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fifth edition

BUSINESS ACCOUNTING AND FINANCE

CATHERINE GOWTHORPE

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Brief contents

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Preface to the fifth edition

Who is this Book Aimed at?

The aim of this book is to provide an introduction to business accounting and finance. The book is suitable for students on introductory accounting courses, or on business and management courses generally, or on more specialized courses such as marketing, human resources management, tourism, hospitality management and information systems. Students outside the business area following courses in engineering, computer science, fashion and fine and applied arts will also find the book a very suitable introduction to accounting and finance.

While the principal intended audience for the book comprises students taking a formal course of instruction at college or university, it is also intended that the book should lend itself to self-study by anyone who is interested in extending their knowledge of basic business accounting and finance. This could include people who are starting, or thinking of starting, their own businesses. Also, the book could be useful for people who are already engaged in business but who are aware that they do not quite understand what their accountant is telling them.

The overarching aim of the book is to develop understanding of accounting. It is not, primarily, a book about how to do accounts. Some of the chapters do, indeed, require students to prepare fairly straightforward accounting statements. However, the principal purpose of this approach is to aid understanding; it is often easier to understand how accounting figures hang together if you have had some experience of working them out for yourself.

If you are a student specializing in a non-accounting subject you may find that you are obliged, unavoidably, to study business accounting and finance. Students in this category are sometimes very unwilling to engage with a subject that they find to be alien and unhelpful. If this describes you, you may find it helpful to read the 'Special Notes for the Suspicious' in Chapter 1 of the book.

Structure of the Book

The first chapter 'The role of accounting in business' provides a general introduction to accounting. Chapters 2 to 9 inclusive introduce students to financial accounting and reporting. The early chapters in this section lead students through the basics of preparing financial reports. These chapters focus upon very small businesses, as these are easier to understand than large corporations. Also, students may find it easier to relate to simple, familiar businesses focused upon a single activity. These chapters are mostly silent on law and regulation and concentrate instead on the accumulation of technical knowledge so that students will be able, by the end of Chapter 6, to prepare the principal accounting statements for very small businesses.

Accounting law and regulation are introduced in Chapter 7, which examines financial reporting by limited companies. The Companies Act 2006 and UK GAAP are introduced in outline, and there is a brief section on International Financial Reporting Standards (IFRS Standards). Detailed knowledge of all of these sources of regulation is outside the scope of the book. Students of this book who go on to further study of accounting will be able to build upon their outline knowledge of the role of regulation in accounting.

Chapters 8 and 9 introduce the important topic of interpretation of financial accounting information. Many of the examples in these chapters focus upon smaller businesses, consistent with the approach taken in the earlier chapters, but larger businesses, including some real-life listed companies, are used as the basis of more complex examples. In Chapter 9, students are required to learn how to calculate accounting ratios. This may seem arduous, and even unnecessary because the ratios of so many listed businesses are readily available on the internet, but calculation aids understanding. Also, the approach taken in this book is guided by the examinations of the professional accountancy bodies (for example, ICAEW and ACCA) which continue to require students to be able to calculate, as well as to comment on, accounting ratios.

Chapters 10 to 18 inclusive introduce students to management accounting techniques. Consistent with the approach taken in the first part of the book, many of the examples focus upon smaller businesses. Many of the management accounting techniques explained in these chapters use examples of manufacturing industries. Most of the techniques originate in manufacturing and so it is appropriate to start there in explaining them. Where techniques have been adapted for use in service industries, examples set in the service sector are provided, and from time to time, where appropriate, public sector examples are also used.

Finally, Chapters 19 and 20 provide brief introductions to the management of working capital and financing business activities. We want to note that at the time of this fifth edition going to press, the global COVID-19 pandemic is still at large worldwide. For the past few months governments across the world have introduced a range of social distancing, isolation and quarantine methods to help control the pandemic and it is too early to tell what the effects of this pandemic will be on topics related to business accounting and finance.

Chapter Structure

All chapters start with Aims and Learning Outcomes. Diagrams and tables aid the narrative explanations and illustrate concepts, and frequent use is made of worked examples.

Most chapters include self-test questions within the text, so that students can test their understanding as they progress through the chapter. At the end of each chapter is an extensive set of exercises so that students can test their knowledge and understanding. Students are often worried and may become demotivated if the end-of-chapter exercises are too difficult. Therefore, the exercises are designed to test the full range of learning points in the chapter, from simple to complex. If students wish to test their understanding with even more exercises, further examples are provided on the book's dedicated website (see below). About half of the end-of-chapter exercises contain answers within the book. Answers to the remainder are available on the instructors' section of the book's website.

Supplementary Material

In addition to the material presented in the book, a variety of supplementary material is available.

Dedicated Website

The instructor section of the website is password-protected and the password is available free to instructors who confirm their adoption of the book. Instructors should complete the registration form on the website to apply for their password.

For Students and Instructors (Open Access)

- Multiple-choice questions. This contains supplementary questions for every chapter, comprising multiple-choice questions (usually five to ten per chapter).
- Additional questions and answers.

For Instructors Only (Password-Protected)

- Answers to the end-of-chapter questions for which answers are not provided in the book
- A downloadable Instructor's Manual including Teaching notes
- PowerPoint presentations to accompany each chapter
- Testbank
- Case Studies
- Additional questions and answers
- Supplementary chapters on double-entry book-keeping
- Supplementary chapter on accounting in Germany.

Changes to the Fifth Edition

The fifth edition has been revised extensively in response to comments and suggestions from instructors and students. Many thanks to all those who provided the useful and constructive comments and reviews on which the fifth edition is built.

The principal changes are as follows:

1. update and/or replacement of many of the real-life examples
2. the addition of a new section and several related questions on ethics in Chapter 1
3. update of Chapter 7, including the addition of a substantial section on corporate governance
4. the addition of downloadable Excel files to assist in answering some of the exercises in the book. These exercises are indicated by the use of the following icon:

Acknowledgements

Thanks to all the reviewers and students who have commented on earlier editions of the book, and to colleagues and students over the years who have influenced and informed the content of this book.

Reviewers whose constructive feedback has helped shape this fifth edition include the following: Marenglen Berisha, American University in Bulgaria; Ashley Casson, University of Kent; Christopher Coles, University of Stirling; Gerd Schmidt, Nordakademie gAG; Natalia Semenova, Linnaeus University; Birgit Wolf, Touro College Berlin; and Kooi See Yeap, Middlesex University London.

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1 The role of accounting in business

Aim of the chapter

To introduce the most common forms of business organization and to understand the reasons why people in business need accounting information, the nature of accounting information and the role of the accountant.

Learning outcomes

After reading the chapter and completing the related exercises, students should:

- Understand the differences between the sole trader, partnership and company forms of business organizations, and know, in outline, about some of the sources of business finance available to commercial organizations.
- Know in outline about some important features of the business environment including the various ways in which tax is charged on businesses.
- Understand why accounting information is produced.
- Be able to identify the principal groups in society who need and use accounting information, and to know about the principal characteristics and features of accounting information.
- Know about the functions that accountants perform in the production of accounting information.
- Understand the importance of ethics for the professional accountant.

Introduction

Accounting information is produced, quite simply, because people need it. This chapter explains the context in which accountants produce accounting information, describes the potential users of that information and outlines the type of information that might be required. The chapter assumes no prior knowledge of accounting or finance, or indeed business in general. Students coming to these areas of knowledge for the first time are often apprehensive about them. Accounting and finance are regarded by many people as particularly difficult subjects and instructors in accounting often face ingrained negative attitudes amongst their new students. Some of the most frequently encountered objections are considered in this introductory section of Chapter 1.

1.0.1 Special Notes for the Suspicious

If you are really looking forward to studying accounting and finance, please feel free to ignore the next few paragraphs. If, however, you are studying accounting only because of a general course requirement and if the quotations at the head of each subsection sound familiar, you might find it helpful to read the text below them.

'ACCOUNTING IS BORING AND IT'S NOT RELEVANT TO WHAT I'M DOING ANYWAY.' Some people are obliged to study accounting as part of a course in, say, marketing, engineering or a creative discipline. If you are a fashion student, for example, you are likely to be much more interested in creative outcomes and in developing your own skills. But people who are successful in making careers in fashion and other creative endeavours have to be very much alive to the business environment in which they work. People who have forged successful careers in the creative arts are often surprisingly well tuned in to the business and accounting aspects of what they do.

'ACCOUNTING SHOULD BE LEFT TO THE ACCOUNTANTS.' If you are looking forward to a career in, say, retail management or marketing, you may feel that you really should not have to bother with accounting – after all, there are plenty of accountants around to sort out the figures. One of the key messages of this book is that accounting, on the contrary, is much too important to be left to the accountants. Business managers in all disciplines owe it to themselves to be able to interpret the reports that accountants present to them; such reports are vital aids to understanding what is going on in the business. Business managers should be able to question accountants from a position of understanding the accounting information. If they are not sufficiently knowledgeable to do this, they risk being quite seriously restricted in their understanding of their business and their ability to make sound decisions.

It is important to appreciate from the outset that accounting is not an exact science. Accounting has emerged in its present-day form, after many centuries of development, because there is a need for it. It is, essentially, about communication between people and so it is vulnerable to all the impediments that hinder proper communication. For example, people sometimes tell lies, and accounting can be used, very effectively, to tell lies. Accounting is often imprecise, and its imprecision can be easily exploited by the unscrupulous. After studying this book, you should be much more aware of the strengths and limitations of accounting as a means of communication.

'ACCOUNTING IS ALL ABOUT MATHS, AND I'M NO GOOD AT MATHS.' Accounting undeniably involves dealing with numbers. However, the study of accounting rarely involves much beyond simple arithmetic. Specifically, the principal prior skills that this book requires are the ability to add, subtract, multiply, divide and to calculate a percentage. Towards the end of the book students will be required to draw simple line graphs and to calculate compound interest. There is nothing in this book that requires knowledge beyond GCSE level (in UK terms).

What the study of accounting does involve, though, is the ability to understand what the numbers signify. This is a skill that some students find relatively difficult to acquire. The book has been written with this difficulty in mind.

'I WON'T BE ABLE TO UNDERSTAND THE JARGON.' Accounting is no different from many other spheres of fairly advanced human endeavour in that it has its own terminology. Jargon is often baffling to the uninitiated but, inevitably, some of the jargon simply has to be learned. This book attempts to explain all the unfamiliar terms in the most straightforward way possible. There is a glossary towards the end of the book which collects together a lot of the most unfamiliar terminology so that students do not have to go back through the book hunting for the original explanation.

1.0.2 Legal and Reporting Requirements

This book refers in several places to legal institutions and requirements. These are all described and named as they operate in the UK. So, for example, the tax authority is described as HMRC (Her Majesty's Revenue and Customs) and the legislation for companies is UK legislation. If you are studying this book outside the context of the UK, you will find that legal institutions and requirements differ in your own country. Students outside the UK are encouraged to familiarize themselves with the applicable requirements and legislation in their own country.

Content of this Chapter

The chapter proceeds with a brief description of different forms of business organization, and sources of finance for them. It is followed by a brief section on some important features of the business environment, including some of the ways that tax is charged on business.

The chapter then proceeds to examine the need for accounting information and the function of the accountant in providing it.

1.1 Forms of Business Organization

There are three common forms of business organization: sole trader businesses, partnerships and limited companies. All three types of organization are run with a view to making profits.

1.1.1 Sole Trader Businesses

A **sole trader** operates a business himself or herself, keeping any profits which are made (after deduction of tax). This is a useful form of business for certain types of trade or profession. For example, a plumber, carpenter, financial services adviser, tax adviser, writer or nightclub singer could each operate as a sole trader business. Each of the people named offers a service to the public; each receives money in exchange for performance of the services. After deduction of the various expenses that are involved in running the business, any sum that is left over is the profit, all of which can be kept by the sole trader.

Example 1.1

Having finished his apprenticeship, Yasin sets up in business as a plumber. He pays a friend to set up a website for him, subscribes to a plumbers' trade association, and waits to be contacted by members of the public and other businesses who require plumbing services. Yasin charges fees for his services out of which he must meet business expenses.

What are Yasin's business expenses? They will typically involve: cost of tools, expenses of running a van, mobile phone bills, advertising and small amounts of administrative expense, such as paying for an accountant to sort out his tax affairs.

In order to keep his business affairs in good order, he will need to keep receipts as evidence of his expenses, copies of the bills he makes out to his customers and bank statements. It is important not to mix up the business income and expenditure with his own personal items.

Yasin or his accountant will summarize all the income he has received from customers and all the expenses of running the business on an annual basis.

Income less expenses = the profit of the business

The tax authorities (Her Majesty's Revenue and Customs in the UK – HMRC for short) will naturally take an interest in Yasin's business activities. He will have to pay tax, based upon the calculation of his profit. Later in the chapter, we will examine the tax regime in a little more detail.

CHARACTERISTICS OF THE SOLE TRADER FORM OF BUSINESS The sole trader is the only person responsible for the management of the business. Although he or she may employ other people as the business gets bigger, all the decision making and risk taking involved in the business rests on the shoulders of one individual. If the business runs into financial difficulties or faces other problems, the sole trader is on his or her own in addressing them.

Sole trader businesses tend to remain fairly small. For people who are self-employed in the types of trade or profession mentioned earlier, this type of business can work very well. However, if the business is of a type that is likely to grow very much bigger, the sole trader form of organization will need to be replaced by a partnership or limited company structure which allows more than one person to act as manager.

If a sole trader overstretches himself or herself financially, perhaps by borrowing too much, or if losses rather than profits are made, he or she is liable for all the consequences as an individual. For example, a lender would be entitled to pursue repayment of a loan even to the point where the sole trader would have to sell personal property to repay it. In extreme cases, this can result in personal bankruptcy.

The sole trader business is relatively informal and easy to set up. The business does not require registration of a separate legal entity and so it is quite likely that no legal costs will arise. In the initial stages, at least, the principal administrative issues are likely to arise with the HMRC. A competent chartered accountant can mediate between the individual and the HMRC to ensure that the correct amount is paid, and that tax does not become a problem.

1.1.2 Partnerships

A **partnership** is a business which is run by two or more people with a view to making a profit. Typically, partnerships are fairly small businesses, but there are certain types of business activity in which very large partnerships are operated. Professional partnerships, such as those between solicitors, may develop to be very large businesses indeed. There is a legal restriction which limits the number of partners in most types of partnership to 20; however, professional partnerships (solicitors, accountants, surveyors, architects, for example) are exempt from the restriction. The very largest partnerships are such big businesses that people who may have barely met each other are in partnership together.

Example 1.2

Winston and Winona start a business selling sports equipment; they will rent shop premises for retail sales, but will also run an online ordering service from the room behind the shop. The business is established as a partnership with a business name of WW Sports. The two partners decide that, as they will both be working full-time in the new business, they will share all the profits from the business equally.

As in the case of Yasin in Example 1.1, it will be necessary to keep some records of the business activities. However, unlike the case of the sole trader, Yasin, there are some legal requirements governing the records that have to be kept by the business, and the way in which the business operates. Partnerships are covered by the Partnership Act 1890. This is a relatively straightforward piece of legislation which sets out a basic structure of legal relationships between partners, minimum record-keeping requirements, and ways of resolving disputes between partners. For example, the Partnership Act states that profits will be shared equally between partners, unless they make some other agreement between themselves. Winston and Winona have agreed in any case to share profits equally; this is a common arrangement where all partners are contributing equally to the success of the business. However, they could share profits in any way that seems appropriate.

Many different trades and professions may be run through the medium of a partnership; apart from the professions noted above, doctors, pharmacists, business consultants, shopkeepers, builders, hairdressers and almost any other type of trade or business activity could be run via a partnership.

Apart from the basic legal structure set out in the Partnership Act 1890, partners may decide to draw up a formal, legal agreement between them. Typically, this would set out the details of the financial and legal arrangements which are to operate; it might, for example, state that Partner A will receive 60% of the profits of the business while Partners B and C each receive 20%. It may also deal with the actions to be taken in the event of a dispute between the partners. Not all partnerships bother to have a formal agreement of this type set up, but it can prove to be very useful if relationships turn sour.

CHARACTERISTICS OF THE PARTNERSHIP FORM OF BUSINESS The success of a partnership depends to some extent on the quality of the relationships between partners. Sometimes, people who are friends, or who are related to each other, set up a business partnership together. The pressures of running a business can sometimes place an intolerable strain on what has previously been a good relationship. On the other hand, where partnerships work well, they can be highly productive, especially if the partners have a range of skills that complement each other. Winona, in the example above, is perhaps very good at selling over the counter, but lacks the attention to administrative detail that is required to run the online ordering side of the business. If Winston is a good administrator, he will complement Winona's skills, and between them they will perhaps be able to run a successful business.

As well as sharing in the running of the business, the partners are likely to be able to command more resources to put into the business. At the start-up stage, each may have savings or other resources (such as equipment) which they can put into the business. If the partnership needs to borrow money, it may be in a better position to do so than the sole trader.

If the partnership loses money, or cannot repay loans, lenders are able to recover money owed by requiring the partners to sell items of property which they own personally. In this respect the partnership is no different from the sole trader, and the partners face the consequence of bankruptcy in the worst cases.

Each partner is liable under the law for the actions of his or her partners. If Winona makes a business decision which turns out badly and the partnership is left owing a large amount of money, both Winona and Winston are liable for the consequences of the decision. Winston could not claim that he knew nothing about the agreement; he would still be equally liable with Winona. (It really is important for partners to know and trust each other thoroughly.)

A partnership business is not difficult to set up. However, partners should be prepared to go to the additional trouble and expense of having a clear partnership agreement drawn up with the help of a solicitor. It will make the resolution of any disputes in the future easier to resolve.

1.1.3 Limited Companies

A **limited company** is a legal arrangement for regulating the ownership of business. A company is regarded as a separate person for the purposes of the law; so, for example, a company, unlike a partnership, can enter into a legal contract. This means that, if the other contracting person sues, he or she sues the company, not the owners of the company. The company itself becomes liable for its unpaid debts, overdrafts and so on.

This legal construction is an extremely important feature of the business world, in the UK and in many other countries. Because the company itself enters into contracts, takes out loans and so on, its owners are protected from any adverse consequences of the action. This is the concept of **limited liability**. It is an extremely useful and helpful device which protects shareholders from personal loss if the business runs into trouble.

Setting up a company (the process of **incorporation**) involves some legal formalities which must be followed strictly. It is therefore more difficult than setting up a sole trader business. However, the difficulties should not be overstated: there are specialist company registration firms which, for a modest fee, take care of all the formalities. It need cost little more than £150 to set up a company.

After the company is incorporated, there are certain regular legal formalities which must be complied with. More details are given below.

Example 1.3

Winston and Winona decide to set up their business as a limited company, rather than as a partnership. The business is registered in the name of WW Sports Limited. They divide ownership of the business between them; each owns exactly 50% of the shares in the business. Winona and Winston are both **shareholders**. Both are involved in the day-to-day management of the business and, as well as being shareholders, are also directors.

CHARACTERISTICS OF LIMITED COMPANIES Shareholders are liable only for the amount which they have paid into the company in exchange for shares. This is the maximum amount which they can lose if the company is, for example, sued for not repaying its loans on time.

The legal formalities involved in setting up and running a limited company are more complex than for partnerships and sole traders. The **directors** of a limited company are responsible for making available to the public a certain amount of financial information about the activities of the company, on a regular basis. They must do this via Companies House, an agency which is responsible for the collection of data relating to companies. Any member of the public can obtain information, including accounting information, about a limited company through the Companies House website (www.gov.uk/government/organisations/companies-house). Information which could remain private in a sole trader or partnership organization must be made public by limited companies.

In small companies, shareholders (who are the owners of the company) and directors (who are responsible for managing it) are the same people. However, in larger companies it is frequently the case that most shareholders have nothing to do with the management of the company. Day-to-day management can be left in the hands of directors who are professional managers. Shareholders in very large companies often have virtually no contact with the company or its managers.

Chapter 7 later in the book provides more detailed information about companies and their accounting.

1.2 Sole Traders, Partnerships and Limited Companies Contrasted

When setting up a business from scratch, the founder or founders must consider carefully which form of business organization is most suitable for them. Usually, it is sensible to take professional advice on the matter as it can be advantageous for tax purposes to choose one form over another. Leaving tax to one side for the time being, the following are the principal advantages and drawbacks of the three different types of organization.

1.2.1 Sole Trader – Advantages

- It is easy to start up as a sole trader.
- There are no legal formalities on start up.
- The sole trader is self-reliant; he or she does not risk the personality clashes which can occur where more than one person is managing a business.
- The sole trader does not have to share the profits from the business with anyone else.

1.2.2 Sole Trader – Drawbacks

- A sole trader bears all of the consequences of legal action against the business for unpaid debts and unfulfilled contracts. His or her personal property may have to be sold to meet business debts.
- A sole trader organization remains small-scale.
- The sole trader bears the brunt of any losses or business difficulties.
- There is no co-manager with whom problems can be shared.
- If the sole trader is weak in some aspect of business expertise (ability to sell, to manage people, to keep track of business records) the business may suffer because there is no one available with complementary skills.

1.2.3 Partnership – Advantages

- In a partnership, management is shared and the business can benefit from the complementary skills that the partners bring to it.
- Business decisions do not have to be taken alone.
- Business risks are shared, as are any losses which the business makes.

1.2.4 Partnership – Drawbacks

- Partners are responsible in law for the consequences of each other's actions.
- Partners face unlimited liability; they must bear all of the consequences of legal action against the partnership. Their personal property may have to be sold to meet unpaid business debts.
- The profits of the business are shared between all the partners whereas a sole trader keeps all the profits for himself or herself (but note that a partnership business, which combines the skills of two or more people, should be able to generate higher profits than a sole trader).

1.2.5 Limited Company – Advantages

- The most significant advantage conferred by company status is the limitation of personal liability. Shareholders can invest in a business knowing that they will not be pursued for further contributions once their shares have been paid for.
- The limited company legal structure allows for shareholders to appoint professional managers as directors.
- A limited company's shares can be used to spread the ownership of the business amongst many people.
- Shares can be sold and bought so that transfer of ownership is relatively easy and straightforward.

1.2.6 Limited Company – Drawbacks

- Setting up a company requires adherence to a set of strict formal legal requirements, and will sometimes require professional advice.
- Regular filing of financial information at Companies House is a legal requirement; this involves additional administration and means that members of the public have access to information which would remain strictly private in a partnership or sole trader organization.

Self-test question 1.1 (answer at the end of the book)

Before moving on, make sure that you can answer the following 'true or false' questions.

a) Setting up a partnership does not involve any particular legal considerations. TRUE or FALSE?
b) A sole trader is liable personally for all losses made by the business. TRUE or FALSE?
c) A director of a company cannot hold shares in that same company. TRUE or FALSE?
d) Partners are responsible in law for the consequences of each other's actions. TRUE or FALSE?

1.3 Finance for Business

When starting a business, the founder or founders must find a source of finance to pay for the setting up costs, any equipment that is needed and, probably, for the expenses of the business for the period during which it is getting established.

Most established businesses will also require finance from time to time to pay for such items as:

- buying major items of equipment or land and buildings
- expanding the scope of the business (for example, opening new offices or conducting research into new product feasibility)
- helping the business through difficult periods such as temporary recessions or decreases in sales.

In this section of the chapter we will examine the principal sources of finance that may be available to a business. Some are more appropriate than others for particular purposes. Note that Chapter 20 considers the financing of businesses in much more detail than the brief summary provided below.

1.3.1 Existing Resources

When a business starts up, the founder(s) will almost certainly make an initial contribution of their own resources. This may be in the form of cash they have saved, or won or been given. It could be in the form of cars or vans, premises or some other item of resource. Such initial contributions are known in accounting terms as **capital introduced**. Where partners contribute to the setting up of a business, they may contribute unequal amounts depending on the resources they have at their disposal. In such cases, it may be decided between the partners that those who contribute more will receive an extra share of the profits to compensate.

Example 1.4

Jakes, Jones and Jessop form a partnership to conduct legal business. The total capital introduced by the partners is £190,000, constituted as follows:

Jakes: office building valued at £100,000
Jones: cash of £50,000
Jessop: cash of £30,000 plus office equipment valued at £10,000

The partners decide between them that they will allocate 10% return on each of these contributions out of the profits made by the business, before dividing the profits equally between them. The business makes £49,000 profit in its first year, which will be allocated between the partners as follows:

	Jakes £	**Jones £**	**Jessop £**
10% on Jakes's capital: £100,000 × 10%	10,000		
10% on Jones's capital: £50,000 × 10%		5,000	
10% on Jessop's capital: £40,000 × 10%			4,000
Remaining profit split equally between the partners:			
£49,000 − (10,000 + 5,000 + 4,000) = £30,000			
Split equally	10,000	10,000	10,000
TOTAL	20,000	15,000	14,000

The introduction of capital is possible at any point subsequent to the foundation of the business. Whenever the business needs more resources, the initial founders may be able to make a further contribution.

1.3.2 Retained Profits

As a business grows it makes profits. The owners of the business usually take out part of the profits as their reward for investing in it. However, they are not obliged to take out the whole of the profits. They may choose to leave some in the business to be invested to produce growth and further profits. The amount of profit left in the business is referred to as **retained profits**. This can be a very good source of funds for further investment as it is not dependent on any outside person or organization.

1.3.3 Borrowing Money

When thinking about potential sources of finance, borrowing may be one of the first possibilities that springs to mind. However, borrowing is not always the most appropriate source of finance for a business. In some circumstances it simply may not be obtainable. Many business start-ups would not be able to borrow money, because no organization would be willing to take the risk of lending it. Lenders need to know that:

- the money they lend will be paid back eventually; and
- the business will be able to pay a reasonable rate of interest on the borrowing. In order to do so the business needs to stand a good chance of being profitable.

THE COST OF BORROWING The cost of borrowing is the interest that must be paid on a regular basis to the lender of the money. Large institutional lenders may agree to lend money to the business but they will expect to receive interest payments on time and without fuss.

THE RISK/RETURN RELATIONSHIP Banks and other lenders do not always charge the same rate of interest. They make an assessment of how risky the lending is, i.e. how likely it is that the borrower will fail to repay. If the loan is perceived as being more risky than average, the lender will either refuse to lend, or will charge a high interest rate on the lending. Sometimes, it may only be possible to borrow at extremely high interest rates.

SECURITY Sometimes banks and other lenders will not lend unless the loan is secured. For example, a bank may make a business loan to an established sole trader business, but only on condition that it is secured on his or her house. This means that if the loan is not repaid, the bank would be able to force the sale of the house in order to ensure that funds are made available for repayment. A **mortgage** is an example of a secured loan. Businesses often take out commercial mortgages to assist in the purchase of property in the form of real estate.

OVERDRAFTS Overdraft facilities may be obtainable through the business's bank account. An overdraft is most likely to be made available to a business if it can prove that the extra funds are needed only in the short-term and that the business is fundamentally sound.

It should be noted that an overdraft is a short-term solution. It is technically repayable on demand; this means that the bank can demand immediate repayment of the overdraft at any time. In practice, however, banks rarely demand immediate repayment.

1.3.4 Leasing and Hire Purchase

When a business makes a large purchase of an item which will be used over the medium- to long-term it has to pay out a lot of cash at one time. Sometimes it makes sense to look at alternative ways of financing a major item.

Under a **leasing** arrangement, the business (the **lessee**) pays a regular amount to a **lessor** in exchange for the use of an item such as a piece of machinery. The lease often extends over a period of years. The lessor, usually a financial institution, pays for the machine which is delivered to the lessee's premises and will, typically, remain there throughout its useful productive life. The lessor organization is the legal owner of the machine but will probably never even see it. The lessee never owns the machine, but will use it, often for years, in the business.

Short-term leases are sometimes taken out on items such as photocopiers and cars. The items may be replaced regularly and each time this happens a new lease is negotiated. Again, the lessee never actually owns the item in question.

Hire purchase is a similar arrangement to the longer-term leasing described above, with the difference that, once the final agreed payment is made under the terms of the agreement, ownership passes to the purchaser business.

1.3.5 Grant Finance

Businesses may be able to obtain grants from the government, local authorities or other agencies and funding bodies. Usually, grants would be awarded only in quite specific circumstances. For example, a local authority which is trying to encourage the growth of local business, might allow companies moving into the area a rent-free period in local authority business units. Although this is not a grant of cash it is a saving on the expense of rental, and it may well entice businesses into the area.

Grant finance is very advantageous in that it usually does not have to be repaid. However, there may be strings attached. In the example given above, a business taking advantage of the rent-free period might have to undertake to stay in the area for a further minimum period of time of, say, three years.

1.3.6 Financing Companies: Share Issues

A company (but not a partnership or sole trader business) can raise additional finance by issuing more shares for cash. If the company is doing well, it can offer existing and potential shareholders a sound investment opportunity.

1.3.7 Financing Companies: Venture Capital

Medium-sized companies may be able to seek finance from venture capitalists. A venture capital company invests for limited periods in growing companies, in order to give them a short- to medium-term financial boost. Usually, the venture capitalist buys into the shares in the company, and will often provide management expertise as well.

1.4 Short-, Medium- and Long-term Finance

It is important for businesses to match their needs for finance with the most appropriate form of finance. Using an overdraft to buy a new office building, for example, would be highly inappropriate. Taking out a ten-year commercial mortgage, on the other hand, would probably be the most sensible course of action.

The table below categorizes the different sources of finance discussed earlier into short-term, medium-term and long-term sources.

	Short-term	**Medium-term**	**Long-term**
Existing resources	✓	✓	✓
Retained profits	✓	✓	✓
Borrowings	✓	✓	✓
Mortgage			✓
Overdraft	✓		
Short leases	✓		
Long leases and hire purchase		✓	✓
Grant finance	✓	✓	✓
Share issues		✓	✓

Self-test question 1.2
(answer at the end of the book)

Which one of the following types of finance would NOT be suitable for a sole trader business?

a) Leasing
b) Overdraft
c) Issue of share capital
d) Grants