SIXTH EDITION

CORPORATE FINANCIAL MANAGEMENT

GLEN ARNOLD
DEBORAH LEWIS

CORPORATE FINANCIAL
MANAGEMENT

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CORPORATE FINANCIAL MANAGEMENT

SIXTH EDITION

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Dedicated to Lesley my wife, for her loving support and encouragement. Glen Arnold

Brief contents

Topics covered in the book xxi
Introduction to the book xxiii
Acknowledgements xxix

Part 1 Introduction 1

1 The financial world 2

Part 2 The investment decision 49

2 Project appraisal: net present value and internal rate of return 50
3 Project appraisal: cash flow and applications 89
4 The decision-making process for investment appraisal 125
5 Project appraisal: capital rationing, taxation and inflation 151

Part 3 Risk and return 173

6 Risk and project appraisal 174
7 Portfolio theory 222
8 The Capital Asset Pricing Model and multi-factor models 268

Part 4 Sources of finance 325

9 Stock markets 326
10 Raising equity capital 363
11 Long-term debt finance 419
12 Short- and medium-term finance, treasury and working capital management 471
13 Stock market efficiency 539

Part 5 Corporate value 607

14 Value-based management 608
15 Value-creation metrics 654
16 The cost of capital 700
17 Valuing shares 734
18 Capital structure 783
19 Dividend policy 836
20 Mergers 864

Part 6 Managing risk 923

21 Derivatives 924
22 Managing exchange-rate risk 972

Appendices A:1

I Future value of £1 at compound interest A:2
II Present value of £1 at compound interest A:3
III Present value of an annuity of £1 at compound interest A:4
IV Future value of an annuity of £1 at compound interest A:5
V Areas under the standardised normal distribution A:6
VI Answers to the mathematical tools exercises in Chapter 2, Appendix 2.1 A:7

Glossary *G:1*
Bibliography *B:1*
Index *I:1*

Contents

Topics covered in the book xxi
Introduction to the book xxiii
Acknowledgements xxix

Part 1 Introduction 1

1 The financial world 2

Learning outcomes 2
Introduction 3
The objective of the firm 3
Case study 1.1 Experian 3
Some possible objectives 5
Corporate governance 16
Primitive and modern economies 22
The role of the financial manager 24
The flow of funds and financial intermediation 27
Growth in the financial services sector 33
The financial system 35

Concluding comments 41
Key points and concepts 41
References and further reading 43
Case study recommendations 46
Websites 46
Self-review questions 46
Questions and problems 47
Assignments 48

Part 2 The investment decision 49

2 Project appraisal: net present value and internal rate of return 50

Learning outcomes 50
Introduction 51
Value creation and corporate investment 52
Net present value and internal rate of return 57
Modified internal rate of return 72

Concluding comments 76
Key points and concepts 77
Appendix 2.1 Mathematical tools for finance 77
References and further reading 84

Case study recommendations *85*
Websites *85*
Self-review questions *85*
Questions and problems *86*
Assignments *88*

3 Project appraisal: cash flow and applications 89
Learning outcomes *89*
Introduction *90*
Case study 3.1 Toyota invests £240m to upgrade car plant in boost for Brexit Britain 90
Quality of information 91
Are profit calculations useful for estimating project viability? 92
The replacement decision 104
Replacement cycles 104
When to introduce a new machine 111
Drawbacks of the annual equivalent annuity method 112
Timing of projects 112
The make or buy decision 113
Fluctuating output 114
Concluding comments *115*
Key points and concepts *116*
References and further reading *116*
Case study recommendations *117*
Self-review questions *117*
Questions and problems *118*
Assignments *124*

4 The decision-making process for investment appraisal 125
Learning outcomes *125*
Introduction *126*
Evidence on the employment of appraisal techniques 127
Payback 128
Accounting rate of return 130
Internal rate of return: reasons for continued popularity 133
The managerial 'art' of investment appraisal 134
The investment process 138
Concluding comments *144*
Key points and concepts *144*
References and further reading *145*
Case study recommendations *147*
Self-review questions *148*
Questions and problems *148*
Assignment *150*

5 Project appraisal: capital rationing, taxation and inflation 151
Learning outcomes *151*
Introduction *152*
Capital rationing 152
Taxation and investment appraisal 156

Inflation 159

Concluding comments *165*
Key points and concepts *165*
References and further reading *165*
Case study recommendations *166*
Self-review questions *166*
Questions and problems *166*
Assignments *171*

Part 3 Risk and return 173

6 Risk and project appraisal 174

Learning outcomes *174*
Case study 6.1 Camelot 175
Introduction *175*
What is risk? 176
Adjusting for risk through the discount rate 178
Sensitivity analysis 179
Scenario analysis 183
Probability analysis 185
The risk of insolvency 195
Problems of using probability analysis 200
Evidence of risk analysis in practice 201
Real options (managerial options) 201

Concluding comments *212*
Key points and concepts *212*
References and further reading *213*
Case study recommendations *215*
Self-review questions *215*
Questions and problems *216*
Assignments *221*

7 Portfolio theory 222

Learning outcomes *222*
Introduction *223*
Holding period returns 223
Expected return and standard deviation for shares 225
Combinations of investments 228
Portfolio expected return and standard deviation 235
Dominance and the efficient frontier 239
Indifference curves 243
Choosing the optimal portfolio 245
The boundaries of diversification 246
Extension to a large number of securities 248
Evidence on the benefits of diversification 249
The capital market line 253
Problems with portfolio theory 256

Concluding comments *259*
Key points and concepts *260*
References and further reading *261*

Case study recommendations 262
Self-review questions 262
Questions and problems 263
Assignments 267

8 The Capital Asset Pricing Model and multi-factor models 268
Learning outcomes 268
Introduction 269
Some fundamental ideas and problems 270
A short history of shares, bonds and bills 271
The Capital Asset Pricing Model 285
Factor models 303
The arbitrage pricing theory 306
The three-factor model 307
The five-factor model 307
Fundamental beta 308
Project appraisal and systematic risk 309
Sceptics' views – alternative perspectives on risk 310

Concluding comments 312
Key points and concepts 314
Appendix 8.1: Note on arithmetic and geometric means 314
Appendix 8.2: Why professors do or do not use CAPM-beta 315
Comments from professors who use calculated betas 316
Comments from professors who use 'common sense' betas 317
Comments from professors who do not use betas 317
References and further reading 318
Case study recommendations 322
Self-review questions 322
Questions and problems 323
Assignments 324

Part 4 Sources of finance 325

9 Stock markets 326
Learning outcomes 326
Case study 9.1 Using the stock market both to create wealth and to treat disease 327
Introduction 327
Stock exchanges around the world 327
Globalisation of financial flows 331
Why do companies list their shares on more than one exchange? 333
The importance of a well-run stock exchange 335
The London Stock Exchange 337
The UK equity markets available to companies 341
Tasks for stock exchanges 343
How stock exchanges work 344
The ownership of UK shares 351
Regulation 352
Understanding the figures in the financial pages 355
Taxation and corporate finance 357

Concluding comments 358
Key points and concepts 359

References and further reading *360*
Case study recommendations *360*
Websites *361*
Video presentations *361*
Self-review questions *361*
Questions and problems *362*
Assignments *362*

10 Raising equity capital 363

Learning outcomes *363*
Case study 10.1 To float or not to float? 364
Introduction *364*
What is equity capital? 365
Preference shares 368
Some unusual types of shares 369
Floating on the Main Market (Official List) 371
The new issue process 376
Other methods of floating 378
How does an AIM flotation differ from one on the Official List? 379
The costs of new issues 380
Rights issues 382
Other equity issues 387
Warrants 389
Equity finance for unquoted firms 389
Crowdfunding 394
How an independent private equity fund is established and managed 397
Disillusionment and dissatisfaction with quotation 404

Concluding comments *404*
Key points and concepts *405*
Appendix 10.1: Reasons for and against floating *407*
References and further reading *413*
Case study recommendations *416*
Websites *416*
Video presentations *416*
Self-review questions *417*
Questions and problems *417*
Assignment *418*

11 Long-term debt finance 419

Learning outcomes *419*
Introduction *420*
Some fundamental features of debt finance 420
Bonds 420
Bank borrowing 426
Syndicated loans 429
Credit rating 430
Mezzanine finance and high-yield (junk) bonds 432
Case study 11.1 The junk bond wizard: Michael Milken 436
Convertible bonds 439
Valuing bonds 442
International sources of debt finance 446
Project finance 453
Sale and leaseback 455
Securitisation 456

Islamic banking 458
Peer-to-peer lending 458
The term structure of interest rates 459

Concluding comments *464*
Key points and concepts *464*
References and further reading *466*
Case study recommendations *467*
Websites *467*
Video presentations *467*
Self-review questions *468*
Questions and problems *468*
Assignments *470*

12 Short- and medium-term finance, treasury and working capital management 471

Learning outcomes *471*
Introduction *472*
Short- and medium-term bank finance 472
Trade credit 477
Factoring 480
Case study 12.1 LG Steelworks 482
Hire purchase 484
Leasing 487
Bills of exchange 492
Bankers' acceptances (banks bills, acceptance credits) 493
Treasury management 493
Financing 495
Risk management 503
Working capital management 507
Investment of temporary surplus funds 524

Concluding comments *527*
Key points and concepts *528*
References and further reading *530*
Case study recommendations *531*
Websites *531*
Self-review questions *532*
Questions and problems *532*
Assignments *538*

13 Stock market efficiency 539

Learning outcomes *539*
Introduction *540*
What is meant by efficiency? 540
Random walks 544
The three levels of efficiency 546
Weak-form tests 546
Semi-strong form tests 558
Strong-form tests 579
Behavioural finance 581
Misconceptions about the efficient market hypothesis 589
Implications of the EMH for investors 589
Implications of the EMH for companies 590

Concluding comments 591
Key points and concepts 592
References and further reading 592
Case study recommendations 603
Self-review questions 603
Questions and problems 604
Assignment 605

Part 5 Corporate value 607

14 Value-based management 608

Learning outcomes 608
Introduction 609
The shareholder wealth-maximising goal 611
Three steps of value 612
Traditional measurement techniques 613
Earnings-based management 613
Return on capital employed (ROCE) has failings 618
An overview of the application of value principles 628
Strategic business unit management 630
Corporate strategy 641
Targets and motivation 644
Case study 14.1 Strategy, planning and budgeting at Lloyds TSB 644

Concluding comments 645
Key points and concepts 645
References and further reading 648
Video presentations 650
Case study recommendations 650
Self-review questions 651
Questions and problems 651
Assignments 653

15 Value-creation metrics 654

Learning outcomes 654
Introduction 655
Using cash flow to measure value 655
Shareholder value analysis 660
Economic profit 668
Economic value added (EVA®) 674
Total shareholder return (TSR) 676
Wealth Added Index (WAI) 679
Case study 15.1 Vone's wealth added index 679
Market Value Added (MVA) 680
Excess return (ER) 683
Market to book ratio (MBR) 685

Concluding comments 689
Key points and concepts 689
References and further reading 692
Case study recommendations 694
Websites 694
Self-review questions 694

Questions and problems 695
Assignments 698
Appendix 15.1: Further consideration of the entity and equity EP 698

16 The cost of capital 700

Learning outcomes 700
Introduction 701
A word of warning 701
The required rate of return 701
The weighted average cost of capital (WACC) 703
The cost of equity capital 708
The cost of retained earnings 711
The cost of debt capital 711
Traded debt 712
The cost of preference share capital 713
Calculating the weights 714
Applying the WACC to projects and SBUs 715
Empirical evidence of corporate practice 716
How large is the equity risk premium? 723
Some thoughts on the cost of capital 726

Concluding comments 727
Key points and concepts 728
References and further reading 728
Case study recommendations 731
Websites 731
Video presentations 731
Self-review questions 731
Questions and problems 732
Assignment 733

17 Valuing shares 734

Learning outcomes 734
Introduction 735
Case study 17.1 Amazon.com 735
Valuation using net asset value (NAV) 737
Valuation using income-flow methods 739
Dividend valuation models 740
The price-earnings ratio (PER) model 748
Valuation using cash flow 753
Valuation using owner earnings 754
Case study 17.2 N Brown – owner earnings analysis 760
EBITDA 763
Valuing unquoted shares 765
Unusual companies 765
Managerial control and valuation 766
Allowing for real option values 768

Concluding comments 772
Key points and concepts 772
References and further reading 774
Case study recommendations 775
Websites 776
Self-review questions 776
Questions and problems 776
Assignments 782

18 Capital structure 783

Learning outcomes *783*
Introduction *784*
Other ideas 784
What do we mean by 'gearing'? 786
The effect of gearing 792
The value of the firm and the cost of capital 798
Does the cost of capital (WACC) decrease with higher debt levels? 799
Modigliani and Miller's argument in a world with no taxes 800
The capital structure decision in a world with tax 803
Additional considerations 805
Some further thoughts on debt finance 819

Concluding comments *823*
Key points and concepts *824*
Appendix 18.1: Asset beta *825*
Appendix 18.2: Adjusted present value (APV) *827*
References and further reading *828*
Case study recommendations *832*
Video presentations *832*
Self-review questions *833*
Questions and problems *833*
Assignments *835*

19 Dividend policy 836

Learning outcomes *836*
Introduction *837*
Defining the problem 837
Miller and Modigliani's dividend irrelevancy proposition 839
Dividends as a residual 841
Clientele effects 844
Taxation 845
Dividends as conveyors of information 846
Resolution of uncertainty 849
Owner control (agency theory) 850
Scrip dividends 852
Share buy-backs and special dividends 852
A round-up of the arguments 853

Concluding comments *856*
Key points and concepts *857*
References and further reading *858*
Case study recommendations *860*
Video presentations *860*
Self-review questions *860*
Questions and problems *861*
Assignments *863*

20 Mergers 864

Learning outcomes *864*
Introduction *865*
The merger decision 865
Merger statistics 867
Merger motives 869

Financing mergers 885
The merger process 890
The impact of mergers 897
Managing mergers 901

Concluding comments *911*
Key points and concepts *912*
References and further reading *913*
Case study recommendations *918*
Websites *918*
Video presentations *918*
Self-review questions *919*
Questions and problems *919*
Assignment *921*

Part 6 Managing risk 923

21 Derivatives 924

Learning outcomes *924*
Introduction *925*
A long history 925
Options 926
Forwards 937
Futures 938
Case study 21.1 Protecting a portfolio against a major market fall 945
Forward rate agreements (FRAs) 950
A comparison of options, futures, forwards and FRAs 952
Caps 953
Swaps 954
Derivatives users 958
Over-the-counter (OTC) and exchange-traded derivatives 959

Concluding comments *960*
Key points and concepts *961*
Appendix 21.1: Option pricing *962*
Appendix 21.2: The relationship between FRAs and swaps *963*
References and further reading *966*
Case study recommendations *966*
Websites *967*
Self-review questions *967*
Questions and problems *968*
Assignments *971*

22 Managing exchange-rate risk 972

Learning outcomes *972*
Introduction *973*
Case study 22.1 What a difference a few percentage point moves on the exchange rate make 973
The effects of exchange-rate changes 974
Volatility in foreign exchange 977
The foreign exchange markets 979
Exchange rates 982
Types of foreign-exchange risk 988
Transaction risk strategies 991

Managing translation risk 1001
Managing economic risk 1002
Exchange-rate determination 1004

Concluding comments *1010*
Key points and concepts *1010*
References and further reading *1011*
Case study recommendations *1012*
Websites *1013*
Video presentations *1013*
Self-review questions *1013*
Questions and problems *1014*
Assignments *1015*

APPENDICES A:1

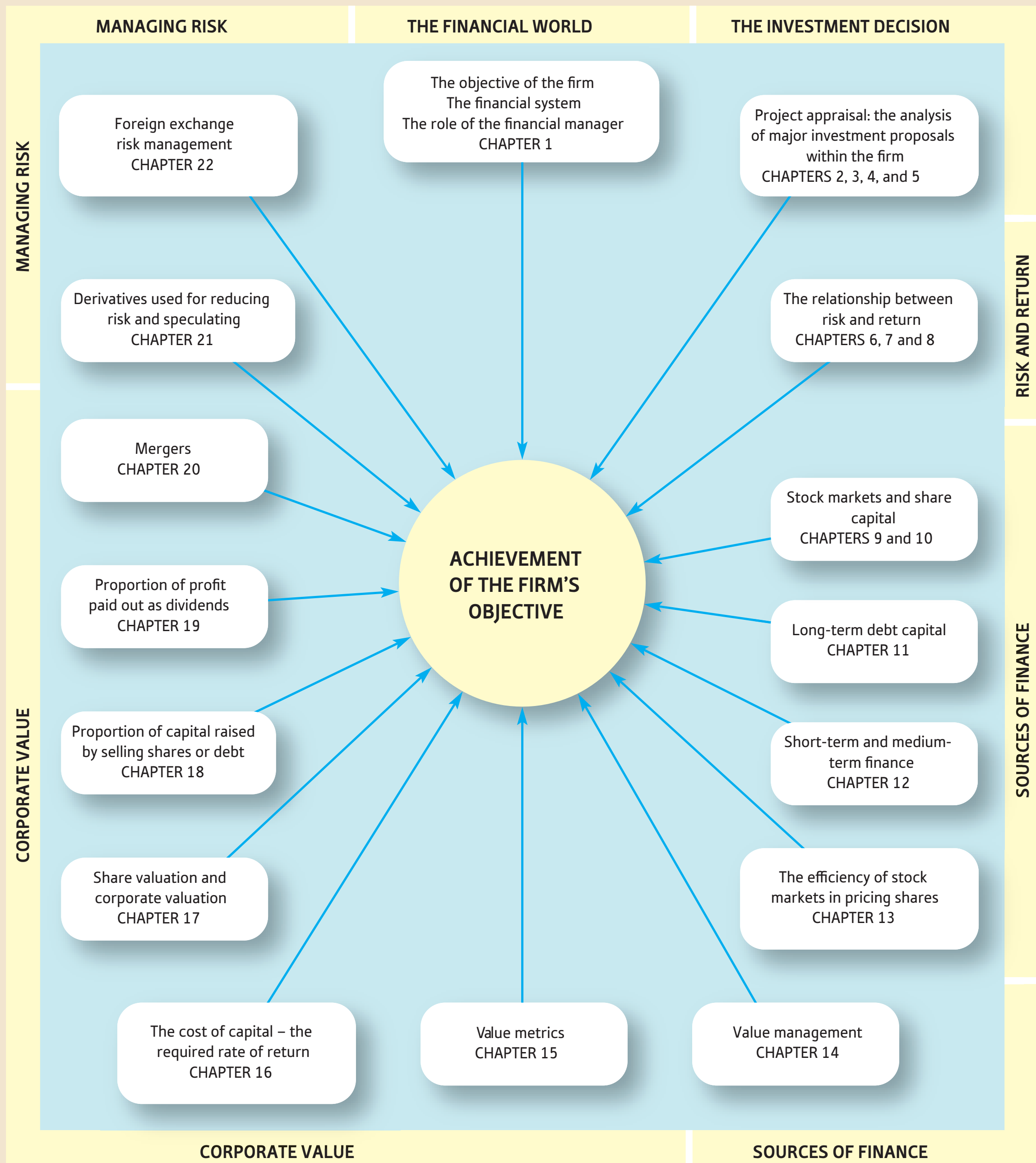
I Future value of £1 at compound interest A:2
II Present value of £1 at compound interest A:3
III Present value of an annuity of £1 at compound interest A:4
IV Future value of an annuity of £1 at compound interest A:5
V Areas under the standardised normal distribution A:6
VI Answers to the mathematical tools exercises in Chapter 2, Appendix 2.1 A:7

Glossary *G:1*
Bibliography *B:1*
Index *I:1*

Lecturer Resources

For password-protected online resources tailored to support the use of this textbook in teaching, please visit **www.pearsoned.co.uk/arnold**

Topics covered in the book



Introduction to the book

Aims of the book

If there is one lesson that the 2008 financial crisis and the Great Recession taught us, it is that there is good and bad financial practice. Unfortunately, many of the basic tenets of finance get forgotten by corporate managers, bankers and leaders of financial institutions from time to time. Important financial issues, such as adopting sensible levels of debt, or simply being aware of risk levels, or checking the validity of the assumptions made when investing in the business, valuing a financial security or embarking on a merger, can be very badly handled.

This book has been updated to emphasise the basic lessons from hundreds of years of finance practice and theory, so that you might be more aware of the difference between good practice and what is plain stupid; so that you can avoid the errors made by countless business leaders.

The book assumes no knowledge of finance. It is comprehensive and provides the key elements needed by business management, accounting and other undergraduates, postgraduates and practising managers. Finance theory and practice are integrated throughout the text, reflecting the extent to which real-world practice has been profoundly shaped by theoretical developments.

Some of the features in this sixth edition are listed below.

- While the underlying principles of finance have not altered since the publication of the fifth edition some further changes have occurred for example in regulation, legislation and the operation of financial markets. These are explained.
- Where appropriate, illustrations from more recent corporate events, many of which draw on *Financial Times* articles, have been incorporated.
- The evidence gathered in the twenty-first century on the usefulness of beta as defined by the Capital Asset Pricing Model has been overwhelmingly negative. When this is combined with the theoretical problems, a much more sceptical line on the CAPM-beta is called for.
- Trillions of pounds are now placed with investment funds buying share portfolios drawing on stock market inefficiency evidence – called 'smart beta' funds. The academic work providing the impetus for this (even though it has now been taken too far) is examined.
- Fintech developments, including crowdfunding and peer-to-peer lending, have brought new ways of raising funds for businesses.
- Surveys of business practice are used through the text, not least in the cost of capital and share valuation sections, where the deviations from pure theory illustrate the compromises that must be made in the real world.
- Statistics on the financial markets and instruments, have been updated.
- The jargon-busting glossary has been extended and updated.

Themes in the book

Practical orientation

Every chapter describes and illustrates how financial techniques are used in the practical world of business. Throughout the text insight is offered into how and why practice may sometimes differ from sound theory. For example, in making major investment decisions, managers still use

techniques with little theoretical backing (e.g. payback) alongside the more theoretically acceptable approaches. We explore the reasons for the retention of these simple rule-of-thumb methods. This book uses theory, algebra and economic models where these are considered essential to assist learning about better decision making. Where these are introduced, however, they must always have passed the practicality test: 'Is this knowledge sufficiently useful out there, in the real world, to make it worthwhile for the reader to study it?' If it is not, then it is not included.

Clear, accessible style

Great care has been taken to explain sometimes difficult topics in an interesting and comprehensible way. An informal language style, and an incremental approach, which builds knowledge in a series of easily achieved steps, leads the reader to a high level of knowledge with as little pain as possible. The large panel of reviewers of the book assisted in the process of developing a text that is, we hope, comprehensive and easy to read.

Integration with other disciplines

Finance should never be regarded as a subject in isolation, separated from the workings of the rest of the organisation. This text, when considering the link between theoretical methods and practical financial decision making, recognises a wide range of other influences, from strategy to psychology.

Real-world relevance

Experience of teaching finance to undergraduates, postgraduates and managers on short courses has led to the conclusion that, in order to generate enthusiasm and commitment to the subject, it is vital continually to show the relevance of the material to what is going on in the world beyond the textbook. Therefore, this book incorporates vignettes/short case studies as well as examples of real companies making decisions drawing on the models, concepts and ideas of financial management.

A UK/international perspective

There is a primary focus on the UK, but also regular reference to international financial markets and institutions. The international character of the book has been enhanced by the detailed evaluation of each chapter by a number of respected academics teaching at universities in Europe, Asia, Australasia and Africa. The global world of modern finance requires that a text of this nature reflects the commonality of financial principles in all countries, as well as interactions and the impact of vast capital flows across borders.

A re-evaluation of classical finance theory

There is considerable debate about the validity of the theories of the 1950s and 1960s upon which much of modern finance was developed, stimulated by fresh evidence generated over the last two decades. For example, the theories concerning the relationship between the risk of a financial security and its expected return are under dispute, with some saying the old measure of risk, beta, is dead or dying. This issue and other financial economics theories are presented along with their assumptions and a consideration of recent revisions.

Real-world case examples

It has been possible to include much more than the usual quantity of real-world case examples in this book by drawing on material from the *Financial Times*. The aim of these extracts is to bring the subject of finance to life for readers. A typical example is shown in Exhibit 1, which is used to illustrate some of the financial issues explored in the book. This article touches on many of the financial decisions which are examined in greater detail later in the book. Expanding a retail empire requires a lot of money. In the summer of 2017, Quiz Clothing raised more money

Exhibit 1

Quiz Clothing soars on IPO to reach £245m market value

By Hannah Murphy

Quiz Clothing, the womenswear retailer, jumped more than 20 per cent on its trading debut on Friday. The company, which was founded in Glasgow in 1993, priced its initial public offering at 161p. The shares leapt 22 per cent to 197p in early trading, pushing its market value up to £245m from £200m.

Quiz said it had raised £102.7m from the float, £92.1m of which it earmarked for selling shareholders, while the remaining £10.6m it said would be used to "accelerate growth".

The successful listing is the latest by a new breed of fashion retailers aimed at millennials. Quiz describes itself as focused on women's "occasion wear and dressy casual wear" for 16-35-year-olds and says it has adopted "fast fashion" processes that allow it to bring designs into shops quickly.

While small in comparison, it will rival the likes of online retailers Asos, now up more than 30,000 per cent to £58.53 since its listing in 2001, and Boohoo, whose shares have risen 360 per cent to 233p since it first floated in 2014. Asos and Boohoo are valued at £4.85bn and £2.68bn respectively.

Unlike the two larger retailers, Quiz has 73 standalone stores in the UK, more than 165 concessions in the regions and Republic of Ireland and 65 franchise stores across 19 countries. But it is focused on boosting its online offering.

"There's still good growth in stores … but the real growth story over the next few years will be international and online," founder and chief executive Tarak Ramzan said.

The company had chosen to float partly as a way to "bring in new talent", he added, citing the appointment of Peter Cowgill, chair of sportswear retailer JD Sports, to the board as part of its entry to the stock market.

Still, the company believes there is life in bricks and mortar, and said earlier this year that it saw potential for 40-50 more stores across the UK in "the medium to long term".

Just over half of the company, 51.2 per cent, is now in public hands.

FT *Financial Times,* 28 July 2017.
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to invest in the next stage of its development. There are four vital financial issues facing management:

1 *Raising finance and knowledge of financial markets.* Quiz grew its business using family money for 24 years until it turned to the London Stock Exchange (LSE) to sell newly created shares raising £9.4m (after expenses) to invest in the business. Also, the Ramzan family sold a proportion of their shares, thus benefiting from their hard work. Being listed on the LSE will enhance its ability to raise more capital in the future because of the additional credibility that flows from being on the exchange. Companies have a wide range of options when it comes to raising finance to allow growth – sources of finance are considered in Chapters 9–13.

2 *Investment in real assets, tangible or intangible.* The directors of Quiz believe that they have investment opportunities in online retailing as well as high street stores. The company intends to invest in new websites in Spain, Australia and the USA, to open six stores in Spain and 20 in the UK in the months following the flotation. Around £6m is earmarked for online marketing and advertising and £2m for capital expenditure on physical items to go in shops. It will also invest in its people and bring in new talent. There are sound techniques which help in the process of deciding whether to make a major investment – these are discussed early in the book (Chapters 2–6).

3 *Creating and measuring shareholder value.* Quiz will need to consider the strategic implications of its actions, such as the current and likely future return on capital in the markets it may

choose to enter. Will Quiz have a competitive edge over its rivals in those markets? Value-based management draws on the analytical techniques developed in finance and combines them with disciplines such as strategy and resource management to analyse whether value is being/will be created or destroyed (Chapters 14 and 15). At the centre of value-based management is recognition of the need to produce a return on capital devoted to an activity commensurate with the risk. Establishing the minimum required return is the 'cost of capital' issue (Chapter 16). Quiz might consider buying another company (mergers are covered in Chapter 20) and so being able to value business units, companies and shares is very useful (Chapter 17). Then there is the question of the proportion of annual profits that should be paid out as dividends or retained for reinvestment (Chapter 19).

4 *Managing risk*. Quiz is faced with many operational risks, e.g. perhaps it will fail to strike a chord with consumers in Spain or America. There are some risks the firm has to accept, including these operational risks. However, there are many others that can be reduced by taking a few simple steps. For example, the risk of a rise in interest rates increasing the cost of borrowings, thus wiping out profits, can be reduced/eliminated by changing the capital structure; raising additional equity and using this to reduce debt (Chapter 18). Derivative financial instruments can be used to reduce interest rate risk (Chapter 21) or exchange rate risk. Quiz will be selling a significant proportion of its clothing in currencies other than sterling but may have costs in other currencies. Currency shifts can have a large impact on profits (Chapter 22).

These are just a few of the financial issues that have to be tackled by the modern finance manager and trying to understand and then answer these questions forms the basis for this book.

Student learning features

Each chapter has the following elements to help the learning process:

- ***Learning objectives*** This section sets out the competencies expected to be gained by reading the chapter.
- ***Introduction*** Intended to engage the attention of the reader, this discusses the importance and relevance of the topic to real business decisions.
- ***Worked examples*** New techniques are illustrated in the text, with sections which present problems, followed by detailed answers.
- ***Mathematical explanations*** Students with limited mathematical ability should not be put off by this text. The basics are covered early and in a simple style. New skills are fully explained and illustrated, as and when required.
- ***Case studies and articles*** Extracts from recent articles from the *Financial Times,* company annual reports and other sources are used to demonstrate the arguments in the chapter, to add a different dimension to an issue, or to show that this sort of decision is being made in day-to-day business.
- ***Key points and concepts*** An outline is given of the essentials of what has been covered; new concepts, jargon and equations are summarised for easy reference.
- ***References and further reading*** One of the features of this text is the short commentaries included with the list of articles and books referred to. These allow students to be selective in their follow-up reading. Whether a particular article takes a high-level, algebraic and theoretical approach or is an easy-to-read introduction to the subject is highlighted, permitting the student to decide whether the article is of interest.
- ***Websites*** A useful list of websites is also included.
- ***Self-review questions*** These short questions are designed to prompt the reader to recall the main elements of the topic. They can act as a revision aid and highlight areas requiring more attention.
- ***Questions and problems*** These vary in the amount of time required, from 5 minutes to 45 minutes or more. Many are taken from university second year and final year undergraduate

examinations, and MBA module examinations. They allow the student to demonstrate a thorough understanding of the material presented in the chapter. Some of these questions necessitate the integration of knowledge from previous chapters with the present chapter. The answers to many of the questions can be found on the website for the book www.pearsoned.co.uk/arnold.

- ***Assignments*** These are projects which require the reader to investigate real-world practice in a firm and relate this to the concepts and techniques learned in the chapter. These assignments can be used both as learning aids and as a way of helping students to examine the relationship between current practice and finance theory and frameworks.
- ***Recommended case studies*** A list of case studies relevant to the chapter material is provided. These are drawn from the Harvard Business School website.

At the end of the book there are also the following elements:

- ***Appendices*** Appendices give a future value table (Appendix I), present value table (Appendix II), present value of annuity table (Appendix III), future value of an annuity (Appendix IV), areas under the standardised normal distribution (Appendix V), answers to questions in Chapter 2, and Appendix 2.1 reviewing mathematical tools for finance (Appendix VI).
- ***Glossary*** There is an extensive Glossary of terms, allowing the student quickly to find the meaning of new technical terms or jargon.
- ***Bibliography*** There is also a Bibliography of references for further reading.

Also on the Companion Website (found at www.pearsoned.co.uk/arnold) there are the following downloadable resources:

- Answers to the numerical questions and problems – with the exception of those question numbers followed by an asterisk (*) which are answered in the instructor's manual.
- Supporting spreadsheets for Chapters 2, 3, 6, 7, 11 & 19

Support for lecturers

Go to www.pearsoned.co.uk/arnold to access:

- Over 800 PowerPoint slides.
- Instructor's manual.
- A link to **MyLab Finance.**

Instructor's manual

This contains:

- Supplementary material for chapters, including learning objectives and key points and concepts listings.
- A multiple-choice question bank (also available on the website).
- Answers to the questions and problems marked with an asterisk * in the book.

Target readership

The book is aimed at second/final year undergraduates of accounting and finance, business/management studies, banking and economics, as well as postgraduate students on MBA/MSc courses in the UK, Europe and the rest of the world. It would be helpful if the student has an elementary knowledge of statistics, algebra, accounting and microeconomics, but this is not essential.

The practising manager, whether or not a specialist in financial decision making, should find the book useful – not least to understand the language and concepts of business and financial markets.

Students studying for examinations for the professional bodies will benefit from this text. The material is valuable for those working towards a qualification of one of the following organisations:

- CFA Institute
- Association of Corporate Treasurers
- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants of Scotland
- Chartered Institute of Public Finance and Accountancy
- Association of Chartered Certified Accountants
- Chartered Institute of Management Accountants
- Institute of Chartered Secretaries and Administrators
- The London Institute of Banking & Finance
- British Bankers Association

The applicability of finance knowledge for all organisations

Most of the theories and practical examples in the book are directed at businesses operating in a competitive market environment. However, the fundamental principles revealed by the logic and frameworks of finance are applicable to organisations other than commercial firms such as non-profit organisations and public sector bodies, ranging from schools and hospitals to charities and churches. The principles contained within the book have validity and applicability to any organisation needing to make decisions involving finance.

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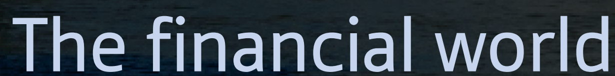
PART 1

Introduction

1 The financial world

CHAPTER 1



The financial world

LEARNING OUTCOMES

At the end of this chapter the reader will have a balanced perspective on the purpose and value of the finance function, at both the corporate and the national level. More specifically, the reader should be able to:

- describe alternative views on the purpose of the business and show the importance to any organisation of clarity on this point;
- describe the impact of the divorce of corporate ownership from day-to-day managerial control;
- explain the role of the financial manager;
- detail the value of financial intermediaries;
- show an appreciation of the function of the major financial institutions and markets.

Introduction

Before getting carried away with specific financial issues and technical detail, it is important to gain a broad perspective by looking at the fundamental questions and the place of finance in the overall scheme of things. The finance function is a vital one, both within an individual organisation and for society as a whole. In the UK, for example, the financial services industry accounts for a larger proportion of national output than the whole of manufacturing industry. Banking, finance, insurance and other finance-related businesses produce about 12% of output. This compares with manufacturing's 10% share, which is down from 30% of all production in 1970. There has been an enormous shift in demand and resources in recent decades. To some this is a cause of great alarm and regret but, given that this trend occurred at a time when free choice in the marketplace largely dictates what is produced, presumably there must be something useful that financial firms are providing. We will examine the key role played by financial intermediaries and markets in a modern economy, and how an efficient and innovative financial sector contributes greatly to the ability of other sectors to produce goods and services. One of the vital roles of the financial sector is to encourage the mobilisation of savings to put them to productive use through investment. Without a vibrant and adaptable financial sector all parts of the economy would be starved of investment and society would be poorer.

This chapter also considers the most fundamental question facing anyone trying to make decisions within an organisation: what is the objective of the business? Without clarity on this point it is very difficult to run a business in a purposeful and effective manner. The resolution of this question is somewhat clouded in the large, modern corporation by the tendency for the owners to be distant from the running of the enterprise. Professional managers are usually left in control and they have objectives which may or may not match those of the owners.

Finally, to help the reader become orientated, a brief rundown is given of the roles, size and activities of the major types of financial institutions and markets. A little bit of jargon busting early on will no doubt be welcomed.

The objective of the firm

Experian, widely regarded as one of the best-managed companies in the world, has a clear statement of its objective in its 2016 Annual Report – *see* **Case study 1.1.**

Case study 1.1 Experian

'Our business model is based on a set of substantial competitive advantages. Our strategy builds on and reinforces these advantages, so we can maximise the value we create for our shareholders in the long term.'

There follows a description of how they attempt to 'maximise the value we create for shareholders in the long term' by creating 'significant value for society' through offering services, including:

- Holding credit data on 918 million people and 107 million businesses. Thus, for example, credit reports can be obtained if an individual or a business is applying for a bank loan.
- Marketing data on 700 million people held and analysed so that companies can better understand customers.

Strategy follows clarity on the objective: 'Our strategy is centred on delivering world-class expertise . . . [to] become the world leader in powering data-driven opportunities.'

Aims follow the strategy:

- To deliver . . . revenue growth consistently
- To operate our business efficiently and cost effectively

▶

Case study 1.1 *(continued)*

- To generate good returns
- To deliver profit growth, while balancing investment in the business and shareholder returns
- To covert at least 90% of [profit] into operating cash flow
- To ensure Experian is a great place to work, attracting and retaining the best people
- To minimize as far as possible our impact on the environment

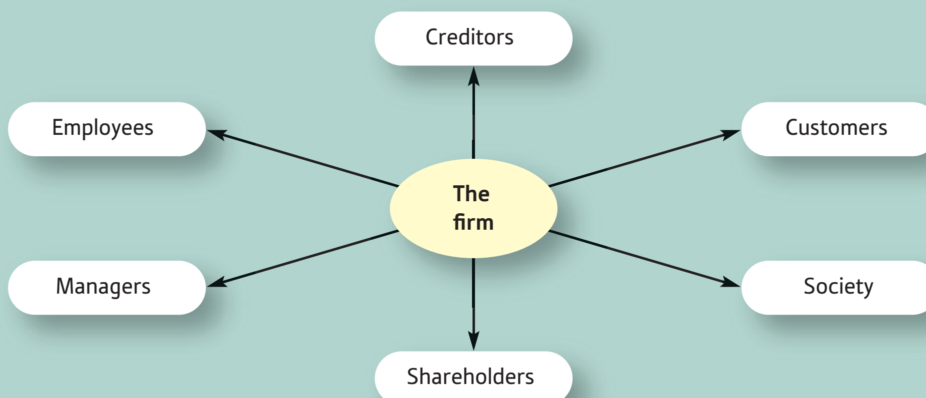
Source: Experian plc Annual Report 2016.

Notice that there is not a confusion of objectives (as there is in many companies) with no one knowing which of a long list of desirable outcomes is the dominant purpose of the firm. Experian does not confuse the objective with the strategy to be employed to achieve the objective. Many managerial teams believe that it is their objective to operate within a particular market or take particular actions. They seem unable to distinguish market positions or actions from the ultimate purpose for the existence of the organisation. This will not only lead to poor strategic decisions but frequently makes intelligent financial decisions impossible.

This book is all about practical decision making in the real world. When people have to make choices in the harsh environment in which modern businesses have to operate, it is necessary to be clear about the purpose of the organisation; to be clear about what objective is set for management to achieve. A multitude of small decisions is made every day; more importantly, every now and then major strategic commitments of resources are made. It is imperative that the management teams are aware of, respect and contribute to the fundamental objective of the firm in all these large and small decisions. Imagine the chaos and confusion that could result from the opposite situation where there is no clear, accepted objective. The outcome of each decision, and the direction of the firm, will become random and rudderless. One manager on one occasion will decide to grant long holidays and a shorter working week, believing that the purpose of the institution's existence is to benefit employees; while on another occasion a different manager sacks 'surplus' staff and imposes lower wages, seeing the need to look after the owner's interests as a first priority. So, before we can make decisions in the field of finance we need to establish what it is we are trying to achieve.

You have probably encountered elsewhere the question, 'In whose interests is the firm run?' This is a political and philosophical as well as an economic question and many books have been written on the subject. Here we will provide a brief overview of the debate because of its central importance to making choices in finance. The list of interested parties in **Exhibit 1.1** could be extended,

Exhibit 1.1 **A company has responsibilities to a number of interested parties**



but no doubt you can accept the point from this shortened version that there are a number of claimants on a firm.

Sound financial management is necessary for the survival of the firm and for its growth. Therefore all of these stakeholders, to some extent, have an interest in seeing sensible financial decisions being taken. Many business decisions do not involve a conflict between the objectives of each of the stakeholders. However, there are occasions when someone has to decide which claimants are to have their **objectives maximised**, and which are merely to be **satisficed** – that is, given just enough of a return to make their contributions.

There are some strong views held on this subject. The pro-capitalist economists, such as Friedrich Hayek and Milton Friedman, believe that making shareholders' interests the paramount objective will benefit both the firm and society at large. This approach is not quite as extreme as it sounds because these thinkers generally accept that unbridled pursuit of shareholder returns, to the point of widespread pollution, murder and extortion, will not be in society's best interest and so add the proviso that maximising shareholder wealth is the desired objective provided that firms remain within 'the rules of the game'. This includes obeying the laws and conventions of society, and behaving ethically and honestly.

At the opposite end of the political or philosophical spectrum are the left-wing advocates of the primacy of workers' rights and rewards. The belief here is that labour should have its rewards maximised. The employees should have all that is left over, after the other parties have been satisfied. Shareholders are given just enough of a return to provide capital, suppliers are given just enough to supply raw materials and so on.

Standing somewhere in the middle are those keen on a balanced stakeholder approach. Here the (often conflicting) interests of each of the claimants are somehow maximised but within the constraints set by the necessity to compromise in order to provide a fair return to the other stakeholders.

Some possible objectives

A firm can choose from an infinitely long list of possible objectives. Some of these will appear noble and easily justified; others remain hidden, implicit, embarrassing, even subconscious. The following represent some of the most frequently encountered.

- ***Achieving a target market share*** In some industrial sectors to achieve a high share of the market gives high rewards. These may be in the form of improved profitability, survival chances or status. Quite often the winning of a particular market share is set as an objective because it acts as a proxy for other, more profound objectives, such as generating the maximum returns to shareholders. On other occasions matters can get out of hand and there is an obsessive pursuit of market share with only a thin veneer of shareholder wealth espousement.
- ***Keeping employee agitation to a minimum*** Here, return to the organisation's owners is kept to a minimum necessary level. All surplus resources are directed to mollifying employees. Managers would be very reluctant to admit publicly that they place a high priority on reducing workplace tension, encouraging peace by appeasement and thereby, it is hoped, reducing their own stress levels, but actions tend to speak louder than words.
- ***Survival*** There are circumstances where the overriding objective becomes the survival of the firm. Severe economic or market shock may force managers to focus purely on short-term issues to ensure the continuance of the business. In firefighting they end up paying little attention to long-term growth and return to owners. However, this focus is clearly inadequate in the long run – there must be other goals. If survival were the only objective then putting all the firm's cash reserves into a bank savings account might be the best option. When managers say that their objective is survival, what they generally mean is the avoidance of large risks which endanger the firm's future. This may lead to a greater aversion to risk, and a rejection of activities that shareholders might wish the firm to undertake. Shareholders are in a position to diversify their investments: if one firm goes bankrupt they may be disappointed but they have other companies' shares to fall back on. However, the managers of that one firm may have the majority of their income, prestige and security linked to the continuing existence of that firm.

These managers may deliberately avoid high-risk/high-return investments and therefore deprive the owners of the possibility of large gains.

- ***Creating an ever-expanding empire*** This is an objective which is rarely discussed openly, but it seems reasonable to propose that some managers drive a firm forward, via organic growth or mergers, because of a desire to run an ever-larger enterprise. Often these motives become clearer with hindsight; when, for instance, a firm meets a calamitous end the post-mortem often reveals that profit and efficiency were given second place to growth. The volume of sales, number of employees or overall stock market value of the firm have a much closer correlation with senior executive salaries, perks and status than do returns to shareholder funds. This may motivate some individuals to promote growth.
- ***Maximisation of profit*** This is a much more acceptable objective, although not everyone would agree that maximisation of profit should be the firm's purpose.
- ***Maximisation of long-term shareholder wealth*** While many commentators concentrate on profit maximisation, finance experts are aware of a number of drawbacks of profit. The maximisation of the returns to shareholders in the long term is considered to be a superior goal. We look at the differences between profit maximisation and wealth maximisation later.

This list of possible objectives can easily be extended but it is not possible within the scope of this book to examine each of them. Suffice it to say, there can be an enormous variety of objectives and significant potential for conflict and confusion. We have to introduce some sort of order.

The assumed objective for finance

The company should make investment and financing decisions with the aim of maximising long-term shareholder wealth. Throughout the remainder of this book we will assume that the firm gives primacy of purpose to the wealth of shareholders. This assumption is made mainly on practical grounds, but there are respectable theoretical justifications too.

The practical reason

If one may assume that the decision-making agents of the firm (managers) are acting in the best interests of shareholders then decisions on such matters as which investment projects to undertake, or which method of financing to use, can be made much more simply. If the firm has a multiplicity of objectives, imagine the difficulty in deciding whether to introduce a new, more efficient machine to produce the firm's widgets, where the new machine will both be more labour efficient (thereby creating redundancies) and eliminate the need to buy from one half of the firm's suppliers. If one focuses solely on the benefits to shareholders, a clear decision can be made. This entire book is about decision-making tools to aid those choices. These range from whether to produce a component in-house, to whether to take over another company. If for each decision scenario we have to contemplate a number of different objectives or some vague balance of stakeholder interests, the task is going to be much more complex. Once the basic decision-making frameworks are understood within the tight confines of shareholder wealth maximisation, we can allow for complications caused by the modification of this assumption. For instance, shareholder wealth maximisation is clearly not the only consideration motivating actions of organisations such as the Co-operative Group, with publicly stated ethical principles and a goal of benefiting its members. The John Lewis Partnership has been a very successful employee-owned company, but recognises the need for a rational financial decision-making framework with a lot of power given to the Board and the executive directors – *see* **Exhibit 1.2**.

The theoretical reasons

The '**contractual theory**' views the firm as a network of contracts, actual and implicit, which specifies the roles to be played by various participants in the organisation. For instance, the workers make both an explicit (employment contract) and an implicit (show initiative, reliability, etc.) deal with the firm to provide their services in return for salary and other benefits, and suppliers deliver necessary inputs in return for a known payment. Each party has well-defined rights and pay-offs. Most of the participants bargain for a limited risk and a fixed pay-off. Banks, for

Exhibit 1.2

John Lewis: trouble in store

by Michael Skapinker and Andrea Felsted

Joanne Griffiths has come from St Albans to do some shopping. "I like John Lewis a lot," she says. "Everyone seems to be very civilised." She knows the staff own the company. "They have a vested interest," she says.

John Lewis, founded in 1864 is one of the UK's best-loved companies. In the past year, it was named most admired British company for honesty and trust in an Ipsos Mori survey. It regularly comes at or near the top of customer satisfaction surveys. It sees itself, and is widely seen, as courteous, organised, high-quality but good value.

It is the UK's largest employee-owned business and one of the most successful in the world. Its central purpose is painted on the wall of the Cambridge branch as you walk up the stairs from what, in any other company, would be the staff entrance. Here it is the partners' entrance. The 93,800 people who work in the organisation are called partners.

Managers remind you of the partnership's purpose whenever they talk about the business. They recite it reverentially, parsing its component phrases. "The partnership's ultimate purpose is the happiness of all its members through their worthwhile and satisfying employment in a successful business."

Many of the John Lewis partners are happy enough to stay for decades. Some wear badges showing their last decade of completed service: a "10" badge or a "20". David Mayo wears a "50" badge. . . . he remembers a sign in his early days that said "The customer is always right". But the partners are not there principally for the customers. The partners are there to be happy — and their happiness comes from working in a business that is successful because you, the customer, are so pleased with the quality and the service the partners provide. Except the partners' happiness has taken a dip. In this year's confidential online survey, 71 per cent of those who responded said they were satisfied with their jobs, down a percentage point from last year, and 81 per cent said John Lewis was a good place to work, down from 86 per cent. To most employers, these would be outstanding results. But this is not a company owned by outside shareholders or a distant founding family. This is a partnership — and 29 per cent, nearly one-third, were not satisfied working at the company they owned.

Charlie Mayfield, chairman: "I think people sometimes view the partnership as some land of milk and honey where nothing bad ever happens," he says of staff complaints. "And it always makes me smile in a wry way because it really, really does a disservice to the vigorous and constant debate that goes on within the partnership about how we're performing and where we need to do better. This is a very self-critical organisation and that's actually an enormous strength."

John Lewis's democratic structures hold the top managers to account, he says. The chairman is appointed by his predecessor but partners elect five members of the 15-member partnership board, which approves big policy decisions, and they vote for 66 members of the 85-member partnership council, which holds the chairman to account. "Fundamentally, we own this business and so we're all concerned about how it's performing," Mayfield says. "That sometimes makes for slightly uncomfortable times but, much more importantly, it's a strength which ensures that we don't get complacent and sit back and think we're very clever and we've got it all."

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example, when they lend to a firm, often strenuously try to reduce risk by making sure that the firm is generating sufficient cash flow to repay, that there are assets that can be seized if the loan is not repaid. The bankers' bargain, like that of many of the parties, is a low-risk one and so, the argument goes, they should be rewarded with just the bare minimum for them to provide their service to the firm. Shareholders, on the other hand, are asked to put money into the business at high risk. The deal here is, 'You give us your £10,000 nest egg that you need for your retirement and we, the directors of the firm, do not promise that you will receive a dividend or even see your capital again. We will try our hardest to produce a return on your money but we cannot give any guarantees. Sorry.' Thus the firm's owners are exposed to the possibilities that the firm may

become bankrupt and all will be lost. Because of this unfair balance of risk between the different potential claimants on a firm's resources it seems reasonable that the owners should be entitled to any surplus returns which result after all the other parties have been satisfied.

Another theoretical reason hinges on the practicalities of operating in a free market system. In such a capitalist system, it is argued, if a firm chooses to reduce returns to shareholders because, say, it wishes to direct more of the firm's surplus to the workers, then this firm will find it difficult to survive. Some shareholders will sell their shares and invest in other firms more orientated towards their benefit. In the long run those individuals who do retain their shares may be amenable to a take-over bid from a firm which does concentrate on shareholder wealth creation. The acquirer will anticipate being able to cut costs, not least by lowering the returns to labour. In the absence of a takeover the company would be unable to raise more finance from shareholders and this might result in slow growth and liquidity problems and possibly corporate death, throwing all employees out of work.

For over 200 years it has been argued that society is best served by businesses focusing on returns to the owner. Adam Smith (1776) expressed the argument very effectively:

> The businessman by directing . . . industry in such a manner as its produce may be of the greatest value, intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants.
>
> *Source*: Adam Smith, *The Wealth of Nations*, 1776, p. 400.

Adam Smith's objection to businessmen affecting to trade for the public good is echoed in Michael Jensen's writings in which he attacks the stakeholder approach (and its derivative, the Balanced Scorecard of Kaplan and Norton (1996)). His main worry is the confusion that results from having a multiplicity of targets to aim for, but he also takes a sideswipe at managers who are able to use the smokescreen of the stakeholder approach to cloak their actions in pursuit of benefits for themselves, or their pet 'socially beneficial' goals:

> Stakeholder theory effectively leaves managers and directors unaccountable for their stewardship of the firm's resources . . . [it] plays into the hands of managers by allowing them to pursue their own interests at the expense of the firm's financial claimants and society at large. It allows managers and directors to devote the firm's resources to their own favorite causes – the environment, arts, cities, medical research – without being held accountable . . . it is not surprising that stakeholder theory receives substantial support from them.
>
> *Source*: Jensen, 2001.

However, Jensen goes on to say that companies cannot create shareholder value if they ignore important constituencies. They must have good relationships with customers, employees, suppliers, government and so on. This is a form of **corporate social responsibility (CSR)**, within an overall framework of shareholder wealth maximisation. (Some of the CSR officers, consultants and departments take this a stage further to a belief that the firm must balance all the stakeholder interests to fulfil its social role – something Jensen disagrees with.) **Exhibit 1.3** illustrates one of the outcomes of the pressure applied by shareholders, who, despite being keenly interested in the returns generated from the shares they hold, nevertheless want companies to act responsibly with regard to educating the poorest, climate change, access by African malaria patients to medicines, etc. They are acutely aware of reputational risk, the potential backlash against 'heartless capitalists', and litigation, but there are more positive reasons for the shift: people working within organisations are more committed if they feel the firm is 'a force for good in the world'. This is a way to attract and retain good staff, leading to improved business performance. A similar positive opinion about the firm can be generated in the minds of customers, encouraging sales.

Also, simply to tell people to maximise shareholder value may not be enough to motivate them to deliver value. They must be turned on by a vision or a strategy, e.g. to put a PC on every desk, to produce a drug to cure AIDs or to build a state-of-the-art aeroplane. Shareholder value can measure how successful you are, but it does not create superior vision or strategy – you need additional (but subsidiary) goals and measures.

Exhibit 1.3

Fortune 500 companies spend more than $15bn on corporate responsibility

by: Alison Smith

US and UK companies in the Fortune Global 500 spend $15.2bn a year on corporate social responsibility (CSR) activities, according to the first report to quantify this spending.

The research, carried out by economic consulting firm EPG, found that there was a clear difference in how US and British companies approached CSR.

In-kind donations, such as donating free drugs to health programmes or giving free software to universities, accounted for 71 per cent of the $11.95bn US spending on CSR.

Oracle, for example, which is one of the biggest CSR spenders, grants its software to secondary schools, colleges and universities in about 100 countries.

Cash contributions were just 16 per cent of the US total, with employee involvement and fundraising making up the remaining 13 per cent.

In the UK, while donating goods and services in kind was the largest component of the $3.25bn CSR activity, it totalled just 46 per cent of the total. Employee volunteering and fundraising made up 34 per cent and cash contributions 20 per cent.

Life assurance group Prudential involved employee volunteers in delivering an education programme to children in an impoverished community in central Jakarta.

Drugs companies are particularly prominent in CSR activity, with Merck and Johnson & Johnson being among the six groups providing almost two-thirds of the US CSR spend, while London-listed AstraZeneca and GlaxoSmithKline were two of the four companies accounting for more than three-quarters of the British total.

The findings will give fresh impetus to the debate about how far companies can persuade investors to see the value in CSR activity.

A survey last year of 1,000 chief executives by the UN Global Compact and Accenture, the consultancy, suggested that the landscape had become harsher. In 2013, 37 per cent of bosses said the lack of a clear link to business value was a critical factor in deterring them from faster action on sustainability – about twice the number who had cited the failure to identify such a link back in 2007. Mr Ioannou says there can be a wide range of investor reaction to sustainability initiatives, but sees some grounds for encouragement.

"Transient investors may not care, but long-term shareholders increasingly see environmental and social governance as a key indicator in terms of investment.

"Back in the 1990s, analysts might put a "sell" recommendation on companies with a strong CSR rating as they saw it as wasting investors' money. But that negative impact has been neutralised in more recent years, and some analysts now view CSR activity more positively."

Mr Pota argues that provided CSR spending is aligned to the company's business model, investors can see it is a matter of enlightened self-interest. "It's a matter of how you articulate it to shareholders," he says, adding that talking about it in terms of "global citizenship and sustainability" can help investors appreciate its value

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John Kay also points out that firms going directly for 'shareholder value' may actually do less well for shareholders than those that focus on vision and excellence first and find themselves shareholder wealth maximisers in an oblique way. He argues that Boeing, in the 1990s, sacrificed its vision of being a company always on the cutting edge of commercial plane design, breaking through technological and marketplace barriers. This reduced the vibrancy of the pioneering spirit of the organisation, as it refocused on short-term financial performance measures – *see* **Exhibit 1.4**. However, it is possible to argue that Boeing's managers in the 1990s were not, in fact, shareholder wealth maximisers because they forgot the crucial 'long-term' focus. Being daring