MGT 388 Finance and Law for Engineers

Financing

Lecture Outline

Revision of types business organisation

Characteristics of business forms

Finance available for business

Business Forms

Sole Trader
Self employed an individual operate a business on their own

Partnership
Two or more people come together under a partnership agreement to run a business. *(John Lewis)*

Limited Company
A legal arrangement where a small business is incorporated. The owners acquire shares in a company.(Laing O'Rowke)

Public Limited Company
An incorporated business where the shares can be made available to the public.(*Next plc)*

Sole Trader and Partnership

A sole trader or partnership is not a separate LEGAL entity.

From an accounting perspective the business is separate from the owners. BUSINESS ENTITY CONCEPT

There should be a clear separation of the owners finances from that of the business.

If a business makes losses and cannot pay creditors the creditors have recourse to the owners.

The owner or partners effectively put all their private assets at risk.

Sole Trader and Partnership

It is not just a financial risk:
Health and safety legislation
Employment law
Environmental legislation
Product warranty issue

It is the owner or partners that will be sued and have to pay compensation.

Partners should trust each other, as they will be joint and several liability.

Initial Funding For A Sole Trader or Partnership

The main source of finance for a sole trader or smaller partnership is the money the owner or each individual partner contributes.

These funds are known as the capital of the business.

Further Funding For A Sole Trader or Partnership

Retained earnings

Retained earnings are profits not distributed to the owners of the business

These profits increase the owners’ capital. (They belong to the owners)

Retained profits provide a growing business with additional funds.

They are the best source of finance as they have no cost to the business

Except an opportunity cost

Further Funding For A Sole Trader or Partnership

Working capital funding

Day to day operations should be self-funded.

Working capital – current assets less current liabilities of a business.

Buy inventory from suppliers on credit

Produce a product or service

Sell the product or service providing customers with credit

Collect the cash from customers and replace inventory.

To quicken the cycle a business can factor or sell customer debt.

Further Funding For A Sole Trader or Partnership

Overdraft

For the short term to cover working capital.

But often an overdraft has charges and high rates of interest.

An overdraft should never be used to fund non-current assets, growth or any other long term project.

The business owner should plan ahead and have secured a cheaper, more appropriate method of financing these long term plans.

Further Funding For A Sole Trader or Partnership

Loans

To fund an expansion the business owner(s) could contribute further capital or obtain a loan.

To obtain a loan from a bank a workable business plan would need to be drawn up along with forecasted cash flows.

It is important that the payments of interest charges are built into projections as well as the eventual repayment of the loan.

The bank will often require security for the loan; this may be the owner's house or other personal assets.

Further Funding For A Sole Trader or Partnership

Following the financial crisis loans are not so freely available with it being reported that 1/5 small or medium sized businesses missed out on opportunities because of a lack of funding.

With a lack of finance available there has been a growth in the Alternative finance markets (crowd funding, P2P lending, credit unions etc)

Further Funding For A Sole Trader or Partnership

Leasing

If a business needs new plant or motor vehicles it may be possible to fund through leasing.

Either the asset is leased and is never owned by the business or the asset can be bought on hire purchase.

In both cases the business will pay regular leasing charges but at the end of the hire purchase contract the business will own the asset.

For assets that are subject to technological change leasing is a good option as the leasing company will often update the asset and provide a servicing and maintenance agreement.

Limited Company

Legally a limited company is a separate person

The financial and business risks belong to the company.

The liability of the owners is limited to the capital they have invested in the company

Limited Company

Initial Funding

Those starting a company will provide capital in exchange for shares in the company.

The shares will carry voting rights in the company.

Venture Capital

A finance company may provide a company with funds in exchange for shares which they will sell back to the company after a specified period.

Limited Company

Seed-corn Finance

Available to innovative or technology based ventures.

Often considered risky for mainstream finance.

Finance Yorkshire will provide up to £780,000 for 3-6 years.

Expect rapid growth and will want a significant minority shareholding.

(part-financed by EU)

Crowd Funding

Raise funds via internet– mediated exchanges. $34 bn worldwide – with equity based crowd funding increasing by 300% in the last 2 years.

BrewDog is one success story growing from 2 people to a global company.

But:

Unregulated

85% early stage businesses fail

Fewer than 1,000 businesses successfully crowd funded.

Intellectual property rights

Limited Company

Peer-2-Peer Lending

The lender acts as an introducer and takes a fee which is less than that a bank would charge.

Zopa has lent £1.8bn and is applying for a banking licence.

Agencies shouldn’t lender to other lenders but?

Investors not protected and high returns promised but don’t always materialise

Services P2P providers can provide are limited.

Limited companies

- Small businesses can often qualify for government grants.
- Can be time consuming to obtain with niche criteria and strict conditions
- Relate to areas – Coalfield regions. Northern Power house fund
- Relate to activity– Research and development
- Start-up loans, export and growth
- Business support and advice – connectivity vouchers
- Employee related – Vocational Training

Limited Company V Sole Trade Tax consequences.

For a sole trader or partnership the earning of the business is income to the sole trader or partner.

The income is added to the individual’s other sources of income and taxed income tax rates (up to 45% with 12% national insurance)

For a company the earnings belong to the company and taxed at corporation tax rates (20%, dividends taxed at up to 38.1%)

Public Limited Company

A plc tends to be very large and are initially funded by shares.

A plc can offer shares to the public either by a placement or a full issue.

To secure extra funding a company can issue more shares to existing share holders via a rights issue or again a full issue.

Public Limited Company

Debt V Equity

In raising finance a company may have a choice between debt and equity.

Equity holders take on more risk and therefore often want a high return (dividend or capital growth)

Debt is more risky to a company as interest payments must be made in high and low profit years.

Interest payments are before tax whereas dividend payments are after tax. Loans shield profits from taxation.