

**The
Economist**

GUIDE TO FINANCIAL MANAGEMENT

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Contents

Preface	vi
1 Defining a successful business	1
2 Business structures	13
3 The role of the finance department	20
4 Financial statements and accounting systems	30
5 Accounting concepts and principles	51
6 Investors	77
7 Cost to serve	105
8 Product pricing and profitability	130
9 Portfolio management	144
10 Investment appraisal	161
11 Business planning, budgeting and reporting	201
12 Operational ratios and measures	232
13 Stockmarket and investor measures	261
14 Working capital management	281
15 Published reports and accounts	305
16 Accounting complexities	318
Glossary of financial terms	330
List of companies	341
References	344
Index	345

Preface

EFFECTIVE FINANCIAL MANAGEMENT is essential for a business to succeed; many have failed for want of it. All too often a career aspiration falters, not for lack of effort or ability in a chosen field, but for not being able to understand the financial impacts of decisions and ultimately a failure to “deliver the numbers”. Managers who find themselves in a senior role unable to ask questions of others – which might imply their own ignorance – have wished that they had got to grips with really understanding financial matters earlier in their career.

This guide to financial management is designed to take you through financial principles and illustrate their application, providing a toolkit for managing financial responsibilities. Each chapter is written from an operational perspective in establishing and running a business. Before the index is a glossary of the financial terms used in the book. There is also a list of companies used in examples. The names are those in existence at the time of writing; merger and acquisition activity will inevitably change this.

All books are not just the work of the author but the results of contributions of many others. I am grateful to clients and colleagues who provided the opportunity to explore aspects of business, complete research and develop my thinking. In particular I would like to thank my colleagues at Corporate Edge for their insights and contributions, and Mandy Aston for her work on the original script and many of the diagrams; Mike Samuel for his support and the time he dedicated to reviewing and commenting upon the first edition; Nick Insall for his review of this edition; and Profile Books for the help they gave me, particularly Stephen Brough, Penny Williams and Jonathan Harley.

Special thanks to my wife, Angela, and my two sons, William and George, who have supported my enthusiasm for writing, even on holidays. Also to my parents, particularly my father, a chartered accountant, who always encouraged my career, and gave me the passion and interest in business.

I would welcome feedback and can be contacted on the following e-mail address: John-Tennent@CorporateEdge.co.uk

John Tennent
May 2013

1 Defining a successful business

EVERY ENTREPRENEUR ASPIRES to create a successful business and investors certainly want management to run successful businesses. So what determines whether a business is being successful? Before answering this question it is helpful to define what a business is and the various forms it can take.

A business is a commercial operation that provides products or services with the aim of making a profit for the benefit of its owners. The significant point is “for the benefit of its owners”, which differentiates it from a government or not-for-profit organisation, such as a charity, where the activity is conducted for the benefit of the people it serves.

A profit is an essential element of running a successful business. It is a trading surplus whereby the revenues earned exceed the costs. This surplus belongs to the owners of the business to use as they choose: to take for themselves, to reinvest back in the business, or a mixture of the two. For a government organisation or charity any surplus is reinvested in the activities to further benefit the people it serves.

Business structure

A business can take many forms ranging from a sole trader to a large multinational company. The principal aim of making a profit for its owners is still the same.

A person starting out and setting up a business will take all the risk and reward as the venture gets under way. As the business grows it can be advantageous to share the risk with others and separate

the business activities from those of the owner by establishing a company.

A company is a legal entity in its own right that is separate from its owners. An investor is risking only the money paid for buying some shares in the company. If the company ceases trading, the shareholders (owners) are not liable to make up any shortfall between the value of the company's assets and its liabilities.

There are five broad categories of business:

- **Sole trader.** Someone who sets up a business alone and takes all the risk and reward of running it, and who may employ staff.
- **Partnership.** Two or more people who set up a business together. The partners have joint ownership and share the risk and reward of running the business. Like a sole trader they may employ staff.
- **Limited liability partnership (LLP).** A hybrid of a partnership and a company which provides the owners with the limited risk of a company and the shared ownership and tax status of a partnership.
- **Private company.** Usually a small organisation raising its money from a few private investors. The shares may be difficult to trade as they are not listed on any stockmarket. Investors' liability in private and public companies is limited to the amount of their investment.
- **Public company.** Typically a large organisation that is usually listed on a stock exchange. Because of its size it may require significant investment, and hence it may need to draw investment from many investors.

In this book the focus is mainly on companies, though the principles can be equally well applied to a sole trader, a partnership and indeed not-for-profit organisations.

The role of the board

The directors of a company are people hired (and at times fired) by the shareholders to be stewards of their investment. However, they

need to balance this with their primary fiduciary duty as a director which is to act in the best interests of the company. Collectively, a board of directors has overall responsibility for running a company successfully. This is achieved by setting and implementing its strategy.

In fulfilling the strategic aims of the company, the board will be responsible for making sure not only that the company has the necessary resources in terms of investment, assets and people, but also that there are appropriate operating controls and procedures for managing business risk and making sure that all monies that flow through the business are properly accounted for.

What is a successful business?

The media love to report on successful entrepreneurs and tell of how they beat the odds as they built their business and became household names. The media also enjoy revelling in the collapse of mighty organisations and unpicking the journey to their downfall. So what is it that defines business success or failure?

Many descriptions are used to describe success, including “the business is profitable”, “revenue is growing” and “the share price is rising”. All these attributes are elements of success though individually they do not embrace the totality. To be successful in business is to “create a sustainable superior return on investment”.

The core element of this definition is “return on investment” (ROI). The business, having been built from money provided by investors, has a responsibility to reward those investors for risking their money in the venture. The ROI is a measure of the reward being generated. The concept is similar to a savings account where an amount of money is placed on deposit with a bank and the investor earns interest on it. Despite the banking crisis of 2008 and its aftermath, the investment in a savings account is still seen as low risk and consequently the return that the investor will make is similarly low.

$$\text{ROI for a savings account} = \frac{\text{Interest}}{\text{Investment}} \%$$

Therefore, if a deposit of \$1,000 is placed in a bank and the gross interest earned over a year is \$30, the ROI can be expressed as being 3%.

For a business to be successful it needs to reward investors by making them wealthier than they would be by putting their money in a savings account. Why should they accept the greater risk of investing in a business, with all the uncertainty it faces, if they are not going to be any better off? The return that investors would require might be double or more than a savings account depending on the perceived risk, which will be related to factors such as the nature and maturity of the business.

The return in a business is derived from the profit it generates compared with the money invested to achieve that profit.

$$\text{ROI for a business} = \frac{\text{Profit}}{\text{Investment}} \%$$

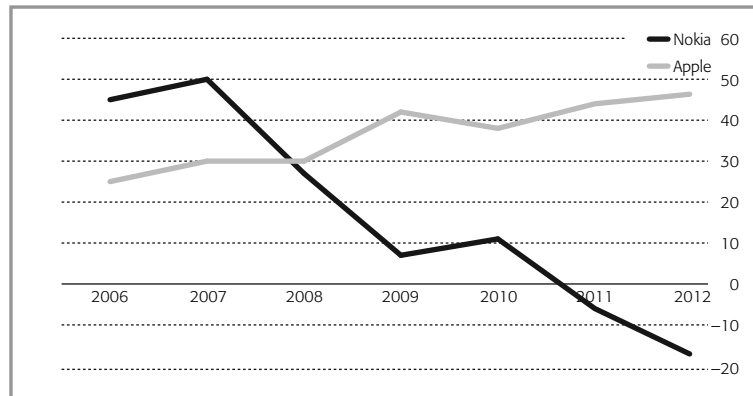
Therefore, if investors place \$1,000 in a business and the operating profit over a year is \$200, the ROI can be expressed as being 20%. Some examples of the returns achieved by companies in 2012 and stated in their annual reports are Walmart (a retailer) 18.2%, ExxonMobil (an oil company) 25.4% and Anglo American (an international mining company) 13.3%.

Generating a “superior” return is to achieve a ROI that is greater than the rate achieved by businesses running similar activities in similar markets, and so to be successful is to generate a return that is at least as good as that achieved by your competitors, but ideally better than them.

A “sustainable” superior return is perhaps the most difficult objective to achieve. It means generating a superior rate of return year in, year out. A business may be flying high when its products or services are in fashion. But the fall can be swift when its products or services are no longer in vogue and the business has gone from producing superior returns to producing inferior ones. To be sustainable is to continuously develop the business proposition in a way that keeps customers buying the company’s products or services in preference to those of its competitors. Innovation, technology and cost reduction are all activities that can help maintain a sustainable return.

For example, the returns generated by Nokia in 2006 were almost 46%. They resulted from a pre-eminence in a growing market coupled

FIG 1.1 Return on investment, %



with an ability to continue to introduce new technology and ignite passion for the company's latest products. Subsequently, Nokia failed to offer leading technology and was late in offering smartphones. As a result it lost customers and the superior returns declined; in 2012 Nokia reported losses of €2.3 billion.

At the same time as Nokia was declining Apple, its American rival, was rising. The two companies' ROI between 2006 and 2012 is shown in Figure 1.1.

On creating a superior ROI the directors of a company have two choices. They can either distribute the wealth to the investors or retain it in the business. The second option depends on whether the directors can identify further investment opportunities that will create even more wealth in the future. Profits can be retained in a company while investment opportunities are identified. However, this is only in the short term as investors (particularly in public companies) will demand the cash be "earning or returning".

Wealth is created for investors in a business in two ways:

- annual income – a distribution of profit to the investor (by way of a dividend);
- capital growth – a reinvestment back in the business to increase its value (share price).