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APC308

Financial Management

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Financial Management

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How to use this workbook

This workbook has been designed to provide you with the course material necessary to complete Financial Management by distance learning. At various stages throughout the module you will encounter icons as outlined below which indicate what you are required to do to help you learn.

This **Activity** icon refers to an activity where you are required to undertake a specific task. These could include reading, questioning, writing, research, analysing, evaluating, etc.



This **Activity Feedback** icon is used to provide you with the information required to confirm and reinforce the learning outcomes of the activity.



This icon shows where the **Virtual Campus** could be useful as a medium for discussion on the relevant topic.



It is important that you utilise these icons as together they will provide you with the underpinning knowledge required to understand concepts and theories and apply them to the business and management environment. Try to use your own background knowledge when completing the activities and draw the best ideas and solutions you can from your work experience. If possible, discuss your ideas with other students or your colleagues; this will make learning much more stimulating. Remember, if in doubt, or you need answers to any questions about this workbook or how to study, ask your tutor.

Introduction

LEARNING OUTCOMES:

On successful completion of the module you will have:

- Examined and critically evaluated the key strategic decisions that a business may have to make and appreciated how accounting and finance can assist in making and evaluating those decisions.
- Applied the key valuation concepts and methodologies of financial decision making in order to contribute to the wider decision making of the organisation.
- A critical understanding of specific analytical skills in key decision areas within strategy and finance at local and international level.
- A critical understanding of the limitations of the current state of financial theory in making strategic business decisions.

CONTENT SYNOPSIS:

The above learning outcomes will be developed through an exploration of key strategic decisions such as:

- Investment appraisal.
- Performance appraisal.
- Financial risk.
- Sources and costs of capital.
- Gearing and the dividend decision.

AMPLIFIED CONTENT:

The course will examine the key strategic decisions that a business faces from a finance and accounting perspective. This will include:

- **Acquisitions and Mergers**

Valuation of the target company.

Investment Appraisal.

Goodwill and intangible asset valuation.

- **Business process re-engineering**

Divisional performance.

Cost evaluation.

Cash management.

- **Financing**

Sources of finance.

Gearing implications.

Weighted Average Cost of Capital (WACC)

- **Capital Budgeting**

Capital rationing - profitability index.

Mutually exclusive investment with unequal lives.

Risk and Uncertainties - probabilities, sensitivity analysis, decision tree.

Unit 1

The Nature of Financial Management

LEARNING OUTCOMES

After completing this first unit, you should be able to:

- identify the main areas of financial management
- explain why, in terms of financial management, maximisation of shareholder wealth is the most appropriate corporate objective
- explain agency theory
- suggest ways of addressing the agency problem.

INTRODUCTION

Welcome to the first unit of the third-level module entitled 'Financial Management'. The module explores, within the context of the limited company, three key areas of finance: investment; the sources of funds to enable investment, and the rewards to the providers of those funds.

First you need to examine what finance is: finance is not 'Accountancy'. A set of accounts will give you some information, but it is not the information that is needed to enable decision-making in the three key areas of strategic financial management. For the ONLY time in this module, therefore, we want you to read a balance sheet – to discover what it doesn't tell you, rather than what it does!

ACTIVITY

Read through the following simplified balance sheet, then answer the questions below:



BRIGHT LTD BALANCE SHEET AS AT 30 JUNE 20XX (ALL FIGURES IN THOUSANDS)

	£ Cost	£ Dep'n	£ Net book value
Fixed assets			
Land and buildings	70		70
Computers and equipment	17	6	11
Motor vehicles	17	8	9
	<u>104</u>	<u>14</u>	<u>90</u>
Current assets			
Stock	15		
Debtors	16		
Cash and bank accounts	5	36	
less: Current liabilities			
Creditors	11		
Corporation tax	15		
Dividends	5	31	5
			<u>95</u>
Shareholders' funds			
Ordinary shares of £1 each		50	
Retained profits		<u>30</u>	80
Debenture			<u>15</u>
			<u>95</u>

1. What has this company invested in?
2. What are the sources of the funds for those investments?
3. How does the company reward the providers of those funds?

FEEDBACK



1. Although you were given only a balance sheet you should have been able to say, without any formal analysis, that the company has invested in land, buildings, computers, equipment and motor vehicles. It has no subsidiaries, investments in other companies or intangible assets such as patent rights. It also has net current assets of £5,000.
2. The funds have been provided by:
 - ordinary shareholders
 - company profits retained in the business
 - a debenture holder.

The first two sources are *equity* funding; the last is *debt* funding.
3. The shareholders are paid dividends. The ordinary shareholders will be paid an amount determined by the company out of residual profits. On the other hand, the ordinary shareholders may not be paid a dividend at all if it is decided that the funds would be better retained in the company for further investment. The debenture holder is paid interest, which is charged to the company's profit and loss account.

You can therefore obtain a lot of information about what the company has done by looking at the balance sheet. However, you cannot deduce from this information:

- why the company decided to invest in those particular fixed assets
- why it decided to issue preference shares
- why it obtained funding from the debenture holder
- how much dividend it has decided to pay to shareholders (the amount shown in the balance sheet is the amount *owed*, not the amount to be paid) and on what that decision was based
- when the dividends are to be paid.

These questions cover the three main areas of decision-making for the corporate financial manager:

- Investment: The choice of projects or assets in which to invest company funds. Competing alternatives have to be

assessed using a number of techniques. This type of decision will also be of concern to the private individual when making choices about which shares to buy.

- Finance: How these investments should be financed. It is necessary to evaluate the possible sources, external and internal, and the effect they will have on the capital structure of the company.
- Dividend: Whether corporate earnings should be retained or paid out in the form of dividends, and if the latter, when the dividends should be paid.

These areas are not independent of each other. For example, the decision to invest in a particular project may require a decision for further finance to be raised.

ACTIVITY



1. How might any investment also affect the dividend payment decision?
2. If the financial manager decides to pay a higher dividend to ordinary shareholders, how will this affect investment and finance decisions?

FEEDBACK



1. A decision to invest in a particular project would mean a lower dividend if the finance had to be raised internally.
2. If it was decided to pay a higher dividend than usual, this could mean that there were insufficient retained funds for investment. If an investment was subsequently thought to be necessary, finance would have to be raised externally.

Financial management will also involve the management of risk. Risk attaches to individual investments, the economy in general, to borrowing and to trading or investment abroad.

ACTIVITY



Give an example of a risk that a company might incur from:

1. investment in a particular firm
 2. the economy generally
 3. foreign exchange rates
 4. borrowing funds to finance its activities.
-

FEEDBACK



Some examples are:

1. The firm may perform badly, causing the value of the investment to fall.
 2. There may be a sharp rise in inflation rates or interest rates, or a general economic recession.
 3. If a foreign country has high rates of inflation, its currency may fluctuate.
 4. The company may not be able to meet the interest payments on the borrowed funds.
 5. You may have thought of other examples.
-

In this module, we will cover the topic of risk management as well as the management of a company's assets and liabilities in its working capital cycle. Assets must be managed effectively so that they generate income and profits, and so that funds are available to pay creditors and take up opportunities for investment.

In summary, therefore, we can say that financial management involves the following areas, which this module will cover:

- investment decisions
- funding decisions, including the capital structure of the company

- dividend decisions
- risk management

Corporate objectives – which is the most significant?

You may have noticed above that we referred to the ‘company’ and ‘corporate’. In this module we deal with strategic financial management in the context, principally, of the publicly quoted limited company. We begin with the question: ‘Why do companies exist?’ This question is not concerned with why the company exists *as a limited company*, but why it exists at all, or in whose interest(s) it exists.



ACTIVITY

So, why are companies created? Try to think of at least three possible objectives that a company could have for being in existence.



FEEDBACK

This might seem to be a strange question and your first reaction to it was probably something like ‘It’s obvious!’ or ‘To carry on business’. You might have come up with some of the following objectives:

1. to make profits from trading
 2. to provide work for people
 3. to sell its goods and services
 4. to grow, perhaps so that it can fulfil the previous objectives
 5. to survive in a competitive environment.
-

We asked earlier the question: ‘In whose interests does the company exist?’ This can be rephrased as: ‘Who are the interested parties, or

stakeholders?’ The objectives that we suggested above imply stakeholders as follows:

Possible objective	Stakeholders concerned
to make profits	shareholders, managers and creditors, including lenders
to provide work for people	employees and society generally
to sell goods and services	customers
to grow	shareholders and managers
to survive in a competitive environment	employees, shareholders and managers

There is a political element to this question. The capitalist viewpoint would be more concerned to emphasise profit-making in the competitive market. A socialist view would emphasise the provision of work, the reduction of unemployment figures and the provision of goods and services to society. The environmentalist would emphasise that the existence of the company should not be at the expense of depleting the world’s natural resources. The political philosophy behind the question is not within the scope of this module. However, the question of in whose interests a company is run is central to the decision-making involved in financial management, since any of the suggested stakeholders will want sensible decisions taken, if only for the company’s survival.

ACTIVITY



- Alongside the following list of stakeholders, write down what it is that they provide to the company and what reward they receive. The first one has been completed for you as an example:

Stakeholder	Provision	Reward
Employees	Time and skills	Salary
Suppliers		
Customers		
Banks		
Shareholders		

- Which, if any, of the stakeholders run a risk of not being rewarded, assuming that the company is trading?