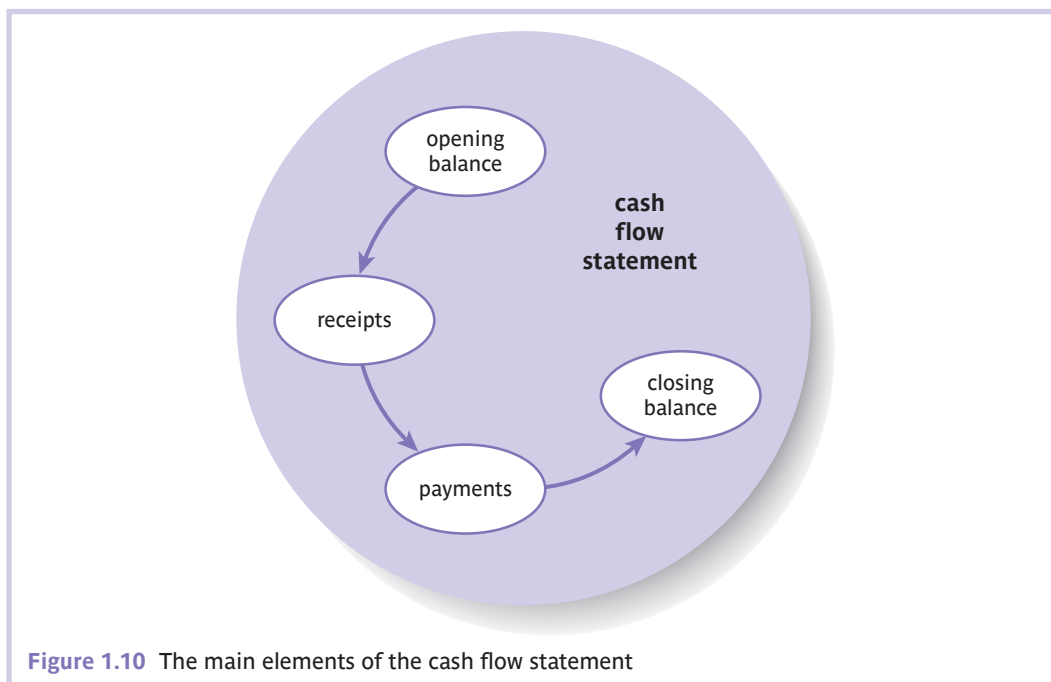


Figure 1.10 The main elements of the cash flow statement

Cash flow statement	
	£000
Net cash inflow from operating activities	936
Returns on investments and servicing of finance (note 1)	40
Taxation	(44)
Capital expenditure (note 1)	<u>(299)</u>
	633
Equity dividends paid	<u>(67)</u>
	566
Management of liquid resources (note 1)	-
Financing (note 1)	<u>373</u>
Increase in cash	<u>939</u>

Figure 1.11 An example of a cash flow statement

The income statement and the cash flow statement are the two ‘DVDs’ which are running in parallel between the two ‘pauses’ – the balance sheets at the start and the finish of an accounting period. However, the cash flow statement goes further in answering the questions like those shown above. The aim of the cash flow statement is to summarise the cash inflows and outflows and calculate the net change in the cash position for the company throughout the period between two ‘pauses’.

Worked Example 1.3

James Brown, a graduate trainee in the finance department of a large engineering group, pursued his accounting studies with enthusiasm. Although James was more interested in business planning and getting involved with new development projects, his job and his studies required him to become totally familiar with, and to be able to prepare, the financial statements of a company. James was explaining the subject of financial statements and what they involved to a friend of his, Jack, another graduate trainee in human resources. James explained the subject of financial statements to Jack, bearing in mind that he is very much a non-financial person.

Limited companies are required to produce three main financial statements for each accounting period with information about company performance for:

- shareholders
- the Inland Revenue
- banks
- City analysts
- investing institutions
- the public in general.

The three key financial statements are the:

- (i) balance sheet
- (ii) income statement
- (iii) cash flow statement.

- (i) **Balance sheet:** a financial snapshot at a moment in time, or the financial position of the company comparable with pressing the ‘pause’ button on a DVD. The DVD in ‘play’ mode shows what is happening as time goes on second by second, but when you press ‘pause’ the DVD stops on a picture; the picture does not tell you what has happened over the period of time up to the pause (or what is going to happen after the pause). The balance sheet is the consequence of everything that has happened up to the balance sheet date. It does not explain how the company got to that position.
- (ii) **Income statement:** this is the DVD in ‘play’ mode. It is used to calculate whether or not the company has made a gain or deficit on its operations during the period, its financial performance, through producing and selling its goods or services. Net earnings or net profit is calculated from revenues derived throughout the period between two ‘pauses’, minus costs incurred in deriving those revenues.
- (iii) **Cash flow statement:** this is the DVD again in ‘play’ mode, but net earnings is not the same as cash flow, since cash is not necessarily received and paid when revenues and costs occur. Sales are accounted for when goods or services are delivered and accepted by the

customer but cash may not be received until some time later. The income statement does not reflect non-trading events like an issue of shares or a loan that will increase cash but are not revenues or costs. The cash flow statement summarises cash inflows and cash outflows and calculates the net change in the cash position for the company throughout the period between two 'pauses'.

- The information provided by plcs in particular is frequently used by City analysts, investing institutions, and the public in general. After each year end plcs prepare their **annual report and accounts** for their shareholders. Copies of the annual report and accounts are filed with the Registrar of Companies and copies are available to other interested parties such as financial institutions, major suppliers, and other investors. In addition to the income statement and cash flow statement for the year and the balance sheet as at the year end date, the annual report and accounts includes notes to the accounts, **accounting policies**, and much more financial and non-financial information such as company policies, financial indicators, corporate governance compliance, directors' remuneration, employee numbers, business analysis, and segmental analysis. The annual report also includes the chief executive's review of the business, a report of the auditors of the company, and the chairman's statement.

The auditors' report states compliance or otherwise with accounting standards and that the accounts are free from material misstatement, and that they give a true and fair view prepared on the assumption that the company is a going concern. The chairman's statement offers an opportunity for the chairman of the company to report in unquantified and unaudited terms on the performance of the company during the past financial period and on likely future developments. However, the auditors would object if there was anything in the chairman's statement that was inconsistent with the audited accounts.

In theory, the balance sheet of a private limited company or a plc should tell us all about the company's financial structure and liquidity – the extent to which its assets and liabilities are held in cash or in a near cash form (for example, bank accounts and deposits). It should also tell us about the assets held by the company, the proportion of current assets, and the extent to which they may be used to meet current obligations. However, an element of caution should be noted in analysing balance sheet information. The balance sheet is a historical document. It may have looked entirely different six months or a year ago, or even one week ago. There is not always consistency between the information included in one company's balance sheet with that of another company. Two companies even within the same industry are usually very difficult to compare. Added to that, different analysts very often use alternative calculations for financial ratios or use them in different ways. In addition to the wide choice of valuation methods, the information in a typical published balance sheet does not tell us anything about the quality of the assets, their real value in money terms or their value to the business.

The audit report provided by external auditors in a company's annual report and accounts normally states that they represent a true and fair view of the business. For a number of reasons, which we will discuss in Chapter 3, companies' reports and accounts may not in fact represent a true and fair view and may hide fraudulent activities or may have been subjected to some **creative accounting**, such as **off balance sheet financing** and **window dressing**. Off balance sheet financing relates to the funding of operations in such a way that the relevant assets and liabilities are not disclosed in the balance sheet of the company concerned. Window dressing is a practice in which changes in short-term funding have the effect of disguising or improving the reported

liquidity (cash and near cash) position of the reporting organisation. The auditors of WorldCom and Enron stated that their reports and accounts provided a true and fair view of those businesses. The reality was somewhat different, as we can see from Worked Examples 1.4 and 1.5.

Worked Example 1.4

WorldCom was one of the world's largest telecommunications companies with 20 million consumer customers, thousands of corporate clients and 80,000 employees. During 2001/2002 WorldCom improperly recorded US\$3.8bn as capital expenditure instead of revenue expenditure, which distorted its reported cash flow and profit. In reality, WorldCom should have reported a loss instead of the US\$1.4bn net income in 2002. WorldCom's accounting irregularities were thought to have begun in 2000. Instead of accounting for expenses when they were incurred, WorldCom hid the expenses by pushing them into the future, giving the appearance of spending less and therefore making more profit. This apparent profitability obviously pleased Wall Street analysts and investors, which was reflected in increases in the WorldCom share price up until the accounting irregularities were discovered. WorldCom filed for bankruptcy, and many of the directors and employees subsequently received custodial sentences for fraud.

Worked Example 1.5

The story of Enron, which was guilty of using off balance sheet financing, is complex. Enron began life as a natural gas company started up by Kenneth Lay. He saw an opportunity to profit from the deregulation of the natural gas industry, for which the core business was established. In its early days Enron did the right things for the right reasons and gained substantial credibility on Wall Street. In its latter years successful operations were replaced with the illusion of successful operations.

The business started to use its substantial credibility to sustain operations through loans to acquire companies on a global basis. In the course of acquiring companies the enterprise recruited a team of financial market experts whose original function was to manage operational risks that the company faced. This team became involved in market speculation and either by luck or perhaps by deception apparently made a lot of money. The directors of the enterprise that became Enron thought that the profits being made were dependable. They therefore kept the team of experts, who were then called market traders, as an integral part of the company.

However, the company also tried to disguise the nature of the operations of the team. After some initial successes the traders began to have some financial failures and Enron was no longer really making a profit. The market traders were really only people who were gambling or speculating for very high stakes, and became no longer a source of profits for the business but a source of huge losses. The company covered up its losses in a number of ways relating to a manipulation of the rules relating to the accounting for securities. Any funding shortfalls that the company had were covered by borrowing money in such a way that it did not have to be disclosed in the company's balance sheet.

The company grew enormously from both domestic and international ventures and at the same time so did cases of management spending of corporate funds on unnecessary luxury items. In the years prior to its bankruptcy Enron executives paid for such luxuries out of company borrowing because it had no real profits, which was therefore at the expense of lenders to the company.

Enron eventually became bankrupt, but it also had a large amount of assets that were sold off to partly meet its even greater liabilities. In 2004, Enron's two key executives, Kenneth Lay and Jeff Skilling, were tried for fraud and convicted in 2006. Kenneth Lay, before his imprisonment, died at the age of 64.

Progress check 1.9

What are the three main financial statements reported by a business? How are business transactions ultimately reflected in financial statements?

Users of financial information

Financial information is important to a wide range of groups both internal and external to the organisation. Such information is required, for example, by individuals outside the organisation to make decisions about whether or not to invest in one company or another, or by potential suppliers who wish to assess the reliability and financial strength of the organisation. It is also required by managers within the organisation as an aid to decision-making. The main users of financial information are shown in Fig. 1.12, which are discussed in Worked Example 1.6.

Worked Example 1.6

Kevin Green, a trainee accountant, has recently joined the finance department of a newly formed public limited company. Kevin has been asked to work with the company's auditors who have been commissioned to prepare some alternative formats for the company's annual report.

As part of his preparation for this, Kevin's manager has asked him to prepare a draft report about who is likely to use the information contained in the annual report, and how they might use such information.

Kevin's preparatory notes for his report included the following:

- **Competitors** as part of their industry competitive analysis studies to look at market share, and financial strength.
- **Customers** to determine the ability to provide a regular, reliable supply of goods and services, and to assess customer dependence.
- **Employees** to assess the potential for providing continued employment and assess levels of remuneration.
- **General public** to assess general employment opportunities, social, political and environmental issues, and to consider potential for investment.
- **Government** for VAT and corporate taxation, Government statistics, grants and financial assistance, monopolies and mergers.
- **Investment analysts** to assess investment potential for individuals and institutions with regard to past and future performance, strength of management, and risk versus reward.
- **Lenders** to assess the capacity and the ability of the company to service debt and repay capital.
- **Managers/directors** to aid decision-making, to a certain extent, but such relevant information should already have been available internally.
- **Shareholders/investors** as a tool of accountability to maintain a check on how effectively the directors/managers are running the business, and to assess the financial strength and future developments.
- **Suppliers** to assess long-term viability and whether the company is able to meet its obligations and pay suppliers on an ongoing basis.



Figure 1.12 Users of financial and accounting information

Progress check 1.10

How many users of financial information can you think of and in what ways do you think they may use this information?

Accountability and financial reporting

The directors of a company are appointed by the shareholders to manage the business on their behalf. The accountability of the directors is maintained by reporting on the financial performance and the financial position of the company to shareholders on both a yearly and an interim basis. The reporting made in the form of the financial statements includes the balance sheet, income statement, and cash flow statement.

There are guidelines, or standards, which have been developed by the accounting profession to ensure truth, fairness, and consistency in the preparation and presentation of financial information.

A number of bodies have been established to draft accounting policy, set accounting standards, and to monitor compliance with standards and the provisions of the Companies Act. The **Financial Reporting Council (FRC)**, whose chairman is appointed by the Department of Trade and Industry (DTI) and the Bank of England, develops accounting standards policy and gives guidance on issues of public concern. In the UK the **Accounting Standards Board (ASB)**, which



is composed of members of the accountancy profession, and on which the Government has an observer status, has responsibility for development, issue, and withdrawal of accounting standards.

 The accounting standards are called **Financial Reporting Standards (FRSs)**. Up to 1990 the accounting standards were known as **Statements of Standard Accounting Practice (SSAPs)**, and were issued by the Accounting Standards Committee (ASC), the forerunner of the ASB. Although some SSAPs have now been withdrawn there are, in addition to the new FRSs, a large number of SSAPs that are still in force.

The ASB is supported by the Urgent Issues Task Force (UITF). Its main role is to assist the ASB in areas where an accounting standard or Companies Act provision exists, but where unsatisfactory or conflicting interpretations have developed or seem likely to develop. The UITF also deals with issues that need to be resolved more quickly than through the issuing of an accounting standard. A recent example of this was the Y2K problem, which involved ensuring that computerised accounting transactions were not corrupted when we moved from the year 1999 to the year 2000.

The Financial Reporting Review Panel (FRRP) reviews comments and complaints from users of financial information. It enquires into the annual accounts of companies where it appears that the requirements of the Companies Act, including the requirement that annual accounts shall show a true and fair view, might have been breached. The Stock Exchange rules covering financial disclosure of publicly quoted companies require such companies to comply with accounting standards, and reasons for non-compliance must be disclosed.

Pressure groups, organisations, and individuals may also have influence on the provisions of the Companies Act and FRSs (and SSAPs). These may include some Government departments (for example, HM Revenue & Customs, Office of Fair Trading) in addition to the DTI and employer organisations such as the Confederation of British Industry (CBI), and professional bodies like the Law Society, Institute of Directors, and Chartered Management Institute.

There are therefore many diverse influences on the form and content of company accounts. In addition to legislation, standards are continually being refined, updated and replaced, and further enhanced by various codes of best practice. As a response to this the UK Generally Accepted Accounting Practices (UK GAAP), first published in 1989, includes all practices that are considered to be permissible or legitimate, either through support by statute, accounting standard or official pronouncement, or through consistency with the needs of users and of meeting the fundamental requirement to present a true and fair view, or even simply through authoritative support in the accounting literature. UK GAAP is therefore a dynamic concept, which changes in response to changing circumstances.

Within the scope of current legislation, best practice, and accounting standards, each company needs to develop its own specific accounting policies. Accounting policies are the specific accounting bases selected and consistently followed by an entity as being, in the opinion of the management, appropriate to its circumstances and best suited to present fairly its results and financial position. Examples are the various alternative methods of valuing stocks of materials, or charging the cost of a machine over its useful life, that is, its depreciation.

The accounting framework therefore includes a large number of concepts, standards, and regulation, and there are a number of strong arguments in favour of such regulation:

- It is very important that the credibility of financial statement reporting is maintained so that actual and potential investors are protected as far as possible against inappropriate accounting practices.

- Generally, being able to distinguish between the good and not so good companies also provides some stability in the financial markets.
- The auditors of companies must have some rules on which to base their **true and fair view** of financial position and financial performance, which they give to the shareholders and other users of the financial statements.

External auditors are appointed by, and report independently to, the shareholders. They are professionally qualified accountants who are required to provide objective verification to shareholders and other users that the financial statements have been prepared properly and in accordance with legislative and regulatory requirements; that they present the information truthfully and fairly; and that they conform to the best accounting practice in their treatment of the various measurements and valuations. The audit is defined by the **Auditing Practices Board (APB)** as ‘an independent examination of, and expression of an opinion on, the financial statements of the enterprise’.

The financial reporting of the company includes preparation of the financial statements, notes and reports, which are audited and given an opinion on by the external auditors. A regulatory framework exists to see fair play, the responsibility for which is held jointly by the Government and the private sector, including the accountancy profession and the Stock Exchange.


The Government exercises influence through bodies such as the Department of Trade and Industry (DTI) and through Parliament by the enactment of legislation, for example the Companies Act. Such legal regulation began with the Joint Stock Companies Act 1844. Subsequent statutes exerted greater influence on company reporting: the Companies Acts 1948, 1967, and 1981. The provisions included in these Acts were consolidated into the Companies Act 1985, which was then amended in 1989. The Companies Act 1985, as amended in 1989, contains the overall current legal framework.

The **International Accounting Standards Committee (IASC)** set up in 1973, which is supported by each of the major professional accounting bodies, fosters the harmonisation of accounting standards internationally. To this end each UK Financial Reporting Standard (FRS) includes a section explaining its relationship to any relevant international accounting standard.

There are wide variations in the accounting practices that have been developed in different countries. These reflect the purposes for which financial information is required by the different users of that information, in each of those countries. There is a different focus on the type of information and the relative importance of each of the users of financial information in each country. This is because each country may differ in terms of:

- who finances the businesses – individual equity shareholders, institutional equity shareholders, debenture holders, banks, etc.
- tax systems, either aligned with or separate from accounting rules
- the level of government control and regulation
- the degree of transparency of information.

The increase in international trade and globalisation has led to a need for convergence, or harmonisation, of accounting rules and practices. The IASC was created in order to develop international accounting standards, but these have been slow in appearing because of the difficulties in bringing together differences in accounting procedures. Until 2000 these standards were called **International Accounting Standards (IASs)**. The successor to the IASC, the

-  **International Accounting Standards Board (IASB)** was set up in April 2001 to make financial statements more comparable on a worldwide basis. The IASB publishes its standards in a series of pronouncements called **International Financial Reporting Standards (IFRSs)**. It has also adopted the body of standards issued by the IASC, which continue to be designated IASs. However, the IFRSs have not been provided as a substitute for the IASs.

The UK ASB contributes to the development of IFRS as a part of the IASB team and is committed to achieve convergence of UK GAAP towards IFRS. In the UK, all listed companies have now adopted IFRS; only non-listed companies and small businesses are exempted. IFRSs originated primarily from the Anglo-American GAAPs and are, therefore, similar to UK GAAP in all major aspects. However, there are still some small discrepancies between IFRSs and UK GAAP. The accounting firm KPMG has provided a detailed comparison between IFRSs and UK GAAP in *Implementing IAS: IAS compared with US GAAP and UK GAAP*, published in 2003.

The chairman of the IASB, Sir David Tweedie, has said that ‘the aim of the globalisation of accounting standards is to simplify accounting practices and to make it easier for investors to compare the financial statements of companies worldwide’. He also said that ‘this will break down barriers to investment and trade and ultimately reduce the cost of capital and stimulate growth’ (*Business Week*, 7 June 2004).

On 1 January 2005 there was convergence in the mandatory application of the IFRSs by listed companies within each of the European Union Member States. However, it is interesting to note, for example, the differences in company reporting requirements that continue to exist, for instance, between the German commercial code (the German *Handelsgesetzbuch (HGB)*), the French accounting plan (the French *Plan Comptable*), and UK financial reporting standards in areas such as:

- valuation of assets
- recognition of income
- accounting for provisions and reserves.

There are differences in approach towards company financial reporting requirements for a number of reasons. For example, differences between the USA and the UK exist primarily because of the alternative approaches adopted by accounting and financial reporting standard setters in the USA and the UK. The ‘rules based’ approach used in the USA predominantly seeks to codify practices and specify particular techniques, while the ‘principles based’ approach used in the UK seeks to provide organisations with choices from a range of practices and techniques.

Despite significant progress towards a standardised international approach, there continue to be very many differences between UK GAAP and IFRSs, for example in the areas of:

- accounting for pension costs for defined benefit schemes
- accounting for deferred tax
- accounting for derivatives
- accounting for investments at fair values
- hedge accounting
- preference shares and convertible bonds
- merger accounting
- goodwill amortisation

- the treatment of negative goodwill
- accounting for investment properties, especially the treatment of revaluations
- accounting for proposed dividends
- accounting for finance leases – for example, operating leases under UK GAAP may be finance leases under IFRS.

It may be argued that the increasing amount of accounting regulation itself stifles responses to changes in economic and business environments, and discourages the development of improved financial reporting. As the various conceptual frameworks continue to be developed it is apparent that there is wide disagreement about what constitutes accounting best practice. The resistance to acceptance of IASs may be for political reasons, the rules perhaps reflecting the requirements of specific interest groups or countries.

Despite increasing accounting regulation there have been an increasing number of well-publicised financial scandals in the USA in particular, where the accounting systems are very much 'rule-based', as well as in the UK, Italy, and Japan. However, these scandals have usually been the result of fraudulent activity. This leads to another question as to why the auditors of such companies did not detect or prevent such fraud. The answer is that, despite the widespread perception of the general public to the contrary, auditors are not appointed to detect or prevent fraud. Rather, they are appointed by the shareholders to give their opinion as to whether the financial statements show a true and fair view and comply with statutory, regulatory, and accounting and financial reporting standards requirements.

Progress check 1.11

In what ways may the reliability of financial reporting be ensured?

Worked Example 1.7

You are thinking of changing jobs (within marketing) and moving from a local, well-established retailer that has been in business for over 20 years. You have been asked to attend an interview at a new plc that started up around two years ago. The plc is a retailer via the Internet. Your family has suggested that you investigate the company thoroughly before your interview, paying particular attention to its financial resources. There is a chance the plc may not be a going concern if its business plan does not succeed.

You will certainly want to include the following questions at your interview.

- Are any published accounts available for review?
- What is the share capital of the company (for example, is it £10,000 or £1,000,000)?
- Is the company profitable?
- Does the company have loan commitments?
- Is the company working within its bank overdraft facilities?
- Are any press analyses of the company available?
- What is the current customer base?

The answers may suggest whether the company can continue trading for the foreseeable future.

Managing corporate finance

The finance function, or more specifically the finance director of a business, has the responsibility for managing the financial resources of the business to meet the objectives of the business. The finance director's corporate finance responsibilities involve:

- raising and controlling the provision of funds for the business
- deciding on the deployment of these funds – the assets, new projects, and operational expenditure required to increase the wealth of the business
- controlling the resources of the business to ensure that they are being managed effectively
- managing financial risks such as exposures relating to movements in interest rates and foreign currency exchange rates.

The finance director is also responsible for the accounting function of the business, but it is a separate and different discipline to corporate finance. The management of corporate finance, or financial management, draws on the techniques of both financial accounting and management accounting, relating to decision-making and financial reporting. However, corporate finance is concerned with the future and relates to the management of the financial resources of the business in order to optimise the returns to investors in the business. In this context the finance directors must decide on:

- what level of assets should the company have?
- how should investment projects be chosen and how should they be funded?
- in what proportions should the company's funding be regarding shareholders' equity and borrowings?
- what proportions of profit after tax should be paid out in dividends or retained for future investment?

Accounting may assist in these decisions, for example capital investment appraisal (management accounting) and the impact on financial statement reporting (financial accounting). Therefore, the two disciplines of corporate finance and accounting are both the responsibility of the finance director, and although they are separate disciplines the former is very much supported by the latter.

Progress check 1.12

What are the key responsibilities of the finance director with regard to the financial management of a business?

Underlying principles of corporate finance

We have seen that corporate finance is about obtaining and managing the financial resources of a business in order to achieve the objectives of the business. The primary objective of the business is the maximisation of shareholder wealth, and there are a number of principles that underpin the decision-making of financial managers in pursuit of this objective.

Shareholder wealth maximisation

The maximisation of shareholder wealth is the prime objective of the majority of companies. The reason why investors put funds into a business is to receive returns that are better than the returns that they may receive from alternative investments. It is the responsibility of the directors of the company to make the optimum use of these funds to ensure that shareholder returns are maximised. But, how do they do this and what is shareholder wealth?

Shareholder wealth is derived by shareholders from two sources:

- dividends paid on their equity, or ordinary, shares
- capital appreciation from the increase in the price of their ordinary shares.

As illustrated in Worked Example 1.8, dividends do not have to be paid by a company. Dividends are paid out of the profits of the company available for distribution after interest and corporation tax has been paid, and assuming that the company has sufficient cash for their payment. The increase in share price depends generally on the demand for the company's shares and the volume of dealing activity in those shares.

Worked Example 1.8

In early 2004 the satellite broadcaster BSkyB restored paying a dividend after a gap of more than five years. BSkyB had suspended its dividend for several years while it rolled out its digital TV service. The announcement of an interim payout of 2.75p per share was announced as the UK pay-TV giant unveiled an 84% jump in half-year operating profits to £283m (US\$529.5m).

A company's shares may be in demand because prospective share buyers believe that there are good prospects of future share price increases and/or increased dividend payments. The reason for such optimism may be that the company has demonstrated its success in investing in value-creating projects ('real' investment) and its ongoing intention of making even greater value-adding investments. The success of such investments in cash terms will provide the future cash flow for the payment of dividends and sustained future investment in new projects.

Cash flow

It is the 'success' of investments in new projects that provides the key to future growth in both dividends and the company's share price (see Chapter 4). In this context, by success we mean returns in cash terms over and above the cost of the funds used for those investments and above the average returns in that particular market. It is cash flow from investments and not profit that is important here. Profit is an accounting term, which is subjective and open to many interpretations. Cash is a fact and its measurement is completely objective – you either have it or you don't. Real funds can be seen in cash but not in accounting profit. Interest charges become payable as soon as money is made available, for example, from a lender to a borrower, not when an agreement is made or when a contract is signed. Therefore, in corporate finance it is cash flow which is important rather than profit.

Worked Example 1.9

Cox Ltd is a local electrical retailer with retail outlets throughout the north of England. The company is currently considering opening a new temporary retail outlet, and is considering three alternative development options. As the company's financial adviser, you have been asked to evaluate the financial aspects of each of the options and advise which option the company should select, from a purely cash flow perspective (ignoring the time value of money, which is discussed in the next section).

The following financial information has been made available:

Year	Option 1 £000	Option 2 £000	Option 3 £000
		Investment	
0	12,000	12,000	12,000
		Cash receipts	
1	9,500	3,000	6,000
2	8,500	4,500	6,000
3	3,500	8,000	6,000
4	2,500	8,500	6,000

In cash flow terms all three options provide the same net cash flow, but the timings of the cash flow receipts differ significantly. Given that the future is invariably uncertain, it is likely that from a purely cash flow perspective, the rational choice would be to maximise the cash flows derived earlier rather than later, in which case the selection would be Option 1.

Time value of money

It is not only the cash flows themselves from investments that are important in terms of their size but also when they are received – the timing of cash flows, and their certainty of being received at all – the risk relating to cash flows. This has not been considered at all in Worked Example 1.9.

A receipt of £100 today has greater value than receipt of £100 in one year's time. Its value changes over time primarily because:

- the money could have been alternatively invested to receive interest
- purchasing power will have been lost over a year due to inflation.

The percentage rate by which the value of money may be eroded over one year is called the discount rate, and the amount by which the value of money is eroded over one year is calculated by dividing it by what is called the discount factor $[1/(1 + \text{discount rate } \%)]$. The value of money continues to be reduced by application of the discount factor (or using the appropriate discount factor if the discount rate has changed); its value therefore normally becomes less and less. Using this method, a discount factor may be applied to future cash flows to calculate the today values of future cash flows. This technique is called discounted cash flow (DCF). It is the today values of cash flows, their present values, which are the relevant cash flows with regard to investments. We will return to DCF in more detail in Chapter 4.

Risk

Increases in shareholder wealth comprise dividends and capital gains from share price increases, which together are termed returns to investors. Interest paid on loans to companies is called the return to debt holders, or lenders. The returns from 'real' investments in new assets and projects are the present values of the cash flows derived from the profits from such investments. Whichever return we are considering, we are talking specifically about future expected cash flows from investments. There is a close correlation between the returns and the level of risk relating to these investments.

An actual return on an investment will never be exactly what was expected – it will be either higher or lower, better or worse. Risk relates to the possibility that an actual return will be different from an expected return. The more risky an investment, the greater is the possibility that the return will be different from that expected. The higher the risk of an investment, the higher will be the expected return; the lower the risk of an investment, the lower will be the expected return. Throughout this book we will return to risk many times in:

- Chapter 4 when we look at capital investment decisions
- Chapter 5 when we look at the cost of capital – the funds used for investments
- Chapter 6 when we look at the type of funds used by companies – equity or loans
- Chapter 9 when we look at financial planning
- Chapter 11 when we look at international operations and investment
- Chapter 12 when we look at financial risk management
- Part II when we look at financial strategy.

Progress check 1.13

What is meant by shareholder wealth maximisation?

Summary of key points

- The four main types of profit-making businesses in the UK are sole traders, partnerships, limited companies (Ltd), and public limited companies (plc).
- The finance function has an important position within an organisation, and includes responsibility for accounting and corporate finance.
- Accountability of directors is maintained by reporting on the financial performance and the financial position of the company to shareholders on both a yearly and a half-yearly basis, and the audit function.
- Financial statements are produced by companies for each accounting period to provide information about how the business has been doing.
- The three main financial statements that appear within a business's annual report and accounts, together with the chairman's statement, directors' report, and auditors' report, are the balance sheet, income statement, and cash flow statement.

- ▶ ■ Corporate finance and accounting are both the responsibility of the finance director, and although they are separate disciplines corporate finance is very much supported by the accounting function.
- The effective management of corporate finance impacts greatly on how well the company is able to achieve its prime objective of maximisation of shareholder wealth.
- The underlying principles of corporate finance include cash flow (rather than profit), the time value of money, and the risk and uncertainty relating to future cash flows.

Glossary of key terms

accounting The classification and recording of monetary transactions, the presentation and interpretation of the results of those transactions in order to assess performance over a period and the financial position at a given date, and the monetary projection of future activities arising from alternative planned courses of action.

accounting concepts The principles underpinning the preparation of accounting information. Fundamental accounting concepts are the broad basic assumptions which underlie the periodic financial accounts of business enterprises.

accounting period The time period covered by the accounting statements of an entity.

accounting policies The specific accounting bases selected and consistently followed by an entity as being, in the opinion of the management, appropriate to its circumstances and best suited to present fairly its results and financial position (FRS 18 and Companies Act).

accounting standard Authoritative statement of how particular types of transaction and other events should be reflected in financial statements. Compliance with accounting standards will normally be necessary for financial statements to give a true and fair view (ASB).

Accounting Standards Board (ASB) A UK standard-setting body set up in 1990 to develop, issue and withdraw accounting standards. Its aims are to 'establish and improve standards of financial accounting and reporting, for the benefit of users, preparers and auditors of financial information'.

accounts payable Also called trade creditors, is the money owed to suppliers for goods and services.

accounts receivable Also called trade debtors, is the money owed to entities by customers.

Alternative Investment Market (AIM) A securities market designed primarily for small companies, regulated by the Stock Exchange but with less demanding rules than apply to the Stock Exchange official list of companies.

annual report and accounts A set of statements which may comprise a management report (in the case of companies, a directors' report), an auditors' report, and the financial statements of the entity.

asset A right or other access to future economic benefits controlled by an entity as a result of past transactions or events (FRS 5).

audit A systematic examination of the activities and status of an entity, based primarily on investigation and analysis of its systems, controls, and records. A statutory annual audit of a company is defined by the APB as an independent examination of, and expression of an opinion on, the financial statements of the enterprise.

Auditing Practices Board (APB) A body formed in 1991 by an agreement between the six members of the Consultative Committee of Accountancy Bodies, to be responsible for developing and issuing professional standards for auditors in the United Kingdom and the Republic of Ireland.

auditor A professionally qualified accountant who is appointed by, and reports independently to, the shareholders, providing an objective verification to shareholders and other users that the financial statements have been prepared properly and in accordance with legislative and regulatory requirements; that they present the information truthfully and fairly, and that they conform to the best accounting practice in their treatment of the various measurements and valuations.

balance sheet A statement of the financial position of an entity at a given date disclosing the assets, liabilities, and accumulated funds such as shareholders' contributions and reserves, prepared to give a true and fair view of the financial state of the entity at that date.

cash flow statement A statement that summarises the inflows and outflows of cash for a period, classified under the following standard headings (FRS 1):

- operating activities
- returns on investment and servicing of finance
- taxation
- investing activities
- liquid funds
- equity dividends
- financing.

creative accounting A form of accounting which, while complying with all regulations, nevertheless gives a biased (generally favourable) impression of a company's performance.

financial accounting Financial accounting is the function responsible for the periodic external reporting, statutorily required, for shareholders. It also provides such similar information as required for Government and other interested third parties, such as potential investors, employees, lenders, suppliers, customers, and financial analysts.

financial management (or management of corporate finance) The management of all the processes associated with the efficient acquisition and deployment of both short- and long-term financial resources. Within an organisation financial management assists operations management to reach their financial objectives.

▶ **Financial Reporting Council (FRC)** The UK body responsible for:

- (i) guiding the standard setting body (ASB) on work programmes and issues of public concern
- (ii) seeing that work on accounting standards is properly financed
- (iii) acting as a proactive public influence for securing good accounting practice.

Financial Reporting Standards (FRSs) The accounting standards of practice published by the Accounting Standards Board since 1 August 1990, and which are gradually replacing the Standard Statements of Accounting Practice (SSAPs), which were published by the Accounting Standards Committee up to 1 August 1990.

financial statements Summaries of accounts, whether to internal or external parties, to provide information for interested parties. The three key financial statements are: income statement; balance sheet; cash flow statement. Other financial statements are: report of the auditors; statement of recognised gains and losses; reconciliation of movements in shareholders' funds.

flotation A flotation, or initial public offering (IPO), is the obtaining of a listing by a company on a stock exchange, through the offering of its shares to the general public, financial institutions, or private sector businesses.

income statement (or profit and loss account) Measures whether or not the company has made a profit or loss on its operations during the period, through producing and selling its goods or services.

internal control As defined in the Cadbury Report, it is the whole system of controls, financial or otherwise, established in order to provide reasonable assurance of:

- (i) effective and efficient operation
- (ii) internal financial control
- (iii) compliance with laws and regulations.

International Accounting Standard (IAS) The international financial reporting standards issued by the IASC, which are very similar to the SSAPs and FRSs, which are used in the UK.

International Accounting Standards Board (IASB) The IASB is the body that is responsible for setting and publishing International Financial Reporting Standards (IFRSs). It was formed on 1 April 2001 and succeeded the International Accounting Standards Committee (IASC) which had been formed in 1973. The parent body of the IASB is the International Accounting Standards Committee Foundation, which was incorporated in the USA in March 2001, and was also responsible for issuing International Accounting Standards (IASs).

International Accounting Standards Committee (IASC) A committee supported by many national accounting bodies worldwide, whose objects are:

- (i) to facilitate and publish in the public interest, accounting standards to be observed in the presentation of financial statements, and to promote their worldwide acceptance and observance

(ii) to work generally for the improvement of harmonisation of regulations, accounting standards, and procedures relating to the presentation of financial statements (IASB).

International Financial Reporting Standard (IFRS) The international financial reporting standards issued by the IASB, which incorporate the IASs, issued by the IASB.

liability An entity's obligation to transfer economic benefits as a result of past transactions or events (FRS 5).

management accounting The application of the principles of accounting and financial management to create, protect, preserve and increase value so as to deliver that value to the stakeholders of profit and not-for-profit enterprises, both public and private. Management accounting is an integral part of management, requiring the identification, generation, presentation, interpretation and use of information relevant to:

- formulating business strategy
- planning and controlling activities
- decision-making
- efficient resource usage
- performance improvement and value enhancement
- safeguarding tangible and intangible assets
- corporate governance and internal control.

net profit (or profit after tax) Profit before tax (PBT) less corporation tax.

net realisable value The amount for which an asset could be disposed, less any direct selling costs (SSAP 9).

off balance sheet financing The funding of operations in such a way that the relevant assets and liabilities are not disclosed in the balance sheet of the company concerned.

private limited company (Ltd) A Ltd company is one in which the liability of members for the company's debts is limited to the amount paid and, if any, unpaid on the shares taken up by them.

public limited company (plc) A plc is a company limited by shares or by guarantee, with a share capital, whose memorandum states that it is public and that it has complied with the registration procedures for such a company. A public company is distinguished from a private company in the following ways: a minimum issued share capital of £50,000; public limited company, or plc, at the end of the name; public company clause in the memorandum; freedom to offer securities to the public.

qualified accountant A member of the accountancy profession, and in the UK a member of one of the six professional accountancy bodies: CIMA; ICAEW; ICAS; ICAI; ACCA; CIPFA.

Registrar of Companies Government official agency that is responsible for initial registration of new companies and for collecting and arranging public access to the annual reports of all limited companies.

- ▶ **shareholders' equity** The total investment of the shareholders in the company – the total wealth. Equity comprises capital, share premiums, and retained earnings.
- Statements of Standard Accounting Practice (SSAPs)** The accounting standards of practice published by the Accounting Standards Committee up to 1 August 1990.
- treasury management** The corporate handling of all financial matters, the generation of external and internal funds for business, the management of currencies and cash flows, and the complex strategies, policies, and procedures of corporate finance.
- true and fair view** The requirement for financial statements prepared in compliance with the Companies Act to 'give a true and fair view' overrides any other requirements. Although not precisely defined in the Companies Act, this is generally accepted to mean that accounts show a true and fair view if they are unlikely to mislead a user of financial information by giving a false impression of the company.
- window dressing** A creative accounting practice in which changes in short-term funding have the effect of disguising or improving the reported liquidity position of the reporting organisation.

? Questions

- Q1.1** What are the different types of business entity and what are the fundamental differences between them?
- Q1.2** (i) Why is financial information produced?
(ii) Who is it produced for and what do they use it for?
- Q1.3** Outline the responsibilities of the finance director of a large public limited company (plc).
- Q1.4** Which are the three key financial statements that are used to provide information to shareholders and others about the company's financial position and financial performance, and what are their limitations?
- Q1.5** (i) What information does a balance sheet provide?
(ii) What information does an income statement (or profit and loss account) provide?
(iii) What information does a cash flow statement provide?
- Q1.6** How do financial statements ensure that accountability for the reporting of timely and accurate information to shareholders is maintained?
- Q1.7** (i) What is corporate finance?
(ii) How does corporate finance relate to accounting and perhaps other disciplines?
- Q1.8** Describe the main corporate finance responsibilities of the finance director of a large public limited company (plc).
- Q1.9** Explain the key principles that underpin the discipline of corporate finance.



Discussion points

D1.1 The managing director of a large public limited company stated: 'I've built up my business over the past 15 years from a one-man band to a large plc. As we grew we seemed to spend more and more money on accountants, financial managers, and auditors. During the next few months we are restructuring to go back to being a private limited company. This will be much simpler and we can save a fortune on finance departments and auditing costs.' Discuss.

(Hint: You may wish to research Richard Branson and, for example, Virgin Air, on the Internet to provide some background for this discussion.)

D1.2 'So long that, as a company, we continue to report profits each year then the shareholders will have no reason to complain.' Discuss.



Exercises

Solutions are provided in Appendix 2 to all exercise numbers highlighted in colour.

Level I

E1.1 *Time allowed – 30 minutes*

At a recent meeting of the local branch of the Women's Institute they had a discussion about what sort of organisation they were. The discussion broadened into a general debate about all types of organisation, and someone brought up the term 'business entity'. Although there were many opinions, there was little sound knowledge about what business entities are. Jane Cross said that her husband was an accountant and she was sure he would not mind spending an hour one evening to enlighten them on the subject. Chris Cross fished out his textbooks to refresh his knowledge of the subject and came up with a schedule of all the different business entities he could think of together with the detail of their defining features and key points of difference and similarity.

Prepare the sort of schedule that Chris might have drafted for his talk and identify the category that the Women's Institute might fall into.

E1.2 *Time allowed – 30 minutes*

Mary Andrews was a finance manager but is now semi-retired. She has been asked by her local comprehensive school careers officer to give a talk entitled: 'What is corporate finance and what is financial management?'

Prepare a list of bullet points that covers everything necessary for Mary to give a comprehensive and easy-to-understand presentation to a group of sixth-formers at the school.

E1.3 *Time allowed – 30 minutes*

It is sometimes said that the only user of financial information is the accountant.

Outline the range of other users of financial information.

Level II

E1.4 *Time allowed – 30 minutes*

Financial statements are produced each year by businesses, using prescribed formats. ▶

▶ **Should major plcs be allowed to reflect their individuality in their own financial statements?**

E1.5 *Time allowed – 45 minutes*

Professionals in the UK, for example, doctors, solicitors, accountants, etc., normally work within partnerships. Many tradesmen, such as plumbers, car mechanics, carpenters, etc., operate as sole traders. Software engineers seem to work for corporations and limited companies.

Consider the size of operation, range of products, financing, the marketplace, and the geographical area served, to discuss why companies like Microsoft and Yahoo should operate as plcs.

E1.6 *Time allowed – 60 minutes*

Bill Walsh has just been appointed Finance Director of a medium-sized engineering company, Nutsan Ltd, which has a high level of exports and is very sensitive to economic changes throughout the UK and the rest of the world. One of the tasks on Bill's action list is a review of the accounting and finance function.

What are the senior financial roles that Bill would expect to be in place and what are the important functions for which they should be responsible?

E1.7 *Time allowed – 60 minutes*

The Millennium Dome was opened to the general public in the UK for the year 2000 and was planned to close at the end of 2000 for the site to be used for some other purpose. There were problems financing the construction and the general day-to-day operations. There were many crises reported in the press during 2000. A proposed takeover of the site fell through in September 2000, with various reasons given by the potential acquirer.

You are required to research into the Dome using the BBC, the *Financial Times* and the other serious newspapers, and the Internet, and summarise the financial aspects of the project that you gather. You should focus on the attitudes expressed by the general public, select committees of MPs, Government ministers, the Opposition, the Dome's management, and consider examples of bias, non-timeliness, and lack of transparency.