INTRODUCTION

As a manager your main task at all times is value creation and protection. You need to know where value comes from and how it is built or eroded. This requires a strategic understanding of financial management and managerial finance, and I hope that this little book will help you to become more financially literate. It is written for non-financial managers to improve their ability to evaluate the financial consequences of their decisions. Integrating finance and corporate strategy will help you and your finance director get a better understanding of how you both contribute to value creation.

The purpose of this book

The purpose of this book is to help non-financial managers understand finance and accounting at a managerial rather than a technical or professional level. This will help them make better decisions and manage their financial responsibilities more efficiently. At a strategic level it will help managers understand how financial strategy is integrated with business strategy. This is not a book aimed at financial experts or academics whose task is to explore new theories. It is a book for the practising business manager who needs practical and useful guidance on corporate finance and accounting.

Money is the common denominator of all business transactions, and accountancy provides a language and a method for recording the movements of money. A successful manager needs to have a strategic understanding of finance and accounting and also to understand how finance supports business strategy. Too much financial information can lead to complexity and confusion. This work will enable a manager

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to question the validity of information received and to concentrate on those financial performance indicators that are key to his/her business.

This work will also explain how different types of finance relate to various business structures, the role of accounting and finance departments, the analysis of financial statements, planning, budgeting, costing, pricing, investment appraisal, finance, taxation and international transactions. You will agree that this is a broad remit for such a short book and I must, therefore, cover the subjects at a high level only. However, this book will enable non-financial managers to feel confident when talking 'finance' with their finance directors, to manage their own financial responsibilities and to gain a better understanding of risk and the financial consequences of their actions.

After reading this book you will have a strategic understanding of:

- how to implement the controls required to protect financial assets;
- how to make sound strategic financial decisions;
- how to plan for and obtain funds;
- how to ensure that assets are used efficiently.

Strategic financial management creates real value within an organization, and this book will enable non-financial managers make sound financial decisions that add value. It is intended to bring together some of the most important financial principles and techniques in a way that will be useful to the practising manager. A key feature of this book is the provision of case studies in the final chapter that demonstrate the practical use and relevance of corporate financial management techniques.

It is expected that this book will be used by managers in different countries with different laws. Accordingly it has been written in a broad generic manner that outlines the general principles that are normal to most jurisdictions and regimes. It does not provide a strict legal or taxation framework. Any rates used are for illustrative purposes only and do not reflect actual rates.

The author

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and overseas. He has also worked with a number of small and medium-sized businesses. His work has been published internationally.

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CHAPTER ONE

TYPES OF BUSINESS STRUCTURE AND THEIR FINANCE

The aim of this chapter is to discuss the principal types of business entity and how they may raise initial capital.

Although there are many types of organization, for the purpose of this book, we will consider just three groups:

- *Sole proprietorships*: These are businesses that are owned by one person. They are generally small businesses. The owner of the business will have unlimited liability for the debts of the business and may even have to sell his/her home to clear the business debts if things go wrong. The capital for this type of business will be provided by the owner and finance may also be provided by way of loans, usually from a bank.
- *Partnerships*: These are businesses that are owned by two or more people who provide the capital. There are three principal types of partnership:
  - General partnerships: where the partners are jointly and severally liable for the debts of the partnership.
  - Limited partnerships: where there are one or more general partners and one or more limited partners whose liability is limited to a specified sum.
  - Limited liability partnerships (LLP): where the partners have limited liability. A partner in a LLP is not liable for another partner's misconduct or negligence.

  Partnerships may also obtain finance from banks and other lending institutions.

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A disadvantage of a general partnership is that a partner may have to pay all partnerships debts if other partners or a partner are unable to do so.

- *Corporations*: These are limited liability businesses that have a separate legal personality from their owners (shareholders). In the event of the company winding up, the shareholders' liability will be limited. There are private limited companies and public limited companies. There are also other types of corporation but these are outside the scope of this book.

A major advantage of a limited liability company is the limit placed on a shareholder's liability in the event that the company folds.

There are advantages and disadvantages to each type of organization and the type of organization will have a bearing on the methods of finance adopted and on accounting and taxation. The advantages and disadvantages of the three principal types of organization are discussed below.

Sole proprietors

Some advantages of being a sole trader

- It is quick and easy to set up as a sole trader.
- The accounting is relatively simple.
- Simplicity. Less accountability.

Some disadvantages of being a sole trader

- There is no limit to the liability of the proprietor. The proprietor will be held personally liable for all debts in full and may have to use personal assets to clear off business debts.
- Sole traders have less ability to raise funds/capital.

As a sole trader you will be the initial provider of capital, unlike a partnership where partners contribute to capital or a company where the shareholders provide capital. So it will be harder to raise additional capital. Because a sole-trader business generally has less capital there will also be a reduced ability to borrow money since there is less 'equity' in the business. However, the great advantage of being a sole trader is that you are answerable primarily to yourself. There is no need to hold

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partner or shareholder meetings and prepare so many reports. This means that more time can be devoted to the business and direct income-earning activities.

A sole trader should keep separate accounts and have a separate bank account for the business so that there can be no confusion between your personal and non-business transactions. This will also make completing your tax returns easier.

As a sole trader you also need to make sure that the tax authorities cannot mistake you for an employee of your customer. This is especially the case if you have few customers. To do this it is important that you can be seen to be working for more than one customer, have your own tools/equipment, are in control of what you do and are able to hire others to do the work.

Banks like to see that a business has a reasonable amount of its own capital before they will lend, and will only lend up to a limit against this equity. This is the same as when you seek a mortgage on a house, where the bank likes you to have some equity. For this reason sole traders are not usually suitable business models for capital-intensive businesses that require large sums invested in plant and equipment.

There may be taxation disadvantages in being a sole trader compared with operating as a limited company or corporation. For example, the rate of taxation for individuals (sole traders) might be higher than the tax rate for corporations. Also, the timing of payments of tax may be different. Tax rules and rates obviously very from one country to another and you will need to seek advice about this from an accountant in your country of operation.

Partnerships: general and limited liability

A partnership has been described as 'the relationship which subsists between persons carrying on business in common with a view to profit'. It is brought into existence through the agreement of the parties concerned to carry on business for profit. Usually there will be a partnership agreement that sets out the rights, duties and responsibilities of the partners. This will include details of the capital of the partnership and the amount to be contributed by each of the partners. Other items included in the agreement will include partners' salaries (if any), interest

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to be allowed or charged to partners on loans or advances, and provisions for accounts, audits and so on.

Some of the principal advantages of a partnership

- It is usually possible to raise more capital than a sole trader can.
- There are various types of partnerships, including limited liability partnerships.
- Partners may bring additional skills, contacts and knowledge.
- The accounting and reporting might be a little simpler than for a company.

Some of the principal disadvantages of a partnership

- Partners may be held jointly and severally liable for the partnership debts. For example, if one partner fails to pay, the other partners may have to pay the failed partner's share.
- The partnership has to be dissolved when a partner dies, becomes bankrupt or leaves the partnership.
- A partnership agreement needs careful drafting.

Some countries place restrictions on the number of partners allowed in a partnership, although there may be exemptions for certain types of business. If you decide that a partnership is the most appropriate type of business structure then it is best to consult a lawyer who can advise you of any constraints and help draft a partnership agreement. At this stage you will also need to decide upon the type of partnership that is best for your business.

A general partnership will only have 'general members', where each partner is involved in the management and running of the partnership and takes responsibility for the liabilities of the firm, becoming both jointly and severally liable. This might be a real concern for some potential partners and would deter them from entering into such a partnership. To get round this it is possible to form a limited partnership whereby some members have their liability limited to a certain amount. This type of partnership will have both general and limited partners. Often the limited partners do not participate in the management of the firm.

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In recent years a third category of partnership has become popular, particularly with accounting and other professional firms. This is the limited liability partnership (LLP), which combines characteristics of partnerships and corporations. An LLP is different from a general or a limited partnership. In an LLP all partners enjoy limited liability and are not responsible for any malpractice, incompetence or mistakes of others. They are, of course, responsible for their own acts.

Because a partnership will generally have access to more funds than a sole trader, it will be in a stronger position to raise loan finance from a bank.

Corporations

There are various types of corporation and for the purpose of this book we will discuss the principal ones.

A corporation is an entity in its own right, having its own legal existence separate from that of its members (owners). This means that when a member dies or sells his/her shares the company continues to exist regardless. This is quite different from a partnership or sole trader, which does not have the same separate legal existence.

A company limited by shares

A limited company is a type of corporation. The shareholders of a limited company own the company collectively and enjoy limited liability. This means that their liability towards the company's debts is limited to the amount, if any, unpaid on the shares taken up by them. Once the capital is fully paid there is no further liability on the shareholders. A company may be a private or a public company.

Limited companies

A private limited company is one that restricts the right to transfer shares and may limit the number of members. Shares may not be offered to the general public and shareholders may be bound to offer

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their shares to their fellow shareholders before offering them to a third party. Specific rules and terminology vary from country to country but this is the general principle. A private limited company will raise capital through the issue of shares and should be able to raise more funds than either a sole trader or a partnership.

Public limited companies

A public limited company (PLC) has shares that are traded to the public on a stock exchange. A PLC will have to comply with greater reporting and regulatory requirements than a private one, and with significant stock exchange regulations. PLCs are generally able to raise more funds than sole traders, partnerships or private limited companies. However, the reporting and regulatory demands on them can be burdensome for smaller companies and for this reason some small PLCs have reverted back to being private companies.

Summary

In this chapter we have discussed the principal types of business entity and how they may raise initial capital. In summary these are listed below:

- *Sole trader*: unlimited liability; initial funds from proprietor; limited ability to raise capital; simplicity; may be tax disadvantages depending on country of operation.
- *General partnerships*: may be liable for other partners' share of debts; initial funds from partners; relatively simple.
- *Limited partnerships*: some partners have limited liability; initial funds from partners.
- *Limited liability partnerships (LLPs)*: partners have limited liability; initial funds from partners.
- *Private limited company*: limited liability for members; initial funds from members; ability to raise more funds.
- *Public limited companies (PLCs)*: limited liability for members; initial funds from public members; possible to raise high levels of funds/capital.

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Choosing the correct type of business structure is a primary strategic decision that will affect funding opportunities and the potential for future growth. All businesses require sound governance; however, as a general rule, the more stakeholders and more complexity in a business structure, the more attention will need to be paid to governance issues and processes.

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