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BUSINESS FINANCE - 1

Assignment - 1

1. 4 medical practitioners are planning to set up their own practice, Compare and contrast Traditional partnership VS LLP. Give your suggestion.

→

① Meaning

1) Traditional partnerships is a business which is owned by two or more than two people and it is not a limited company.

2) LLP i.e Limited Liability Partnership is a type of forming a business which has some aspects of a traditional partnership and some characteristics of a limited company. Any firm with two or more members (not partners) can become a LLP.

② Legal Identity.

1) A traditional partnership does not have a seperrate legal identity. The existance of the firm is dependant on the existance of its partners.

2) LLP is a separate legal entity like a limited company. Due to this, it is able to enter into contracts, hold property and its existance is not dependent on the existance of its members.

③ Liability.

1) In traditional partnership, unlimited liability is one of the biggest disadvantage. If the assets of the firm are not sufficient to pay off its liabilities, then the partners' personal wealth can be sold off to pay off the firm's debts.

2) However, for LLP, the liability of the members is limited. ~~Like~~ The members enjoy limited liability like in limited company.

④ Expansion.

1) A traditional partnership can grow and expand. After some time if the partnership wants to become a limited company and go public, it can do so.

2) A LLP however can grow and expand, but cannot go public and issue shares in the stock market.

Therefore, for the 4 medical practitioners want to start their practice and not go public in the future LLP is an ideal choice.

This way they have limited liability as well as they are governed by a partnership agreement. Also there is no need to have a Memorandum of Association and Articles of Association. However, they must register themselves at Companies House.

2. Mr. Darshan Lodha the new CFO is of the perspective that shareholders give more value to corporations which have higher earnings. What is your opinion about his views?

→ Rather than corporations which have higher earning, in my opinion Shareholders give more value to corporation that increase shareholder wealth, which is done by increasing profits. I partly agree with the CFO, because higher earning don't always mean that the shareholder's value also increases.

Shareholders invest their hard-earned cash in the corporations and are the owners of the company. The CFO should understand that to maximise shareholder wealth should be the main financial goal of the Company. Therefore, financial manager should take decisions keeping in mind this aim in his/her head. Companies that increase the shareholder's wealth are valued by the shareholders. If they are not satisfied, then they might sell off their shares of the company. ~~The manager should~~ Different shareholders have different expectations and the manager/CFO has to manage them. If a majority of the shareholders are not satisfied with the manager's decisions, then the CFO might lose their job. But a minority of shareholders have a problem they can simply sell their shares. The stock market is a perfect indicator if the CFO's decisons are appreciated or not by the shareholders.

If the shareholders' wealth maximisation is not the main aim of the corporations, the shareholders will either remove the CFO or will sell their shares. Therefore even if a company has higher earnings, the shareholders value corporations that maximise their wealth.

Q.3.] As an investor in a startup suggest Mr. Kevin subscribe to ESC, PSC or convertibles ?

1) ESC i.e Equity share capital. By investing in equity shares the investor becomes the owner of the company and has voting rights in proportion to the no. of shares he/she owns. Equity shares offer high returns due to the potential high risk. The initial yield is low, but if an investor holds the share for long term the dividends can grow by a substantial amount if the business takes off.

These shares can be easily traded in the stock market.

~~Howev~~

2) PSC i.e Preference Share Capital.

Unlike equity shareholders, Preference Shareholders do not enjoy the ownership of the company. Similarly they are paid a fixed stream of dividend. Preference shareholders have no voting rights as they are not the owners of the company. Preference shareholders are given preference while paying dividends and at time of liquidation they are paid before the equity shareholders. The returns are low on Preference Share as they bear less risk and as their are more similar to unsecured loan stock.

3) Convertibles

Convertibles are like best of both worlds. They have some characteristics of Preference shares/ unsecured loan stocks and some characteristics of equity shares ~~capt~~. Convertibles are unsecured loan stocks or preference shares which can be later converted to equity shares. However as the issuer gives them the benefit of converting into equity shares at a later date, the interest on it is lower than preference share/ unsecured loan stock. Also the risk is lower as the investor has an option to convert into equity shares at a later date but there is no compulsion. In the future, if the ~~e~~ return on equity shares are not favourable to the investor, he/she can continue to receive the interest on the unsecured loan stock / preference shares

As 90% of the start-ups ~~have~~ tend to fail, the risk of investing in equity shares is very high. And if the idea of the start-up ~~the~~ clicks and the business takes off, the preference shareholders miss out on great returns. Therefore, for Mr. Kevin it would be best to invest in ~~the~~ convertibles of the start-up. This way the risk is reduced without missing out on amazing returns in the future.

4. Explain the differences between private limited and public limited Companies.

→ Public limited company and Private limited company are two forms of a limited company.

Limited Company is a business which is a separate legal identity.

The differences between private and public limited company are as follows:-

Public Limited Company	Private limited Company
1) Meaning	
A public limited company is a company whose documentation states that it is a public company and has an issued share capital of at least £50,000.	The limited companies ~~who don~~ which are not a public limited company and cannot issue shares are known as private limited Company.
2) Company name.	
The name of the public limited company must end with the words 'public limited company' or 'PLC'.	A private limited company's name must end with the word 'limited' or 'LTD'.
3) Issue of Share	
A public limited company can be listed on the Stock Exchange and issue shares to the public.	Private limited companies are not allowed ~~sh~~ to issue shares to the public.
4) Regulation	
Public Companies have to follow a lot of regulations from authorities.	Whereas, private limited companies are subject to less regulations.

5) Accounting and financial Reporting.

Public limited companies are required to publish their financial reports to the public every year.	A private limited company is not under any such obligation to publish it's reports to the public.
6) Funding	
Public limited companies can raise capital by issuing shares to the public.	Private limited company can raise funds only through private investors.

5. Mr. Mohit feels that setting up a proprietorship business is best suitable to him. Explain him pros and cons.

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Sole proprietorship

A sole proprietorship is a business owned by one person and which is not a limited company. A sole trader is the owner of the business and is responsible for taking all the business decisions. A sole trader may also have employees working for him/her.

Ex. Freelancers, grocery store owner as some of the examples of a sole proprietorship.

However, this business form has some advantages (pros) and disadvantages (cons).

They are as follows:-

1] Advantages (Pros)

1. Ease of formation.

Sole trader ~~is~~ / Sole proprietorship is a business which is owned by a single owner. It can be easily formed and does not require to be registered.

2. Quick decision-making.

As the sole trader is the one who takes all business decisions and need not consult with others he/she can take quick decisions.

3) Less Capital requirement.

Proprietorship can be easily set up and requires less amount of Capital. With limited capital the business can be formed.

4) Profit-sharing.

As the sole trader is the only person handling /managing the business, he/she is entitled to all the profits of the business. If the sole trader has employees working for him/her, then he/she is entitled to the profits after paying off their salaries.

5) ~~No~~ No Separate Tax on Business profits.

A proprietorship firm is not separately taxed. The sole trader must however pay income tax on his earnings.

~~He~~ With advantages (pros) there are also some disadvantages to the Sole proprietorship.

2] Disadvantages (cons)

1. Unlimited Liability

Unlimited liability is one of the biggest cons (disadvantage) of the proprietorship firm. If the firm's assets ~~and~~ are not sufficient to pay off its liabilities then the personal wealth of the sole trader can be sold to pay of the firm's debt.

2. Lack of ~~managerial skill~~ expertise

As a sole trader may not possess different skillsets, there is a lack of ~~managerial skill~~ expertise. A single person cannot be well-versed with financial management, sales, production, marketing and etc therefore the sole trader may lack specialized skills.

3. Limited Capital.

A sole trader can raise ~~a~~ limited amount of capital. Unlike a public company which can issue shares to public, a sole trader can only raise capital by taking out a loan or by borrowing from friends and family.

4. No separation between owner and business
A sole proprietorship is not a separate legal identity. The existance of the firm is dependent on the existance of the owner.

5. Risk-bearing
As the owner is entitled to all the profits, he/she must also bear all the risks and losses.

6. Delta Corp wishes to raise short term funds for working capital needs. Suggest suitable methods.

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Short-term ~~very~~ methods to raise finance for a company are as follows:-

1] Bank overdrafts.
Bank overdraft is a facility of short-term borrowing that is provided to ~~Short~~ current account holders. By using the facility, the accountholder can withdraw more money ~~from~~ than the account balance to a certain limit. The accountholder must pay interest on the extra amount withdrawn. These overdrafts are secured by floating charge i.e the bank can take any asset of the account holder in case of default. The interest on overdraft is higher than a bank loan. It is ~~easily~~ usually used ~~to~~ for short-term working capital needs. ~~of the~~ However, a huge drawback of overdraft is that the bank can ~~d~~ demand the repayment of overdraft without any notice.

~~2] Trade Credit.~~
~~Trade Credit is an agreement between a company~~

2] Factoring.
There are two types of factoring:-
a) Non-recourse factoring
Non-recourse factoring is when the supplier/company sells on its trade debts to a factor and receives cash payment of the accounts before the due date. The factor takes the responsibility of collecting the payments, credit losses and analysis. However, the factor deducts a certain amount as it is making early payment.

~~a~~ b) Recourse factoring.
This type of factoring only provides early payment of invoices. It is kind of a secured loan. Here the company is responsible for collection of payments and credit risk. It pays interest to the factor for the amount borrowed against the invoices.
This is suitable to raise short-term funds to meet working capital needs.

3. Bills of Exchange.
A bill of exchange is a claim of the amount owed by ~~the~~ a debtor to his/her creditor. Usually when goods are bought on credit, a bill of exchange is issued. The person who will receive the payment in the future usually the drawer (the person who issues the bill of exchange) can discount the bill with a bank or sell it to raise short-term finance.

4. Commercial Paper
Commercial paper is a form of short-term borrowing for companies. It comes in the form of bearer documents i.e payment is made to whoever presents the document at ~~the~~ that time ~~of~~. Commercial papers are issued at discount and redeemed at par. Commercial paper are for raising short-term funds and can help to satisfy working capital needs. It is an alternative to Bank Loans and Overdraft

So, Delta Corp can raise funds for meeting its short-term working capital needs by the above methods.

7. Explain operating lease and financial Lease.

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Lease
A lease is an agreement where the owner of the asset gives the lessee the right to use an asset over a period of time, in exchange for regular series of payment.
~~The~~ Lessor - Lessor is the owner of the asset
Lessee - Lessee is the one who uses the asset for a regular series of payment.

There are two types of lease :-

1] Operating Lease.

Under an operating lease, the risks associated with owning an asset are retained by the owner i.e Lessor. ~~Wh~~ The period of lease will be substantially smaller than the life of the asset.

Ex.

A Company requires a boiler for ~~a~~ certain production process. The working life of the boiler is 7 years, but the company takes the lease only for 2 years. This is an example of operating lease.

2] Financial Lease.

Under a financial lease, the lesee takes over the risks ~~as~~ associated with owning an asset. ~~S~~ Moreover, the term of the lease is similar to the likely ~~lit~~ life of the asset. ~~Te~~ In effect, using a financial lease the lesee is in a similar position to buying the asset, but instead of paying the amount outright, it is financed by paying rent rather than a lumpsum

Ex.

A construction company, leases a crane for 14 years and the likely life of the crane is 15 years. As the lease is for almost all the likely life period of the crane, it is an example of financial lease.

8. Explain :-

i) Convertible.

Convertibles are unsecured loan stock or preference shares that convert into ordinary (equity) shares after a period of time. Convertibles have some characteristics of unsecured loanstock/ preference shares and some characteristics of equity shares. The investors receives coupon payments on the convertible and after a certain period, if the investor wishes they can be converted to equity shares. The coupon payments are relatively low but the investor has an option to convert into equity shareholder at a later date.

ii. Warrant.

The Convertibles come with a warrant. The warrant is the right to convert the unsecured loan stock / preference shares into equity shares at a later date. If the investor wishes he/she can use the warrant or if not they can continue to receive the coupon payments on the unsecured loanstock / preference shares.

iii. Why a convertible must normally trade at a price higher than equity stock?

- A convertible consists of a loanstock / preference share and the right to convert into equity ~~a~~ share at a later date. If the price of equity share goes up then the price of convertible also goes up. If the convertible is traded at a price lower than equity, then the investors would buy the convertibles ~~and~~ at a low price and convert it into equity shares which are trading at a higher price by no extra payment. Thus, a convertible must normally trade at a price higher than equity stock.

iv. Why the running yield of convertible must be greater than equity?

A convertible consists of an unsecured loan stock / preference shares and an option to convert into equity. As convertible consist of also and equity that unsecured loan stock / preference shares their running yield should be higher than equity.