Business Finance - I

Q1)

Traditional Partnership → ~~Ownership~~ A ~~part~~ partnership is a business which is owned by more than one person. The partnership may be owned in equal or unequal amounts by the partners. Sometimes members just provide capital and don't take part in running of business (sleeping partners). The owners have unlimited ~~its~~ liability. They will be liable to ~~the~~ all their personal estate for the deficiencies of the partnership. Most partnerships will have a 'partnership agreement' which sets out the rights of individual partners. Partners pay income tax.

Limited Liability Partnership → The LLP is a seperate legal entity. Any firm consisting of two or more members engaged in a profit-making venture, may become a LLP. Unlike limited companies, there are no directors and shareholders. While the LLP itself is responsible for its assets and liabilities, the liability of it's members is limited. In general terms, a LLP is governed by the partnership agreement that may already be in force within an existing partnership. A LLP has to be registered at Companies House. A LLP is taxed in the same way that conventional partnerships.

I would suggest the 4 medical practitioners to set up a LLP. A LLP gives benefits of limited liability while retaining other characteristics of a traditional business partnership.

Q2) The statement is not entirely true as the shareholders also take into consideration other factors while valuing a company. It is a fact that shareholders are interested in maximising the value of their investments in shares. They want high returns on their investments. A company which has higher earnings will be given more value by the shareholders as higher earnings implies increasing profits which will automatically attract the investors and result in increasing the share price. Higher earnings also implies a strong and wise board of directors and senior management whose strategic decisions to make wise investments generated a healthy return on invested capital. However, the shareholders also take into consideration the social responsibilities undertaken by the company and their ethics of practicing business. The shareholders look into the ways by which the company is generating profits. Companies reputations can be seriously damaged if they are found to be untrustworthy or thought to be unethical, and these can be serious consequences for the share price. Thus, shareholders also value the company on the basis of their business ethics and social responsibilities undertaken by them. The CFO must strive to maximise shareholders' wealth within external constraints such as social responsibilities and business ethics.

Q3) Convertible preference shares are preference shares which give the right to convert into ordinary shares at a later date. The investor does not pay anything to convert other than surrendering the convertible preference shares. The investor also has the option to not convert into ordinary shares if he believes that the company isn't performing well.

Ordinary shares offer investors the potential for high returns but shareholders take a great risk, particularly the risk of capital losses. Dividends can be volatile, as can the market values of the shares. It is not mandatory for the company to pay dividends to the shareholders. When companies are wound up, ordinary shareholders often end up with nothing as they rank below creditors and usually rank below preferences shareholders. So, ordinary shares in most companies are risky.

Preference Shares offer the investor a lower risk than ordinary shares and therefore a lower expected rate of return. The crucial difference between preference shares and ordinary shares is that preference share dividends are limited to a set amount which is almost always paid.

Thus, a convertible preference share will be best for Mr. Kevin as an investor. There will generally be less volatality in the price of the convertible than in the share price of the underlying equity.

Q2)

Differences between Public Limited Companies and Private Limited Companies ⇒

* Public Limited Companies — ① Public limited companies offer shares to the general public and shareholders have limited liability.

② The name of a public limited company must end with the words 'public limited company' or the abbreviation PLC or plc.

③ The public limited company should have an issued capital of at least £50,000

④ A public limited company must be 'correctly registered' with the Registrar of Companies at Companies House

⑤ All public companies must produce audited accounts

Private Limited Companies → ① A private limited company is not allowed to offer it's shares to the public. It is a requirement of the Stock Exchange that a company that wants to have a full Stock Exchange listing must be a public limited company.

② A private limited company's name must end with the word "limited".

Q5) A proprietorship is a business which is owned by one person and which is not a limited company.

Pros → ① A proprietorship is very easy to set up.

② A sole trader takes all the decisions of the business. He doesn't have to take approval of any partners or a board before taking any decisions.

③ The sole trader can draw out money from the business as needed

④ No specific documentation is needed to legally establish this form of business entity.

Cons → ① The legal indentity of the owner and the business is the same.

② The sole trader has unlimited liability.

③ A proprietorship cannot obtain large funds for investments due to their limited liability. They do not have their stocks traded in the market.

Q6) The methods to raise short-term funds for working capital needs are →

① Bank Overdrafts – An overdraft is a form of short-term borrowing from a bank where the borrower is granted ~~a~~ facility to draw money out of a current account such that it becomes negative, down to an agreed limit. The borrower pays interest only on the amount by which they are actually overdrawn.

② Trade Credit – Trade credit is an agreement between a company and ~~some~~ one of its suppliers to pay for goods ~~or~~ services after they have been supplied. Trade credit is available from almost all suppliers of goods and services to their business customers. Typically, after goods are delivered, the business customers will be sent an invoice demanding payment within a set period eg of 28 or 41 days.

③ Factoring – Trade credit can cause problems for the suppliers of goods. There are two types of factoring; 'non-recourse factoring' and 'recourse factoring'.

a) 'Non-Recourse Factoring' – Non-recourse factoring is where the supplier sells on it's trade debts to a factor in order to obtain cash payment of the accounts before their actual due date.

b) Recourse factoring – A copy of the invoice is sent to the factor who then gives the supplying company the money up front. However, the supplying company is still responsible for collecting its debt. When the supplying company eventually gets paid by a customer, it passes the money on to the factor.

④ ~~Bank~~ Bills of Exchange – A bill of exchange is effectively a claim to the amount owed by a purchaser of goods on credit and may be 'accepted' by a bank (for a fee). This means that the bank guarantees payments against the bill to whomsoever holds the bill at maturity.

Q7) A lease is an agreement where the owner of an asset gives the lessee the right to use the asset over a period of time, in return for a regular ~~price~~ series of payments. Legal ownership does not change hands. A lease is simply an agreement for the 'lessee' to rent from the 'lessor'. There are two types of lease: operating lease and finance lease.

Operating lease – Under an operating lease, the owner of the asset will retain most of the risks associated with owning the asset. The lease will be for a period substantially shorter than the likely life of the asset.

Financial Lease – Under a financial lease, the lessee takes on most of the risks associated with the owning the asset. The lease will be for a period similar to the likely life of the asset. In effect, in using an finance lease the lessee is in a similar positions to buying the asset outright, but financing this by paying rent rather than by paying a lump sum up front.

Q8)

(i) Convertible – Convertibles form of company securities ~~are~~, almost invariably, unsecured loan stocks or preference shares that convert into ordinary shares of the issuing company. Convertible preference shares are preference shares which give the right to convert into ordinary shares at a later date. The investor does not pay anything to convert other than surrendering the convertible preference shares. From, the investor's point of view, convertible securities offer the opportunity to combine the lower risk of a debt security with the potential for large gains of an equity.

(ii) Warrant – Warrants are call options written by a company on its own stock. The purchaser of a warrant has the right but not the obligation to buy a fixed number of the company's shares at a fixed price at a fixed date. The exercise of a warranty leads to an increase in the number of shares that are outstanding. This, in turn, leads to some dilution in the value of the equity.

(iii) A convertible must normally trade at a price higher than equity stocks so as to prevent the investor to make instantaneous profit at the time of conversion and sell his stocks immediately.

(iv) The running yield of a convertible must be greater than equity ~~becoma~~ because of the mandatory coupons or dividends payments in preference shares and loan stocks.