Edexcel

AS Level

BS

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Unit 02

Planning a business and raising finance

Chapter 23 – Planning

WHY IS PLANNING IMPORTANT?

When organising an important event like a wedding, a holiday abroad or a house move, the event will be more successful if it is carefully planned. How many people would organise such events without making thorough plans before hand? If the planning process is not done things can go wrong and the consequences could be very unpleasant.

Setting up a business can be a very complex and time-consuming. However, with careful planning the whole process is easier, less stressful and a number of expensive mistakes might be avoided.

THE CONTENTS OF A BUSINESS PLAN

A business plan is a plan of how the business will develop over a future period of time. It outlines the strategy of the business and helps to clarify what is needed to achieve its goals. It also helps entrepreneurs to think through their options, identifying the best opportunities and how to make the most of them. Guidance may also be obtained from banks or business advisory agents. There may be different styles but most business plans will contain some common and very important details. These include the following.

An executive summary: Some would argue that this is the most important part of the business plan. This is because anyone who reads only part of the plan, such as potential investors or banks, will always look at this particular section. It is an overview of the business start-up. It describes briefly the business opportunity to be exploited, the marketing and sales strategy, operations and then finance.

Elevator pitch: Entrepreneurs will be expected to tell others about their business idea - particularly investors, money lenders and potential customers. Therefore, a useful section in a business plan will be the elevator pitch. This is a summary that can be used in a 'pitch' about the business. The pitch should be quick and concise and delivered in the time an elevator ride would take.

The business and its objectives: This section should state the name of the business, its trading address, its legal structure and its objectives. The whole planning process is driven by the firm's aims and objectives. When setting up a business it is much easier to make plans if the business has something specific to aim for. In the early stages of business development, the aim might be quite modest - perhaps to break even by the end of the first trading year. Survival is always an important objective for a new business.

The business opportunity: It is necessary to explain clearly what the business plans to sell. In some cases, this section is very important indeed because readers may not be familiar with the products. They may be of a highly technical nature or outside the field of readers' interests. It may be possible to provide some visual material in this section to show what products look like. In many developed countries businesses are likely to be selling services.

Owners' background: A number of people will be interested in the entrepreneur(s) who plan to set up the business. Therefore, the business plan must include some details about the owners, such as the motives for setting up a business, their level of commitment, the nature of their training and work experience, their education and qualifications, and their hobbies and interests. Readers will want to know whether the owners have the skills and characteristics needed to run a successful business.

The market: In this section entrepreneurs need to show the size of the potential market. They will also need to identify the customer profile (the characteristics of individuals or other businesses that will be targeted). The nature of competition and the various marketing priorities will also have to be discussed. Many entrepreneurs will support this section with some market research.

Personnel: When a business is first set up there may be very few, if any, other employees. However, in some cases other people will be needed and as the business grows, so will the need for help from other workers. Therefore, the business plan needs to clarify the number of employees needed and the skills, qualifications and experience that will be important.

Premises and equipment: Most new businesses will need a place from which to trade and a wide range of physical resources.

Costing and finance: A very important part of the process when starting a business is working out how much it will all cost. This can be an intimidating task but entrepreneurs will find it almost impossible to raise capital or borrow money if they cannot say with some accuracy how much will be needed before trading can begin. This section may contain spreadsheets that list all the costs of setting up. Costs may be divided into 'one-off' start-up costs and ongoing expense (those which will continue to be incurred once the business is trading).

Financial forecasts: A business plan is likely to contain a variety of financial forecasts. These might include a sales forecast, showing how the value of sales will change over a future time period, a cash flow forecast, which shows how money will flow into and out of the business on a week to week or month to month basis, a profit and loss forecast, showing when the business might move from making a loss into making a profit and how big a profit will, and a break-even analysis, showing the level of sales where total costs and total revenue will be exactly the same.

SWOT analysis: Some business plans might include a SWOT analysis. This involves looking at the internal strengths (S) and weaknesses (W) of the business idea and the external opportunities (O) and threats (T).

Finally, no two business plans will look the same. This is because both business ideas and entrepreneurs are all likely to be different in some way. There may also be variations between the styles used in different countries. Most of the sections discussed above are likely to be included but they may be ordered

THE PURPOSE AND RELEVANCE OF A BUSINESS PLAN

For many people, setting up a business is a life- changing decision and will have wide-ranging consequences. Therefore, it is necessary to spend some time carefully planning the whole process.

. Also, when a company plans to raise money by floating on the stock market, it must publish a prospectus. This will contain important elements of a business plan. Investors have to be relatively confident that the company is going to be a success before buying shares.

A thorough and well-written business plan is likely to:

- force owners to take an objective, critical and unemotional look at the whole business idea
- provide a strategy for the development of the business
- provide an action plan that identifies key tasks that must be undertaken and goals which must be met to improve the chances of success
- highlight potential problems in advance so that solutions can be found
- help show money lenders and investors that the owner is realistic, responsible, serious and trustworthy.

SUBJECT VOCABULARY

business plan a documented plan for the development of a business, giving details such as the products to be made, resources needed and forecasts such as costs, revenues and cash flow.
undercapitalised a business with insufficient capital to run effectively.

Chapter 24 – Internal finance

THE NEED FOR FINANCE

Firms require funds to start, such as equipment, raw materials, and premises. Once these initial expenses are met, sales can generate revenue. As a continuous business, additional funds may be needed for raw materials and debt settlement. Expansion may require additional funds, which can be raised through capital expenditure or revenue expenditure. **Capital expenditure** includes items used repeatedly, while **revenue expenditure** covers consumed goods and services, including maintenance and repair.

OWNER'S CAPITAL

Capital is the money provided by business owners as part of **internal finance**. Entrepreneurs often take on the risk of providing capital, often from personal resources like savings, redundancy payments, or limited company shares. Owners can introduce fresh capital in the future if needed, and their capital is not only provided at the start-up stage.

RETAINED PROFIT

Retained profit is a crucial source of finance for businesses, as it is the cheapest and most important. It is the only source of funding without financial charges. However, it cannot be returned to owners, potentially affecting their lifestyles and shareholders' dividends. Retained profit is flexible and can be collected gradually, earning interest, and used at a later date. If a business does not make a profit, retained profit is not viable.

SALE OF ASSETS

Established businesses can raise finance by selling unwanted assets like machinery, obsolete stock, land, and buildings. Large companies can sell parts of their organization to raise funds. In 2017, LeEco sold a prime property in Beijing for over US$420 million to invest in core businesses. Another option is a sale and leaseback agreement, where the seller sells an asset to a specialist company who leases it back to the seller. In 2016, Air India raised around 6000 crore from a **sale and leaseback deal.**

ADVANTAGES AND DISADVANTAGES OF INTERNAL FINANCE

There are a number of advantages when using internal finance to fund business activity, though despite the attractive nature of internal finance, there may also be some drawbacks.

Table 1 summarises the advantages and disadvantages of using internal finance.

Advantages	Disadvantages
The capital is available immediately – there is no time delay between identifying a need for finance and obtaining it. For instance, retained profit will be in a bank account ready and waiting. Assets can be sold quickly if the price is competitive.	Internal finance can be limited – a business may not be sufficiently profitable to use retained profit or may not have unwanted assets to sell. Also, the current owners may not have any personal resources to contribute.
Internal finance is cheap – there are no interest payments, which means that costs will be lower and profit higher. Also, there are no administration costs.	Internal sources of finance cannot be subtracted from business profits to reduce tax owed. If external finance is used, the interest paid on a loan or leasing charges for assets, for example, can be treated as a business cost and subtracted from business profits to reduce tax owed.

The business will not be subject to credit checks. External finance often requires investigations into credit history of the borrowers.	Internal finance can be inflexible compared to external sources of finance. There are a wide variety of funding options for external finance, which can give the business flexibility.
There is no need to involve third parties.	There are no inflationary benefits with internal finance. Inflation can reduce the value of debt if external sources are used.
	Opportunity cost of using internal sources of finance can be high. For example, a plc considering the use of retained profits for funding will have to consider the reactions of shareholders if dividends are frozen or cut. Some shareholders may have a very short-term view and demand higher dividends now. This could result in conflict between shareholders and directors.

▲ Table 1 Advantages and disadvantages of internal finance

SUBJECT VOCABULARY

capital money put into the business by the owners.
capital expenditure spending on business resources that can be used repeatedly over a period of time.
internal finance money generated by the business or its current owners.
retained profit profit after tax that is 'ploughed back' into the business.
revenue expenditure spending on business resources that have already been consumed or will be very shortly.
sale and leaseback the practice of selling assets, such as property or machinery, and leasing them back from the buyer.

Chapter 25 – External finance

EXTERNAL FINANCE

Few businesses can rely entirely on internal financing (see Chapter 24) to fund all business activity. Initially, external finance, which is finance from sources outside the business, may not be available. This is because new businesses have no trading record and present too much risk for many lenders. However, once a business has survived the initial 'uncertain' stages of business development, external sources of finance are likely to become a realistic option.

SOURCES OF FINANCE

There is quite a wide range of external sources that businesses can choose from.

Family and friends: A common source of finance, particularly for small businesses, is family members or close friends. This may be a cheap source because if the money is a loan, interest charges may be low, or possibly zero. In some cases money might be gifted to an entrepreneur.

Banks: Commercial banks such as ANZ (Australia), State Bank of India, Commerzbank (Germany) and HSBC provide a range of different external funding arrangements for businesses. These include loans, overdrafts and mortgages. Most commercial banks have specialist departments or staff that deal exclusively with businesses.

Peer-to-peer lending: Peer-to-peer lending (P2PL) involves people lending money to unrelated individuals or 'peers' and therefore avoiding the use of a bank. Transactions are undertaken online and are organised by specialists such as Lendbox in India, Zopa in the UK and Pandai in China. . Anyone can apply for a peer-to-peer loan. The key features of peer-to-peer lending include the following.

• All loans are unsecured, which means there is no protection for lenders. Therefore, lenders might lose their money if a borrower is unable to repay the loan.

• The whole financial arrangement is conducted for profit.

• All transactions take place online.

• No previous knowledge or relationship between lenders and borrowers is needed.

• Lenders may choose which borrower to lend to.

• Peer-to-peer sites make a charge - typically about 1 per cent.

Business angels: Business angels invest between £10,000 and £100,000+ in a business, often in exchange for a stake. They typically make one or two investments in a 3-year period, either individually or with a small group. Many investors come to business angels for excitement, risk, tax relief, or surplus income. However, finding a suitable angel can be challenging, as they must have shared interests and a common vision for the business's future. Business owners must present a compelling business proposition, considering risks and sharing profits with the angel. Funding from business angels is popular globally, with Ireland's investment estimated to be worth between €70 million and €120 million annually.

Crowd funding: Crowd funding is similar to peer-to-peer funding in that banks are excluded and individuals can lend money to others without previous knowledge of them. However, the fundraisers tend to be businesses or groups who are involved in a particular venture such as putting on production, building a school or setting up a community project. The lenders or investors will be large numbers of individuals who collectively represent 'the crowd'.

Other businesses: Another external source of finance might be provided by other businesses. For example, a business might set up a fully funded subsidiary. This might occur when a manufacturer sets up a business to supply it with components. Some businesses set up joint ventures, where the businesses share the finance, costs and profits of a specific venture. Some plcs buy shares in other companies. This might be to earn an income, if they have surplus cash for example. Alternatively, plcs might buy shares in other companies to build a controlling stake, perhaps with a view to taking them over in the future.

METHODS OF FINANCE

Businesses can use a variety of different methods to raise finance.

Loans: A loan is an arrangement where the amount borrowed must be returned over a fixed period of time in regular equal payments. Loans tend to be inflexible and interest will be added to the total. There are different sorts of loan capital.

• Bank loans are probably the most common type of loan. They may be unsecured loans. This means that the lender has no protection if the borrower fails to repay the money owed. They can be used for long- term or short-term purposes depending on the needs of the business.

• Mortgages are secured loans where the borrower has to provide some assets as collateral to support the loan. This means that if the borrower defaults, the lender is entitled to sell the assets and use the money from the sale to repay the outstanding amount.

• Debentures are a specialised method of loan finance. The holder of a debenture is a creditor (someone to whom the business owes money) of a company, not an owner. Debenture holders are entitled to a fixed rate of return, but have no voting rights. They must also be repaid on a set date- when the the term of the loan ends. Public limited companies use this long-term source of finance.

Share capital: For a limited company **share capital** is likely to be the most important source of finance. The sale of shares can raise very large amounts of money. **Issued share capital** is the money raised from the sale of shares. **Authorised share capital** is the maximum amount shareholders want to raise. Share capital is often referred to as **permanent capital**. This is because it is not normally redeemed, i.e. it is not repaid by the business. Once the share has been sold, the buyer is entitled to a share in the profit of the company, i.e. a dividend. Dividends are not always declared. Sometimes a business makes a loss or needs to retain profit to help fund future business activities. A shareholder can make a **capital gain** by selling the share at a higher price than it was originally bought for. Shares are not normally sold back to the business.

• **Ordinary shares**. These are also called equities and are the most common type of share issued. They are also the riskiest type of share since there is no guaranteed dividend. The size of the dividend depends on how much profit is made and how much the directors decide to retain in the business. All ordinary shareholders have voting rights. When a share is first sold it has a nominal value shown on it - its original value. Share prices will change as they are bought and sold again and again.

• **Preference shares**. The owners of these shares receive a fixed rate of return when a dividend is declared. They carry less risk because shareholders are entitled to their dividend before the holders of ordinary shares. Preference shareholders are not strictly owners of the company. If the company is sold, their rights to dividends and capital repayments are limited to fixed amounts. Some preference shares also allow their holders to receive late-payment of dividends that were missed in years when dividends were not declared. Some are also redeemable, which means that they can be bought back by the company.

• **Deferred shares.** These are not used often. They are usually held by the founders of the company. Deferred shareholders only receive a dividend after the ordinary shareholders have been paid a minimum amount.

• **Venture capital**: Venture capitalists are specialists in the provision of funds for small- and medium-sized businesses. Typically they invest in businesses after the initial start-up and often prefer technology companies with high growth potential. They prefer to take a stake in the company, which means they have some control and are entitled to a share in the profit.

• **Bank overdraft**: This is an important source of finance for a large number of businesses. A bank overdraft means that a business can spend more money than it has in its account. In other words they go 'overdrawn'. The bank and the business will agree on an overdraft limit and interest is only charged when the account is overdrawn. The amount by which a business goes overdrawn depends on its needs at the time.

• **Leasing**: A lease is a contract through which a business acquires the use of resources, such as property, machinery or equipment, in return for regular payments. In this type of finance, the ownership never passes to the business that is using the resource. With a finance lease, the arrangement is often for 3 years or longer and, at the end of the period, the business is given the option of then buying the resource.

There are some advantages of leasing.

• No large sums of money are needed to buy the use of equipment.

• Maintenance and repair costs are not the

• responsibility of the user.

• Hire companies can offer the most up-to-date equipment.

• Leasing is useful when equipment is only required occasionally.

A leasing agreement is generally easier for a new company to obtain than other forms of loan finance. This is because the assets remain the property of the leasing company.

However:

- over a long period of time leasing is more expensive than the purchase of equipment and machinery
- loans cannot be secured on assets that are leased.

Trade credit: It is common for businesses to buy raw materials, components and fuel, and pay for them at a later date, usually within 30-90 days. Paying for goods and services using trade credit seems to be an interest- free way of raising finance. It is particularly profitable during periods of inflation.

Grants: Some businesses might qualify for financial support in the form of a grant. Both central and local government in most countries around the world back a wide range of schemes. A list of grants available can be accessed using the government's 'business finance support finder' tool.

SUBJECT VOCABULARY

authorised share capital the maximum amount that can be legally raised.
bank overdraft an agreement between a business and a bank that means a business can spend more money than it has in its account (going 'overdrawn'). The overdraft limit is agreed and interest is only charged when the business goes overdrawn.
capital gain the profit made from selling a share for more than it was bought.
crowd funding where a large number of individuals (the crowd) invest in a business or project on the Internet, avoiding the use of a bank.
debenture a long-term loan to a business.
equities another name for an ordinary share.
external finance money raised from outside the business.
issued share capital amount of current share capital arising from the sale of shares.
lease a contract to acquire the use of resources such as property or equipment.
peer-to-peer lending (P2PL) where individuals lend to other individuals without prior knowledge of them, on the Internet.
permanent capital share capital that is never repaid by the company.
secured loans a loan where the lender requires security, such as property, to provide protection in case the borrower defaults.
share capital money introduced into the business through the sale of shares.
unsecured loans a loan where there are no assets to which the lender has a right if the borrower does not make repayments.
venture capitalists providers of funds for small- or medium-sized companies that may be considered too risky for other investors.

Chapter 26 – Forms of business

SOLE TRADERS

A **sole trader or sole proprietor** is the simplest form of business organisation. It has one owner, but can employ any number of people. Sole traders can be involved in a wide range of business activity. In the **primary sector**, they may be farmers or fishermen. In the **secondary sector**, they may be small building or manufacturing businesses. However, most sole traders will be found in the **tertiary sector**. Many of these are retailers running small shops. Setting up as a sole trader is easy, as there are no legal requirements. However, sole traders do have some legal responsibilities.

• They may have to pay taxes and other government charges.

• Once their turnover reaches a certain level, they must register for value added tax (VAT). However, in some countries some sole traders choose to register because they can claim back VAT that they have paid, even though they do not charge VAT.

• They may need a licence to trade if they are involved in activities, such as selling in a marketplace or street or supplying a taxi service or public transport.

• They may need planning permission - for example, a person may have to apply to the local authority for planning permission to convert a shop into a restaurant.

• They must comply with legislation aimed at business practice - for example, they are legally required to provide safe working conditions for their employees.

All sole traders have **unlimited liability**. This means that if the business fails, a sole trader can lose more money than was originally invested. This is because a sole trader can be forced to use personal wealth to pay off business debts. The advantages and disadvantages of operating as a sole trader are summarised in Table 1.

Advantages	Disadvantages
The owner keeps all the profit.	The owner has unlimited liability.
The business is independent and the owner has complete control.	The owner may struggle to raise finance, as lenders may consider them too risky to offer credit.
The business is simple to set up, with no legal requirements.	Independence may be a burden, for example if an owner is ill.
The business can be flexible and can adapt to change quickly.	The owner and any employees are likely to work very hard, with long hours.
The business can offer a personal service because it is small.	The business is usually too small to exploit economies of scale.
The business may qualify for government help.	The business cannot be continued if the owner passes away.

▲ Table 1 Advantages and disadvantages of sole traders

PARTNERSHIPS

A **partnership**, in the UK, is defined in the Partnership Act 1890 as the 'relation which subsists between persons carrying on business with common view to profit'. Put simply, a partnership has more than one owner. The 'joint' owners will share responsibility for running the business and also share the profits. Partnerships are often found in professions, such as accountants, doctors, estate agents, solicitors and vets. After sole traders, partnerships are the most common type of business organisation.

There are no legal requirements to complete when a partnership is formed. However, partners may draw up a **deed of partnership**. This is a legal document that states partners' rights in the event of a disagreement. It covers issues such as:

- how much capital each partner will contribute
- how profits (and losses) will be shared among the partners
- the procedure for ending the partnership
- how much control each partner has
- rules for taking on new partners.

If no deed of partnership is drawn up the arrangements between partners will be subject to the Partnership Act. For example, if there is a dispute regarding the share of profits, the Act states that profits are shared equally among the partners.

The advantages and disadvantages of partnerships are shown in Table 2 on the next page.

Advantages	Disadvantages
The partnership is easy to set up and run, with no legal requirements.	Partners have unlimited liability.
Partners can specialise in their area of expertise.	Partners have to share the profit.
Partners share the burden of running the business.	Partners may disagree and fall out with one another.
More owners can raise more capital.	One partner's decision creates legal obligations for all partners.
The partnership does not have to publish financial information.	Partnerships have limited growth potential.

▲ Table 2 Advantages and disadvantages of partnerships

LIMITED PARTNERSHIPS

The Limited Partnerships Act 1907, in the UK, allows a business to become a **limited partnership**, although this is rare. This is where some partners provide capital but take no part in the management of the business. Such a partner will have **limited liability** - the partner can only lose the original amount of money invested. A partner with limited liability cannot be made to sell personal possessions to meet any other business debts. This type of partner is called a **sleeping partner**.

LIMITED COMPANIES

A limited company has a separate legal identity from its owners. The company can own assets, form contracts, employ people, sue people and be sued.

Certain features are common to limited companies.

• Capital is raised by selling shares. Each shareholder owns a number of these shares and is a joint owner of the company. They are entitled to vote on important business decisions, such as a choice of who should run the company. They also get dividends paid from profits. Shareholders with more shares will have more control and get more dividends.

• Unlike sole traders or partnerships, the owners (shareholders) have limited liability. If a limited company has debts, the owners can only lose the money they originally invested. They cannot be forced to use their own money to pay any debts that have been run up by the business.

• Limited companies are run by directors who are elected by the shareholders. The board of directors, headed by a chairperson, is accountable to shareholders. The board runs the company as the shareholders wish. If the company performs badly, directors can be voted out at an annual general meeting (AGM).

• Unlike sole traders and partnerships, who pay income tax on profits, limited companies pay corporation tax.

Forming a limited company: To form a limited company, it is necessary to follow a legal procedure. This involves sending some important documents to the Registrar of Companies: these are the memorandum of association and the articles of association. These are shown in Figures 1 and 2 (below).

If the documents in Figures 1 and 2 are acceptable, the company gets a certificate of **incorporation**. This allows it to trade as a limited company. The shareholders have a legal right to attend the AGM and must be told of the date and venue in writing.

The memorandum of association sets out the constitution and gives details about the company. The following details must be included:

- name of the company
- name and address of the company's registered office
- objectives of the company and the nature of its activities
- amount of capital to be raised and the number of shares to be issued.

▲ Figure 1 Memorandum of association

This document deals with the internal running of the company. The articles of association include details such as:

- rights of shareholders depending on the type of share they hold
- procedures for appointing directors
- length of time directors should serve before re-election
- timing and frequency of company meetings
- arrangements for auditing company accounts.

▲ Figure 2 Articles of association

PRIVATE LIMITED COMPANIES

Most private limited companies are small- or medium- sized businesses, though some are large businesses, similar in size to public limited companies. Private limited companies share the following features.

• Their business name ends in Limited or Ltd.

• Shares can only be transferred privately, from one individual to another. All shareholders must agree on the transfer and they cannot be advertised for sale.

• They are often family businesses owned by family members or close friends.

• The directors of private limited companies tend to be shareholders and are involved in running the business. The advantages and disadvantages of private limited companies are outlined in Table 3.

Advantages	Disadvantages
Shareholders have limited liability.	Private limited companies have to publish their financial information.
More capital can be raised by issuing shares.	Setting-up costs have to be met.
Control over the business cannot be lost to outsiders.	Profits are shared between more members.
The owners have tax advantages. Owners may pay less tax, for example.	It takes time to transfer shares to new owners.
Private limited companies are considered to have a higher status than some other types of business organisations, such as a sole trader.	Private limited companies cannot raise large amounts of money like public limited companies.

▲ Table 3 Advantages and disadvantages of private limited companies

FRANCHISING

Starting up your own business carries a lot of risk. Most new start-ups have ceased to exist after 5 years of trading. One way of possibly reducing this risk is to buy a franchise. The franchisor is a company that owns the franchise. It has a track record of running a successful business operation.

The franchisor provides a variety of services to its franchisees.

• It gives the franchisee a licence to make a product that is already tried and tested in the marketplace. This could be a physical product but is far more likely to be a service.

• The franchisor provides a recognised brand name which customers should recognise and trust. This helps generate sales from the moment the franchise starts trading.

• The franchisor will provide a start-up package. This will include help and advice about setting up the business. The franchisor might provide the equipment to start the business. It might help find a bank which will lend money. It will provide training for the new franchisee.

• Many franchises provide materials to use to make the product. A company like McDonald's, for example, sells food ingredients to its franchisees. If the franchisor does not directly sell to the franchisee, it might organise bulk-buy deals with suppliers to cut costs for all its franchise operation.

• It is likely to provide marketing support. For example, it might have national advertising campaigns. It may provide marketing materials like posters to place in business premises, or leaflets to send to customers.

• There should be ongoing training. This will be linked to issues such as maintaining standards, sales and new products.

• There is likely to be a range of business services available at competitive prices. For example, the franchisor might negotiate good deals on business insurance or vehicle leasing with suppliers.

• Many franchises operate exclusive area contracts. This is where one franchisee is guaranteed that no franchise deal will be signed with another franchisee to operate in a particular geographical area. This prevents competition between franchisees and so helps sales.

• Over time, the brand should be developed by the franchisor. For example, new products should be developed to appeal to customers.

In return for these services, the franchisee has to pay a variety of fees.

• There will be an initial start-up fee. Part of this will cover the costs of the franchisor in giving advice or perhaps providing equipment. Part of it will be a payment to use the franchise name.

• Most franchisors charge a percentage of sales for ongoing management services and the ongoing right to use the brand name.

• Franchisors will also make profit on the supplies they sell directly to their franchisors.

• There may also be one-off fees charged for management services such as training.

There are advantages and disadvantages of franchising. Table 4 shows some general advantages and disadvantages for the franchisee.

Advantages to the franchisee	Disadvantages to the franchisee
Franchises are lower risk, as they use an idea that has already been tried and tested.	A franchisee's profit is shared with the franchisor.
Franchisees get support from the franchisor.	Franchisees have to sign contracts with franchisors, which can reduce independence.
The set-up costs of a franchise are predictable.	Setting up a franchise can be an expensive way to start a business.
Franchisees can benefit from national marketing campaigns organised by the franchisor.	Franchisees lack independence and must follow strict operating rules.

▲ Table 4 Advantages and disadvantages to franchisees of franchising

Advantages to the franchisor	Disadvantages to the franchisor
Franchising is a fast method of growth.	Potential profit is shared with franchisees.
Franchising is a cheaper method of growth because growth is mainly funded by the franchisee.	Poor franchisees may damage the brand's reputation.
Franchisees take some of the risk on behalf of the franchisor.	Franchisees may get their supplies from elsewhere.
Franchisees are more motivated than employees.	The cost of supporting franchisees may be high.

▲ Table 5 Advantages and disadvantages to franchisors of franchising

SOCIAL ENTERPRISES

Some businesses operate as a social enterprise. These organisations trade with the aim of improving human and environmental well-being, rather than making profit for external owners. Generally, social enterprises:

- have a clear social and/or environmental mission
- generate most of their income through trade or donations

- reinvest most of their profits
- are not connected to the government
- are majority controlled in the interests of the social mission
- are accountable and transparent. Social enterprises may take a variety of forms.

Co-operatives: Most modern co-operatives operate as consumer or retail co-operatives. They are owned and controlled by their members. Members can purchase shares that entitle them to a vote at annual general meetings (AGMS). The members

Worker co-operatives: These are businesses jointly owned by their employees. Examples might be a creative workers co-operative or a co-operative of farmers producing milk. In a worker co-operative, employees are likely to:

- contribute to production and be involved in decision making
- share in the profit (usually on an equal basis)
- provide some capital when buying a share in the business.

Mutual organisations: Most building societies in the UK are **mutual organisations**. They are owned by their customers or members, as they are known - rather than by shareholders. They offer a wide range of financial services, such as mortgages and savings products. Profits are returned to members in the form of better and cheaper products.

Charities: These exist to raise money for various causes and draw attention to the needs of disadvantaged groups in society. Charities rely on donations for their revenue. They may also organise fundraising events such as cake sales, sponsored activities and raffles. A number of charities also run business ventures such as charity shops.

LIFESTYLE BUSINESSES

A person running a lifestyle business aims to make enough money and provide the flexibility needed to pay for a particular lifestyle. Many online businesses, such as web design, coaching," advisory or marketing services also operate as lifestyle businesses. Some features of lifestyle businesses are as follows.

• The business will often be small and is likely to have just one owner.

• The personal interests of the entrepreneur are likely to influence the nature of the business, so that time spent working is enjoyable.

• An owner may undertake a variety of different ventures. For example, a musician may generate income by playing live in a band, teaching people to play an instrument, teaching part time in a college and writing music for adverts.

• Running the business is likely to be much less stressful than other forms of business.

• The business is likely to be home-based.

• They are likely to have similar advantages and disadvantages to those of sole traders.

• Lifestyle businesses are sometimes considered an alternative to retirement.

Lifestyle businesses are sometimes contrasted with start-up businesses, which are intended to grow and create increasing amounts of profit. Because growth in revenue and profit is not a key objective to lifestyle businesses, owners of lifestyle businesses usually have to provide all the funding themselves. Not many external investors will fund businesses that do not aim to maximise profits. However, there are exceptions.

ONLINE BUSINESSES

Amazon.com, Alibaba, Confused.com®, eBay and Facebook are examples of large and well-known online businesses. However, there are many thousands of much smaller examples including retailers, consultants, gaming companies, bloggers, share dealers, teachers, web designers and information providers. Despite being very different companies, they all use the Internet to trade and are likely to have the following features in common.

• Customers access the business via the Internet. All online businesses have a website which gives information about their products, their prices and general information about the company.

• Online businesses collect payment for goods and services electronically. Credit cards, debit cards and PayPal are the most common methods used.

• There are no formal procedures to follow or legal requirements when starting an online business. However, traders must have secure websites with adequate protection against technical breakdowns and fraud.

• Online businesses have low set-up costs. A trader could build their own website for a few hundred pounds. Alternatively, for a higher set-up cost, a new online trader could purchase a complete set-up package, including web design, domain name registration and arranging the hosting of the website by an Internet service provider. Many online businesses are also run from home, which eliminates the need to find business premises.

	2011	2012	2013	2014	2015	2016
Global Internet users (million)	2216	2459	2660	2931	2207	3488
Global e-commerce sales (US$ million)	894,000	1,088,000	1,233,000	1,472,000	1,548,000	1,915,000

Based On global ecommerce sales chart, Number of internet users worldwide from 2011 to 2017 (in millions).

▲ Table 6 Growth in global Internet use and total global e-commerce sales

Chapter 27 – Forms of business PLCs

THE GROWTH OF BUSINESSES

Most owners want their businesses to grow. This is usually because larger businesses enjoy a higher profile in the marketplace, larger revenues, lower unit costs due to economies of scale and higher profits. Larger businesses also feel more secure and find it easier to raise money. Many entrepreneurs may dream of owning a huge business that they built from nothing.

PUBLIC LIMITED COMPANIES

A public limited company is owned by shareholders and the name of the company ends in plc. Like a private limited company, it is run by a board of directors under the supervision of a chairperson who is accountable to the shareholders. In most countries around the world the majority of limited companies are private. Only a very small fraction - perhaps as little as 1 or 2 per cent in some countries - are public. However, they contribute significantly to national output and employment. The shares of public limited companies can be bought and sold on the **stock market**.

SUBJECT VOCABULARY

articles of association a document that provides details of the internal running of a limited company.
certificate of incorporation a document that declares a business is allowed to trade as a limited company.
co-operatives business organisations owned by their members, who have equal voting rights.
deed of partnership a binding legal document that states the formal rights of partners.
franchise a business model in which a business (the franchisor) allows another operator (the franchisee) to trade under their name.
lifestyle business a business that aims to make enough money and provide the flexibility needed to support a particular lifestyle for the owner.
limited company a business organisation that has a separate legal entity from that of its owners.
limited liability a legal status which means that a business owner is only liable for the original amount of money invested in the business.
limited partnership a partnership where some members contribute capital and enjoy a share of profit, but do not participate in the running of the business. At least one partner must have unlimited liability.
memorandum of association a document that sets out the constitution and states key external details about a limited company.
mutual organisations businesses owned by their members, who are customers not shareholders.
online businesses businesses that use the global communications infrastructure of the Internet as a trading base.
partnership a business organisation that is usually owned by between 2–20 people.
primary sector production involving the extraction of raw materials from the earth.
secondary sector production involving the conversion of raw materials into finished and semi-finished goods.
sleeping partner a partner that contributes capital and enjoys a share of the profit but takes no active role in running the business.
social enterprise a business that trades with the objective of improving human or environmental well-being charities and workers' co-operatives, for example.
sole trader or sole proprietor a business organisation which has a single owner.
tertiary sector the production of services in the economy.
unlimited liability a legal status which means that the owner of a business is personally liable for all business debts.

STOCK MARKET FLOTATION

A stock market flotation occurs when a company 'goes public. The process is also called an initial public offering (IPO), which means that a company's shares are offered to the public for the first time. The process is time-consuming and expensive. A great deal of administration is necessary and it is common for a specialist such as an investment bank to be awarded the task. One of the first jobs when undertaking an IPO is to publish a prospectus. This is a detailed document that advertises the company to potential investors and invites them to buy shares before the day of the flotation.

The prospectus is likely to contain the following.

• A brief history of the business.

• A list of the directors and other key personnel.

• A description of its operations.

• An outline of how the money raised will be spent. The company's future strategy.

• Some financial details such as historic accounts.

• Details of any unresolved legal action.

• Details of possible risks to investors.

• Clear information about how to buy shares - including key dates for example.

• An application form to buy shares. 'Going public' is expensive. This is because:

• the company needs lawyers to ensure that the prospectus is 'legally' correct

• a large number of these expensive publications have to be made available

• the company is likely to pay an investment bank to process share applications

• the share issue has to be underwritten (which means that the company must insure against the possibility of some shares remaining unsold) and a fee is paid to an underwriter who must buy any unsold shares

• the company will have advertising and administrative expenses

• the company must have a minimum of £50,000 share capital.

A public limited company cannot begin trading until it has completed these tasks and has received payment of at least 25 per cent for the value of shares. It will then receive a trading certificate and can begin operating, and the shares will be quoted on the stock exchange.

A full stock exchange listing means that the company must comply with the rules and regulations laid down by the stock exchange. Many of these rules are to protect shareholders from fraud.

ADVANTAGES OF PUBLIC LIMITED COMPANIES

Some of the advantages of public limited companies are the same as those of private limited companies (see Chapter 26). Other advantages of public limited companies are as follows.

• Huge amounts of money can be raised from the sale of shares to the public. For example, when Alibaba went public in 2014, around US$20,000 million was raised for the company.

• Production costs may be lower as firms may gain economies of scale. Public limited companies are expected to grow and as they get bigger unit costs are likely to fall. This will improve their competitiveness and help to generate more profit.

• Because of their size, public limited companies can often dominate the market. Most plcs aim to grow and may eventually exercise some control in the market. For example, they may be able to create **barriers to entry,** preventing competition.

• It becomes easier to raise finance, as financial institutions are more willing to lend to public limited companies. A plc with substantial assets can provide the guarantees needed by financial institutions to receive secured loans. Larger plcs also have a wider range of capital sources to choose from.

• Pressures from the media and financial analysts, as well as the danger that the public limited company might be taken over by another company, encourages executives and managers to perform well and make profits. These pressures do not exist for private limited companies.

DISADVANTAGES OF PUBLIC LIMITED COMPANIES

Setting up as a public limited company can also have disadvantages.

• The setting-up costs for public limited companies can be very expensive-running into millions in some cases. The various costs of 'going public' are listed under 'stock market flotation' on the previous page.

• As anyone can buy their shares, it is possible for an 'outsider' to have power over the company. They might even take complete control of a company if they buy enough shares.

• Members of the public can inspect all of the company's accounts. Competitors may be able to use some of this information to their advantage. Public limited companies have to publish more information than private limited companies.

• Because of their size it is more difficult to deal with customers at a personal level. Some customers do not like dealing with giant 'faceless' corporations. They may prefer the personal service of a much smaller enterprise, perhaps even dealing directly with the owner.

• The way they operate is controlled by various company acts, which aim to protect shareholders.

• There may be a divorce of ownership and control. This means that the shareholders may not be able to exert enough pressure on those that end up running the company, such as senior managers. As a result the senior managers might pursue their own objectives, possibly at the expense of shareholders. This may happen if the shares are spread between a very large number of small shareholders. In recent years some shareholders have been unhappy about the huge pay increases awarded to senior executives in plcs, and also their extravagance when running the company.

• It is argued that some very large public limited companies are inflexible due to their size.

Some public limited companies are very large indeed. They have millions of shareholders and a wide variety of business interests situated all over the world. They are known as multinationals, which means that they have international markets and production operations in a number of different countries.

SUBJECT VOCABULARY

barriers to entry obstacles that make it difficult for new firms to enter a market.
private equity company a business usually owned by private individuals backed by financial institutions.
public limited company a company owned by shareholders where the shares can be traded openly on the stock market.
stock market a market for second-hand shares.
stock market flotation or initial public offering (IPO) the process of a company 'going public' – making shares available to the public for the first time.

Chapter 28 – Liability

LIMITED LIABILITY AND UNLIMITED LIABILITY BUSINESSES

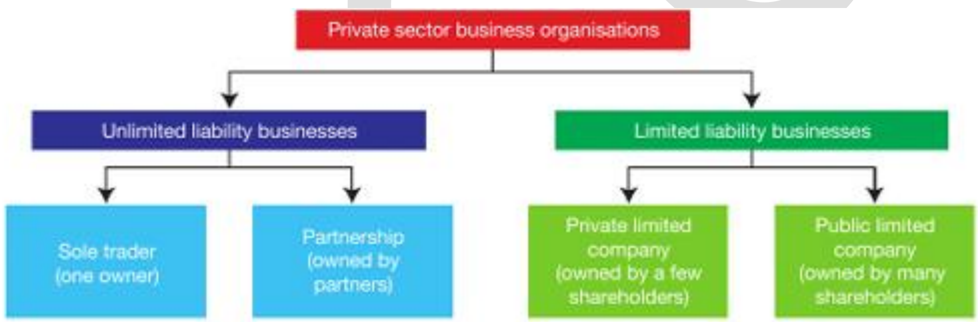
Whether business owners have **limited liability** or unlimited liability depends on the legal status of their businesses. This may take one of two different forms.

- Unlimited liability businesses. These are businesses where there is no legal difference between the owners and the business. They are sometimes called an unincorporated business. Everything is carried out in the name of the owner or owners. These firms tend to be small, owned either by one person or a few partners. The owners of these businesses will have unlimited liability.
- Limited liability businesses. A limited liability business has a legal identity separate from its owners. In other words, the business (as opposed to the owners) can be sued, taken over or liquidated. These firms are sometimes called an incorporated business. The owners of these businesses will have limited liability.

Figure 1 shows the different types of businesses, their legal status, their ownership and the owner's liability.

ADVANTAGES AND DISADVANTAGES OF UNLIMITED LIABILITY

Business owners with unlimited liability are exposed financially to the failure of their businesses. If their business collapses while owing money to external parties, such as banks, suppliers and the tax authorities, the owners will have to meet these debts from their personal resources. This means that if owners do not have the money to pay off these debts they can be forced to sell private assets to raise the necessary cash.



▲ Figure 1 Businesses with unlimited and limited liability

ADVANTAGES AND DISADVANTAGES OF LIMITED LIABILITY

The owners of businesses with limited liability are shareholders. The main advantage of this is that shareholders' financial liability is limited to the amount of money they invested in the business. It is a fixed sum and equal to the amount of money they paid for their shares. If a limited company collapses, the owners' private assets are fully protected. Shareholders cannot be legally forced to sell personal assets to meet the business's debts.

. They will then be liable for those debts in the event that the company cannot pay, although the other shareholders will not be. The advantages and disadvantages of limited companies are discussed in Chapters 26 and 27.

CHOOSING APPROPRIATE FINANCE

The wide range of sources and methods of finance was discussed in Chapters 24 and 25. However, not all of these sources can be accessed by all businesses.

The method of finance chosen by a business can be influenced by a number of factors.

Whether short-term or long-term finance is needed: If a business needs to borrow money for a lengthy period of time, say 10 years or more, certain types of funding are more suitable than others. Debentures can be issued for up to 30 years. Share capital - money raised from the sale of shares is permanent capital and never repaid. This is the most **long-term finance method**. A business is not likely to use trade credit, bank overdrafts or leasing for long-term funding. These are more suitable for **short-term borrowing.**

The financial position of the business: The financial situation of businesses is constantly changing. When a business is in a poor financial situation, it finds that lenders are more reluctant to offer finance. At the same time, the cost of borrowing rises. Financial institutions are more willing to lend to secure businesses, which have a large amount of collateral.

The type of expenditure for which the money is needed: When a company undertakes heavy capital expenditure, it is usually funded by a long-term source of finance. For example, the building of a new factory might be financed by a share issue or a mortgage. Revenue expenditure tends to be financed by short-term sources. For example, the purchase of raw materials might be funded by trade credit or a bank overdraft.

Cost: Businesses will prefer sources and methods that are less expensive, both in terms of interest payments and administration costs. For example, share issues can carry high administration costs, while the interest payments on bank overdrafts tend to be relatively low.

The legal status of the business: This will depend on whether a business has limited or unlimited liability. This is discussed in more detail below.

FINANCE APPROPRIATE FOR UNLIMITED LIABILITY BUSINESSES

Unlimited liability businesses, such as sole traders and partnerships, have fewer sources and methods of finance to choose from. They are most likely to include some of the following.

Personal savings. Most small business owners with unlimited liability are likely to use their own money to set up a business. It is an important source of finance.

Retained profit. This source can only be used if the business survives and becomes established. As the business develops it must generate enough profit to support both the owner and future business investment. However, for many unlimited liability businesses, the scope for using retained profit is restricted.

Mortgage. It is common for unlimited liability businesses to use the owner's house as collateral for a business loan. This provides a source of long- term finance. However, the owners are at increased risk. If the business goes into heavy debt and fails, the owners can suffer serious financial hardship, such as losing their homes.

Unsecured bank loans. On occasion, banks might advance unsecured loans to established and successful businesses. This might depend on the financial climate at the time of request. For example, banks may have tighter criteria for unsecured bank loans if there is a credit crunch. Owners must be prepared to produce detailed business plans to obtain bank loans.

Peer-to-peer lending (P2PL). Small business owners can raise finance through dedicated websites from people interested in lending money to their enterprise, thus avoiding the need for a bank. However, some P2PL funding is not available to businesses. The owners will have to check with individual P2PL sites to see whether businesses can borrow.

Crowd funding. Crowd funding can provide long- term finance for businesses. Once this new concept has had time to develop and prove to be reliable, it could well become a very popular source for unlimited liability businesses.

• **Bank overdraft**. Most businesses will have access to a bank overdraft. However, the size of the overdraft limit will vary considerably. Established and profitable businesses will have access to much larger overdrafts than those that are not.

Grants. These can provide a 'free' source of finance to unlimited liability businesses. However, businesses have to prove that they qualify for grants and some owners might be put off by the lengthy application process. All of the finance sources outlined above are appropriate for unlimited businesses because they are accessible to small businesses.

FINANCE APPROPRIATE FOR LIMITED LIABILITY BUSINESSES

Generally, limited liability businesses, particularly plcs, have a much wider range of funding opportunities. Some methods of finance, such as shares and debentures.

• Share capital. The sale of shares allows limited companies to raise very large amounts of capital. Share capital is provided by the owners of the business from their own resources. Once shares are purchased, the money raised is not normally repaid to shareholders, so the capital remains in the business for as long as it is trading. Also, a business might raise more money in the future by selling more shares. They may use a **rights issue,**

• Debentures. Public limited companies can raise large amounts of money by selling debentures. This loan capital can be very long term up to 30 years. One key advantage of this method to the business is that, unlike shareholders, debenture holders do not have any control over the business.

• Retained profit. Around half of all business finance comes from retained profit. Limited liability businesses are no exception. Some very large companies have hundreds of millions of pounds in cash reserves, which have accumulated over the years. Some of this is likely to be used by the business in the future.

• Venture capitalists. The majority of finance provided by venture capitalists finds its way into limited companies. One reason is because they usually take a share in the business, thereby having some control over the key decisions. Venture capitalists also like to invest larger amounts of money than business angels - several million pounds sometimes. However, they are also prepared to invest in small- and medium-sized enterprises.

• Business angels. Business angels may provide funds for both limited and unlimited liability businesses. They will normally take a share in the business, but this does not mean they will avoid sole traders and partnerships. They are also more inclined to invest at an earlier stage than venture capitalists. One problem with business angels is that they are often difficult to find. This sometimes means that entrepreneurs spend too long searching for suitable angels when their time could be better spent focusing on the development of the business.

• Other sources. Businesses with limited liability are all likely to use bank overdrafts, trade credit, leasing, unsecured bank loans, mortgages and grants in some combination or other. Larger limited companies are much less likely to use sources, such as crowd funding and P2PL.

All the finance sources outlined above are appropriate for limited liability businesses. One reason for this is due to their legal status.

SUBJECT VOCABULARY

collateral an asset that might be sold to pay a lender when a loan cannot be repaid.
incorporated business a business model in which the business and the owner(s) have separate legal identities.
limited liability a legal status which means that a business owner is only liable for the original amount of money invested in the business.
long-term finance money borrowed for more than 1 year.
rights issue issuing new shares to existing shareholders at a discount.
short-term borrowing money borrowed for 12 months or less.
undercapitalised a business with insufficient capital to run effectively.
unincorporated businesses a business model in which there is no legal difference between the owner(s) and the business.
unlimited liability a legal status which means that the owner of a business is personally liable for all business debts.