

FINANCIAL MANAGEMENT FOR DECISION MAKERS

NINTH EDITION

Peter Atrill



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

Contents

Preface	xiii
Publisher's acknowledgements	xiv
1 The world of financial management	1
<i>Introduction</i>	1
<i>Learning outcomes</i>	1
The finance function	2
Structure of the book	4
Modern financial management	4
Why do businesses exist?	6
Balancing risk and return	14
Behaving ethically	16
Protecting shareholders' interests	18
Shareholder involvement	23
<i>Summary</i>	30
<i>Key terms</i>	32
<i>References</i>	32
<i>Further reading</i>	32
<i>Critical review questions</i>	32
2 Financial planning	33
<i>Introduction</i>	33
<i>Learning outcomes</i>	33
Planning for the future	34
The role of projected financial statements	35
Preparing projected financial statements	36
The sales forecast	36
Preparing the projected statements: a worked example	37
Projected cash flow statement	38
Projected income statement	42
Projected statement of financial position (balance sheet)	44
Per-cent-of-sales method	47
Long-term cash flow projections	51
Projected financial statements and decision making	54
Taking account of risk	56
Financial planning and gearing	58
Financial gearing	58

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

3 Analysing and interpreting financial statements 89

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

4 Making capital investment decisions 147

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

Investment appraisal and strategic planning	180
The investment appraisal process	181
Investment decisions and human behaviour	187
<i>Summary</i>	188
<i>Key terms</i>	189
<i>References</i>	190
<i>Further reading</i>	190
<i>Critical review questions</i>	190
<i>Exercises</i>	191
5 Making capital investment decisions: further issues	199
<i>Introduction</i>	199
<i>Learning outcomes</i>	199
Investment decisions when funds are limited	200
Comparing projects with unequal lives	205
The ability to delay	208
The problem of inflation	208
The problem of risk	210
Sensitivity analysis	211
Scenario analysis	219
Risk preferences of investors	220
Risk-adjusted discount rate	223
Expected net present value (ENPV)	225
Event tree diagrams	228
Risk and the standard deviation	232
The standard deviation and the normal distribution	236
The expected value–standard deviation rule	237
Simulations	237
Measuring probabilities	240
Portfolio effects and risk reduction	241
<i>Summary</i>	249
<i>Key terms</i>	251
<i>Further reading</i>	251
<i>Critical review questions</i>	252
<i>Exercises</i>	252
6 Financing a business 1: sources of finance	257
<i>Introduction</i>	257
<i>Learning outcomes</i>	257
Sources of finance	258
External sources of finance	258
External sources of long-term finance	259
Attitudes towards the level of borrowing	272
External sources of short-term finance	282
Long-term versus short-term borrowing	287
Internal sources of finance	288
Internal sources of long-term finance	289

Internal sources of short-term finance	290
<i>Summary</i>	296
<i>Key terms</i>	297
<i>Further reading</i>	298
<i>Critical review questions</i>	298
<i>Exercises</i>	299
7 Financing a business 2: raising long-term finance	305
<i>Introduction</i>	305
<i>Learning outcomes</i>	305
The Stock Exchange	306
Stock market efficiency	311
Are the stock markets really efficient?	316
Share issues	322
Long-term finance for the smaller business	330
Business angels	337
Government assistance	339
The Alternative Investment Market (AIM)	340
<i>Summary</i>	346
<i>Key terms</i>	347
<i>References</i>	347
<i>Further reading</i>	348
<i>Critical review questions</i>	348
<i>Exercises</i>	348
8 The cost of capital and the capital structure decision	353
<i>Introduction</i>	353
<i>Learning outcomes</i>	353
Cost of capital	354
Weighted average cost of capital (WACC)	371
Specific or average cost of capital?	375
Limitations of the WACC approach	376
Cost of capital – some evidence	377
The capital structure debate	378
Gearing and signalling	388
<i>Summary</i>	390
<i>Key terms</i>	391
<i>References</i>	392
<i>Further reading</i>	392
<i>Critical review questions</i>	392
<i>Exercises</i>	393
9 Making distributions to shareholders	399
<i>Introduction</i>	399
<i>Learning outcomes</i>	399

Paying dividends	400
Dividend distributions in practice	402
Dividend policy and shareholder wealth	404
The importance of dividends	410
Factors determining the level of dividends	416
Dividend policy and management attitudes: some evidence	420
Dividend smoothing in practice	422
What should managers do?	423
Alternatives to cash dividends	424
<i>Summary</i>	434
<i>Key terms</i>	436
<i>References</i>	436
<i>Further reading</i>	436
<i>Critical review questions</i>	437
<i>Exercises</i>	437

10 Managing working capital **441**

<i>Introduction</i>	441
<i>Learning outcomes</i>	441
What is working capital?	442
The scale of working capital	443
Managing inventories	446
Inventories management models	453
Managing trade receivables	460
Managing cash	471
Managing trade payables	478
<i>Summary</i>	482
<i>Key terms</i>	484
<i>Further reading</i>	484
<i>Critical review questions</i>	484
<i>Exercises</i>	485

11 Measuring and managing for shareholder value **491**

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

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

12 Business mergers and share valuation **539**

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

13 International aspects of financial management **597**

<i>Introduction</i>	597
<i>Learning outcomes</i>	597
The internationalisation of business	598
Internationalisation and risk reduction	599

Internationalisation and shareholders' wealth	599
Foreign exchange	600
A theoretical explanation of relative exchange rates	603
Foreign exchange markets and market efficiency	604
Problems of internationalisation	605
Dealing with transaction risk	606
Economic risk	615
Translation risk	618
International investment appraisal	620
International investment at the portfolio level	623
International investment and agency cost	623
<i>Summary</i>	624
<i>Key terms</i>	627
<i>References</i>	627
<i>Further reading</i>	627
<i>Critical review questions</i>	627
<i>Exercises</i>	628
Appendix A Present value table	631
Appendix B Annual equivalent factor table	633
Appendix C Solutions to self-assessment questions	635
Appendix D Solutions to critical review questions	649
Appendix E Solutions to selected exercises	659
Glossary of key terms	685
Index	695