

# INTRODUCTION

**A**s 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**

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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

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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Clive Marsh is an experienced accountant, chief finance officer, corporate banker and business development director. He has worked for Shell, IBM, Cap Gemini, Ernst & Young and several corporate banks in the UK

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

Clive has a Masters' degree in strategic financial management from the Business School of Kingston University, London, is a member of the Institute of Chartered Accountants of New Zealand (ACA NZ), a fellow of the Chartered Bankers' Institute (FCIBS), a chartered banker and a fellow of the Chartered Management Institute.

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# TYPES OF BUSINESS STRUCTURE AND THEIR FINANCE

**T**he 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.

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**

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### ***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

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 vary 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**

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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