Chapter 1

Types of business

In this chapter we will be looking at the types of business organisations, we will see how they differ.

We will look at the difference between a manufacturing business and a service business.

We will explore the types of funding available to businesses.

We will look at internal and external stakeholders and their attitude to risk.

As an accounting technician, you are likely to come across a number of business types. To be effective in your role, you will need to know how businesses are structured, how they are governed and funded, the legal framework in which they operate, and the needs of its stakeholders. Stakeholders are the people who have an interest in the organisation and are directly affected by its decisions and performance, such as shareholders, banks, suppliers etc. (We will look at these in more detail later in this chapter.)

There are two main sectors of business; the **private sector** and the **public sector**. The private sector consists of businesses that are owned by private individuals or groups of individuals. The public sector consists of entities overseen or owned by either central government or local government

Sole Trader

The business will be owned and run by an individual. He or she will probably be responsible for most of the running of the business. He or she will be in charge of buying and selling goods or services and be in charge of hiring and firing staff. Many sole traders maintain their own books and then employ an accountant to prepare the final accounts ready for the tax calculation at the end of each financial year.

A sole trader will fund the business by introducing their own capital, retaining profits to reinvest into the business, or from bank (or other) loans.

It is important to remember that a sole trader not only has the rights to all the profits a business makes, but also, he or she is personally responsible for any losses. If a sole trader finds that he or she cannot pay his or her creditors from the business's income, then the money has to be found from the sole trader's personal belongings. For example, if a sole trader cannot keep up the repayments on the loan secured from the bank, the bank has the

right to any or all of the sole trader's personal belongings until the debt has been repaid or the sole trader has no more belongings.

A sole trader business is the easiest form of business to register. The only requirement is that you register the business with His Majesty's Revenue and Customs (HMRC). You will then need to complete a self-assessment tax return each year and pay Income Tax and National Insurance on the profits made by the business. The tax return can be completed online or a paper return can be sent. Most sole traders will pay their tax in two instalments.

From April 2026 the requirements for sending a tax return are due to change. From that date all sole traders with a turnover above £50,000 are required to keep their financial records electronically and send an update of income and expenditure every 3 months to HMRC. There will be a final declaration after the end of the financial year. The updates and final declaration must be sent using suitable computer software.

Where the sole trader's taxable sales are over £90,000 per year, they must register for Value Added Tax (VAT). The trader must then charge VAT to their customers on most goods and services, and pay this to HMRC (usually every 3 months). The VAT return must be completed electronically.

There is no statutory requirement for a sole trader to keep any financial records, other than a record of income and expenditure. However, a sole trader would find it difficult to get funding (from banks or other investors) without a Statement of Profit or Loss (SPL) and a Statement of Financial Position (SFP). (You can find out more about these in the *Principles of Bookkeeping Controls* book from the same publisher. Go to https://www.premier-books.co.uk)

Many well-known business entrepreneurs started as sole traders. For example, Jeff Bezos created an online bookstore in 1994, which he ran from his garage in a rented house. In 1995 he launched Amazon. Amazon is now worth $1.9 trillion.

Alan Sugar, of '*The Apprentice*' TV show fame started his business career by selling car radio aerials from a van he bought for £50. The business grew to become Amstrad. Amstrad was eventually bought by BskyB for £125 million.

However, the Institute for Fiscal Studies (IFS) suggests that one fifth of sole traders don't survive the first year and over 50% don't survive five years.

Partnerships

This is where a group of individuals come together to form a business. Typically, there will be two to twenty individuals in a partnership (but there could be more) and an agreement will have been made as to the proportion of profits to which each partner will be entitled. Partnerships are formed usually because, with more people involved in the business, there will be more expertise and money available to invest in the company. The owners of the business are called individually 'partners' or collectively they are called a 'firm'.

However, as with sole traders, the partners are personally responsible for any losses. All partners are equally responsible for all the debts of the business. Initially, creditors will ask the business to pay its debts. If it can't pay, the creditors can ask the individual partners to pay. Partners are 'jointly and severally' liable for the business's debts. This is legal jargon and means that the creditor can take action against any partner, but they can also take action against more than one partner at the same time. If one partner pays more than their agreed share of the business debts, they can take action against the other partners to recover the money the other partner(s) should have paid.

Partners are not jointly and severally liable for income tax and National Insurance. Each partner must pay Income Tax and National Insurance on their own share of the profits, as if they were a sole trader.

A partnership must register with HMRC and appoint a **'nominated partner'** who is responsible for managing the partnership's tax returns and keeping records. Just as with sole traders, there is no statutory requirement to keep any financial records other than a record of the income and expenditure for the partnership, but as before, it would be wise to draw up a SPL and SFP along with a record of the profits awarded to each partner. The nominated partner must complete a partnership tax return each year for the whole business and, in addition, each partner must complete their own personal tax return for their share of the profits.

Just as with sole traders, from April 2026, there will be a requirement to send an update of the income and expenditure to HMRC every 3 months. This must be sent using suitable computer software.

Just like a sole trader, a partnership must register for VAT when the sales (or turnover) exceed £90,000 per year.

Partnerships are covered by the **Partnership Act 1890** which allows for partners to share profits and losses equally. The Act is old and some parts are outdated. It is, therefore, wise for the partners to draw up a **Partnership Agreement** (though this is not mandatory).

The Partnership Agreement will set out the rights and responsibilities of the partners and can also show how the profits will be divided between the partners. It will show any salaries or commissions due to each partner (if any). 'Salary' in this context is not the same as an employee's salary. It simply means a set amount to which the partner is entitled each year. Income Tax and National Insurance will not be deducted by the business – this will be the responsibility of each partner separately.

Additional partners can only be admitted on the agreement of all the others. When a partner joins, they will invest a certain amount of money. This money will be used to generate profits. As compensation for keeping this money in the business, some partnerships allow interest on the capital. This is a little like getting interest on the money you put in the bank, but the interest in a partnership will be paid out of the profits. The rate of interest will be shown in the Partnership Agreement.

On the other hand, the partners may agree to charge interest on their drawings. When partners withdraw money from the business for their personal use, these withdrawals are called **drawings.** If a partner takes drawings early in the year, then it is like a loan from the business as the profit won't become due until the end of the year. Therefore, to compensate for this early withdrawal, the partners may agree to charge interest on these drawings. The rate of interest will also be shown in the Partnership Agreement.

Over time, a partnership may build up **goodwill**. This may be the result of a loyal customer base, a skilled workforce, a good location, or a well-known brand name. (You're likely to pay more for a business called Coca Cola than a business called Fizzy Drinks.) In accounting terms, it is the difference between the value of the business as a whole and the net value of its assets and liabilities. The value of the business as a whole is very much a matter of estimation and negotiation.

Where a partner retires, the value of the goodwill will need to be estimated. The retiring partner will need to be paid their share of this goodwill along with the remaining capital which they invested in the business when they joined.

When a partner retires or a new partner is admitted, the partnership agreement will need to be amended to show the new profit share, salaries and interest.

Limited Liability Partnership

Many professional partnerships are now becoming **Limited Liability Partnerships (LLP).** This is where the partners (or 'members' as they are known in LLPs) are only liable for amounts up to their investment in the business. Unlike sole traders or ordinary (unlimited) partnerships, a member is responsible for losses only up to the amount which that member has as equity in the business. While the members of an LLP will pay Income Tax and National Insurance, like in a regular partnership, in other ways it is much like a Limited Company (see later in this chapter). LLPs are covered by the Limited Liability Partnership Act 2000.

Most LLPs will draw up a Members' Agreement. This will be very similar to a Partnership agreement, but again it is not mandatory.

An LLP is a separate legal entity. Contracts and legal agreements are technically made with the partnership rather than the individual partners.

An LLP is set up by registration with the Registrar of Companies at Companies House. There must be at least two 'designated' members at all times. These designated members will have more responsibilities, including keeping company accounts. The accounts must include a Statement of Profit or Loss, a Statement of Financial Position, supporting notes and an annual auditors report. (Smaller LLPs may be exempt from an auditor's report.)

The company accounts must be filed with Companies House annually and will be available to the general public. These accounts must be set out in a specific way, following the accounting rules set out in the Companies Act 2006 and by the Financial Reporting Standard (FRS) 102. The designated partner must also send the accounts to HMRC.

Each member must register for self-assessment with HMRC. They will be taxed on their own share of the profits. The business as a whole pays no other taxes on profits or income.

Limited Partnership

A Limited Partnership (LP) has features of both an unlimited partnership and a Limited Liability Partnership. A group of people often form an LP for limited time projects. This may include:

- Film production.
  The partnership will be set up only for the time it takes to produce the film.

- Larger housing projects.
  The partnership will be set up for the time it takes to complete a housing development in a particular area.

- Natural resources exploration.
  Resources such as gas, oil and precious metals may have a limited lifetime and so an LP is ideal for these situations.

An LP must appoint at least one general partner and one limited partner. A person cannot be both. All limited partners will have limited liability, meaning that they are only liable for any debts up to the amount they have invested in the business. However, a general partner will have unlimited liability.

It is the general partner or partners who are responsible for the day to day running of the business. Limited partners don't usually get involved in the running of the business. Their main function is to provide funding for the project and they will be entitled to a share of the profits. They are sometimes known as 'silent partners'.

The LP must be registered with Companies House and must also register for self-assessment with HMRC. Each partner must also register individually for self-assessment with HMRC.

Limited Company

A limited company is where a business is formed which is quite separate in legal terms from its 'owners'. The 'legal' entity goes further than the entity concept, (discussed in the *Business Environment* book available from the same publisher). The 'legal' entity means that it will be treated as separate unit, being able to trade in its own name and make its own contracts. Unlike sole traders and regular partnerships, the owners of a limited company are only responsible for the amount of money they have invested (or guaranteed) to the company. It is said they have 'limited liability'.

The equity (capital) of a limited company will be divided into small equal units. Each unit is known as a **share**. Investors are then encouraged to buy some (or all) of the shares in return for a share of the profits. People who buy the shares become **shareholders**. The shareholders are owners of the business and are entitled to the profits of the business in proportion to the number of shares they have bought. Shareholders receive their share of the profits as '**dividends**'. There is no limit to the number of shares a business can offer for sale; the minimum is one share.

Limited companies pay Corporation Tax on the profit it makes. They must complete a tax return every 12 months (called a CT600) and send it to HMRC electronically.

Shareholders are not responsible for the day-to day running of the business. Shareholders will only make decisions on significant matters, such as changing the name of the company and appointing or removing directors.

Anyone can be a shareholder, but a director must be 16 years of age and not disqualified from being a director. Directors are legally responsible for running the business and must ensure that company accounts are properly prepared. Any remuneration that a director receives from the company will be subject to Income Tax and National Insurance in the same way as any other employee. This is as well as the Corporation Tax paid by the company. Directors will have their tax deducted at source under Pay As You Earn (PAYE). This means that the tax and National Insurance will be deducted from their pay before they receive the money, and it will be deducted on each payment. The directors will not have to complete a self-assessment tax return each year for their own personal income from the business as the tax will be deducted under PAYE rules.

A shareholder can also be a director. In many small and start-up companies there will be just one person who assumes the role of shareholder and also the role of director. Funds for the business are provided by the shareholders. Directors do not provide funds unless they become shareholders too.

To form a limited company, it must register with **Companies House**. This is the government department which deals with all UK limited companies. Once registered, the business becomes 'incorporated'. To register it must send a '**memorandum of association**' which is a legal document signed by all the initial shareholders agreeing to form a company. Where a business registers online, the memorandum will be automatically generated. The memorandum cannot be updated once recorded.

The business must also submit an '**articles of association**' which is a document showing the rules that must be followed in the running of the company. It will include items such as the extent of the powers of the directors, how directors are appointed or dismissed, and procedures for declaring dividends.

The business is legally required to send the company accounts to Companies House every year. These will then be available to the public at large. The company accounts will include a Statement of Profit or Loss, a Statement of Financial Position, and must include notes to the accounts stating how the accounts have been prepared and if there is any relevant financial information not included in the accounts. Larger companies must send a director's report showing particulars of important events since the end of the financial year and an indication of likely future developments. Larger companies will also need to have their accounts audited. An external auditor will be appointed by the shareholders, and it is the auditor's responsibility to comment on the accuracy of the financial statements. The auditors then report back to the shareholders.

Small companies are those with sales of £10.2 million or less, a balance sheet with £5.1 million or less, and fewer than 50 employees. These small companies are exempt from providing a director's report and do not need to have the accounts audited. They can choose whether or not to send a SPL. They do still have to provide an SFP. However, a public limited company (see next) must always provide a director's report and an audit report.

The Companies Act 2006 is the law relating to limited companies. This is a mammoth piece of legislation with 1300 sections. Sections 380-474 cover accounts and reports. It states that 'the directors of every company must prepare accounts for the company for each of its financial years'

According to the Companies Act, the SPL and SFP must meet certain standards and be drawn up in a particular way. The business can follow either

- International Financial Reporting Standards (IFRS)
- UK Generally Accepted Accounting Practice (GAAP)

(The AAT uses the IFRS in its courses.)

There are two main types of limited company. A **private limited company** may have one or more shareholders. The shares cannot be offered to the public. A **public limited company** (plc) must have at least two shareholders and must have issued shares worth at least £50,000.

Both kinds of limited company must be registered at Companies House, and each must appoint a director (at least two if it's a plc) who will manage the business. Each year a limited company must file its accounts with Companies House where the figures are open to the public. Profits are distributed to the shareholders each year (called **dividends**) in proportion to the number of shares owned. Some of the profit may be retained by the company for use within the company to pay future debts or for future investments. These retained profits are known as '**retained earnings**'.

Limited companies must also register for Corporation Tax with HMRC. If the company registers online, the registration with Companies House and HMRC will be done at the same time.

Not-for-Profit Businesses

This includes charities or clubs. Typically, they will have been established with the objective of addressing a social need, rather than simply to provide a service or generate revenue. They receive funds from individuals or groups. They will reinvest revenue for the purpose of serving their client group or achieving their objective.

Charities

To be eligible to become a charity, the organisation must have a charitable purpose. Valid purposes are listed in the **Charities Act 2011** and include the prevention of poverty, the advancement of education or religion, environmental protection, and human rights. Charities are prevented by law from political campaigning.

Charities have '**trustees**' who are responsible for the running of the charity. They don't usually get paid but they can claim reasonable expenses. It is recommended that a charity has at least 3 unconnected trustees.

The trustees are responsible for preparing annual financial statements as required in the Charities Act 2011. This is supplemented by a Statement of Recommended Practice (SORP). This provides detailed guidance on how charities in the UK and Ireland should prepare their financial statements.

The potential charity will need to write a 'purposes' document which, obviously, sets out the purposes of the charity. This will be needed by the Charity Commission to decide if it can become a charity, and HMRC to decide if it qualifies for tax relief.

The charity will also need a '**governing document**' which sets out how the charity will be run. This document will cover items such as who can be a member, how trustees will be appointed, how meetings will be held and how the charity's money will be looked after.

Charities based in England and Wales must register with the **Charity Commission** if its income is £5,000 per year or more. When charitable status is achieved, the charity will be exempt from most taxes on profits and they will be able to claim back tax that's been paid on donations (known as **Gift Aid**). While charities are not exempt from VAT, there are a range of goods and services where they pay 5% or zero rate VAT where those goods would normally attract a rate of 20%.

Charities are also allowed to become incorporated. They don't need to register with Companies House for this. The advantage is that trustees have limited liability status.

Public Sector

Public sector organisations are entities that are owned and funded by the government. Their aim is not to make a profit, but to provide some sort of public service. Schools, hospitals, law enforcement, social care, and the provision of public utilities, are all public sector organisations.

The funding of these organisations comes from public taxation. How much these organisations have to spend depends on how much is allocated to them by the government. Many public services are organised by local councils from town halls, where additional funds are provided by the Council Tax.

Some public sector organisations form partnerships with private sector organisations. These are Public-private partnerships (PPP). The public sector organisation will typically provide oversight and a regulatory framework, while the private sector organisation will bring expertise and capital investment.

PPPs may be formed to build and maintain roads, construct and manage hospitals, collaborate with school construction or vocational training, or power generation and distribution.

Organisational Structures

We often refer to an organisation as any business. However, the definition of an organisation is:

a group of people who work together in an organised way for a shared purpose.[1]

[1] Cambridge Dictionary

Therefore, an organisation must have more than one person. Someone who works alone cannot be an organisation.

Businesses have certain features in common.

The people in the organisation must work together in an organised way. This means that the people in an organisation will have specific roles and there will be specific procedures.

The people in the organisation must have a shared purpose. They must all be working towards the same end. Where the goals of the individuals are the same as the goals of the business, it is known as **goal congruence**. For example, a school will have a shared purpose of educating pupils, and this will be the objective of the teachers within that school. A retail company may aim to increase profitability, so top managers may set targets to open new stores and store managers may implement new marketing campaigns.

Individuals within business organisations must have good working relations. They will cooperate with one another to achieve the aims and objectives of the business.

The work of the business will be shared between the individuals within it. Therefore, business organisations will give these individuals defined responsibilities. There may be a group of people (a team) responsible for sales, while another group may be responsible for purchases. Each individual should know what is expected of them and for this there will be varying levels of authority.

Manufacturing and Service Businesses

Manufacturing businesses are those that actually make and sell products. In a manufacturing business, it's relatively easy to work out a selling price for the finished goods. A business will know the cost of the materials, it can work out how long it takes to make the product and so apply a labour cost, and it can estimate overheads. A profit will then be added to the cost.

Service businesses are those that offer a service to customers or other businesses. In a service business it's not quite so easy to work out a selling price. Often materials are negligible, and what price do you put on expertise? Often the service will be unique. For example, a solicitor taking a case to court may take a few hours or it may be a few weeks.

Service businesses have a number of features which make them different from a manufacturing business:

Intangibility

Services cannot be physically touched or inspected before purchase. You cannot physically examine the expertise of a solicitor before hiring them.

Experience-Based

Services are often experienced rather than owned. A package holiday or a haircut are examples of where the service is experienced.

Inseparability

Production and consumption occur at the same time. A school teacher and the pupil need to be present at the same time when delivering a lesson. The hairdresser and the customer must be present at the same time for a haircut.

Perishability

A service cannot be stored until later on. An empty seat on a tour bus cannot be saved and sold later. It represents lost revenue as soon as the tour begins.

Heterogeneity

This is a fancy word to show that services can vary in delivery and quality. Services are often tailor-made to meet the demands of each individual customer. An accountancy service will vary according to the level of complexity. A service may also vary according to the expertise of the supplier, the workload at the time the service is delivered or even the rapport with the customer.

Types of Funding

No business can exist without monetary funds. Funds will be needed to start a business and the business may later need further funds for growth. For start-up business there may be a need for a premises or at least a business computer. They may also need to buy goods and materials which they can sell. A business which is already established may need to grow by investing in new machinery, a larger workforce or even new and additional premises.

Funds can be sourced either internally or externally. They fall into three main categories:

Equity (Capital)

A sole trader may use his/her own personal savings to invest in the business.

A partnership can also increase their equity by putting more of the partners' own funds into the business. However, introducing a new partner will also increase funds as the incoming partner will be expected to invest in the business from their personal savings.

In a private limited company, further share capital may be issued to existing shareholders or it may privately offer more shares to new investors.

In a public limited company, more shares will be offered for sale on the stock market.

Funds may be generated internally. While shareholders will expect a dividend from their investment, there is no legal minimum to what can be paid. Indeed, in hard times, dividends can be suspended completely. This means that some of the profits that the business has made in the past can be retained and used as funds to grow the business. These funds are known as **retained earnings** or **retained profit**.

The advantage of raising funds by issuing shares is that dividends need only be paid when the business can afford it. There is less financial risk. Having reputable investors can also enhance the business's credibility, which is important when attracting customers, or additional investors.

As drawings or dividends are not counted as a liability (money which has to be paid back within a certain length of time) there is more chance of raising further money through borrowing. Lenders will only lend money where liabilities are considered to be manageable.

The disadvantage of raising funds through issuing shares is the loss of control and ownership. Shareholders share ownership and control of a business, so, as there will be more 'owners' there is likely to be conflict of interest if the interests of the investor differ from the interests of the founder.

Investors will expect a return on their investment. We have seen that dividends don't necessarily have to be paid, but the investor is unlikely to continue to invest if there is little or no return. Investors will be looking for a higher return than they can get elsewhere, so when dividends are paid, it is likely that the investor will be putting pressure on the business to perform and distribute profits.

Issuing shares can be time-consuming and costly due to legal and underwriting fees. In addition, the pressure from shareholders for high returns in the form of dividends could potentially make it more expensive than raising money from debt (see next).

Debt (Borrowing)

Businesses can raise funds by borrowing money, usually from banks. If a business borrows money, it will be expected to pay the amount back plus interest over an agreed time period.

There are two main forms of borrowing from banks: a bank loan and a bank overdraft:

The traditional bank loan is where an amount is borrowed for an agreed length of time. Interest will be charged on the amount borrowed either at a fixed rate, or a variable rate. The fixed rate won't change over the period of the loan, while a variable rate may vary during the period of the loan usually according to the rise and fall of the Bank of England rate. The interest is usually paid monthly but may be paid annually if agreed with the bank. The capital

may be paid back in equal monthly amounts along with the interest payments, or, in some cases, the bank may allow the borrower to pay back the capital at the end of the period.

The traditional bank loan should be used for long term investments. A business may want to borrow money to buy a new improved machine, which it expects to keep for (say) 10 years. The repayments will then be tailored to cover the ten years the machine will be kept.

This is ideal if you expect to need the machine for 10 years, but a bank loan should not be used to cover day to day expenses. These can be covered by a bank overdraft. An overdraft is where a bank agrees that a customer can draw money over and above what has been put into the bank up to an agreed limit. Again, interest will be charged, often at a higher rate than a loan, but the advantage is that the interest will be paid only while the overdraft is needed. All businesses are likely to need money to cover shortfalls, maybe while waiting for credit customers to pay their invoices. The overdraft should only be needed for a month or two at a time.

Another form of borrowing is where suppliers offer credit terms. If a supplier says you can pay for your goods a month after you actually purchase them, the supplier will, in effect, be allowing you to borrow the money for a month.

The advantages of raising funds through debt include:

Payments are relatively predictable. The bank will calculate how much needs to be paid each month so the business can plan their cash flow and budget accordingly. There may need to be an adjustment where interest rates fluctuate, but changes in interest rates don't usually occur frequently.

Unlike issuing shares (see previous) there will be no loss of control or ownership. The bank will not have a direct say in how the business operates.

The interest on loans is tax deductible, so the tax burden on the business will be reduced.

The disadvantages include:

Payments must be made irrespective of the business's performance. If the business can't afford to pay its interest or its principal amount when it becomes due, the business risks bankruptcy or insolvency.

A bank will require some security that they will get their money back. Often business assets are used as this security (called collateral), whereby the bank will take ownership of the business's assets if the business defaults on its repayments.

Unlike issuing shares (see previous) the debt will impact on further loans. A bank will not loan more than it thinks the business can afford to pay back.

Banks may add covenants to any loan. A covenant is a restriction on how the business may operate. For example, the bank may only make the loan if they agree to limit further borrowing, or they may require the business not to sell certain assets. They may even require that working capital (see next) is maintained at a certain level.

Working Capital

Working Capital is the money in the business created from day to day buying and selling. By its very nature it is likely to fluctuate from day to day. Working Capital aims to ensure that the business has enough cash to pay its suppliers. However, working capital is also used to pay for regular transactions such as paying wages or paying the VAT due.

Working capital is calculated by taking the business's current assets and deducting the current liabilities. Current assets will include cash at the bank, inventories (goods kept in the business ready to sell) and receivables (money owed to the business by credit customers). It will include any asset which can be turned into cash (realised) within a year. Current liabilities are amounts due to be paid, usually within a year. This will be mainly credit suppliers.

Working capital can be positive or negative. It is likely to fluctuate between the two. Where working capital is negative, the shortfall will be covered by a bank overdraft. However, shortfalls should be only temporary if the business is to thrive. Working capital should not be used for long term borrowing due to the fluctuating nature of the funds.

The advantages of using working capital as a funding method are:

There is little or no cost, unlike debt (where interest will be paid to external lenders) or shares (which will involve legal and underwriting costs).

There is no loss of control. External or further investors are not required, and so external parties will not have a say in the running of the business,

Working Capital is easily available through the normal day-to-day operations of the business.

The disadvantages will include:

The level of funding is limited. It will rarely be enough to cover larger investments.

If Working capital is poorly managed, there may not be sufficient funds to pay liabilities when they become due and can even lead to bankruptcy or insolvency.

Other types of funding.

The above methods of funding are the most common, but there are other methods as well.

- **Grants and subsidies**. The government or other organisations may provide funding for specific purposes. There is usually no repayment required, but business activities will be closely monitored by the giver of the grant or subsidy.

- **Angel investors and Venture Capital.** An angel investor is a wealthy individual who will invest in the early stages of a business. (This is similar to the investments made on the TV series '*Dragon's Den*'.) Venture Capital is where organisations provide funds to startups. Again, there is usually no obligation to pay the money back, but the money will be given in return for a say in how the business operates and they will expect a share of the profits.

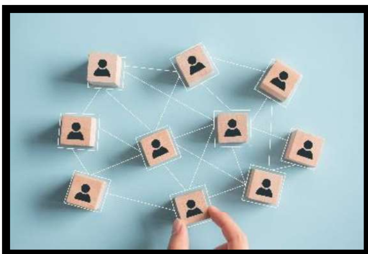
- **Factoring and Invoice Discounting.** Factoring is where a business will sell its sales invoices to a third party (the factoring company). The factoring company will provide immediate cash against these invoices but typically only 70% to 90% of their value. The factoring company then collects the invoice payments directly from the customer. Invoice discounting is very similar except that the business continues to collect the payments from the customer.

- **Crowdfunding.** Crowdfunding is a method of raising cash from a large number of individuals or organisations, usually online. Each individual will contribute a small amount but with many contributors it can provide substantial sums. The individual contributes money for a reward (such as a product or service), or a promise to pay back the money with interest. Some crowdfunding will make a contribution without expecting anything in return, but this is usually for disaster relief, personal causes or charitable reasons.

- **Donations.** Donations are usually associated with charities. Money is given to the organisation without expecting anything in return.

Stakeholders

A stakeholder is an individual, group or organisation with an interest or concern in the business. There are two main categories of stakeholder: internal and external.



Internal stakeholders will include:

Employees. This group will be looking for job security and so will want to know that the business is financially sound, is capable of sustaining the workforce, and can offer a competitive salary. Employees will also expect a physically safe environment and that the

business is following Health and Safety regulations. They will be looking for career development in the form of training and the opportunity or promotion. By addressing these needs the workforce will become motivated and loyal and continue to bring their knowledge and skills to the business. This will contribute to the overall success of the business.

Managers. This group will have very much the same needs as any other employee, but in addition they will be looking for the business's clear goals and objectives. They will expect adequate human resources (sufficient in number and skill), financial resources (sufficient allocation of money to carry out projects), and physical resources (sufficient tools, equipment and technology). They will be looking for a certain amount of autonomy and authority to make decisions in their area of responsibility.

Directors. This group will require up-do-date and detailed financial reports in order to assess the company's performance. They will need information on the day-to day operations, and access to Key Performance Indicators (KPIs) or ratios such as Gross/Net profit margins and Return on Capital Employed (these are covered in the *Financial Accounting: Preparing Financial Statements* unit in this course.) which will measure the business's performance. They will need access to the company's strategic goals and the plans for achieving them. They will expect clear communication channels with other stakeholders particularly customer feedback and competitor activity. In return the directors will be able to ensure that the business achieves its goals and creates value for all stakeholders.

Owners. These individuals will be looking for the business to make a profit in order to earn a living from the business. They will need assurance that the business is following the owner's objectives. They will be looking for efficient management and accurate reporting. They will expect an active role in major business decisions. In return the owner will remain committed to the business, providing continued support and investment.

Shareholders. We will look at shareholders as internal stakeholders, but traditionally they are regarded as external stakeholders. A small shareholder will have no say in the day-to-day running of the business and will provide little more than the finances for the business. However, where there is a major shareholder, they can be considered as internal stakeholders, where they have considerable involvement over the business's strategic goals and management. Shareholders will expect regular dividend payments and a growth in the value of their shares over time. They will expect access to financial statements in order to assess the company's profitability and long term growth. They will expect good leadership and management (this is governance which we will look at in more detail later in this book). They will expect engagement in sustainable and socially responsible activities. In return shareholders will continue to offer their financial support.

External stakeholders will include:

Customers. This group will expect a good standard of quality and reliability from the goods or services they buy, and they will expect the quality to be consistent. They will expect value for money and good customer service. They will need price lists and credit customers will need

regular statements showing how much they owe and how and when to pay. In return the business will have strong customer loyalty and repeat orders, achieving long-term success.

Suppliers. This group will expect clear and timely orders in order to supply goods and services on time. They will expect clear communication with the purchasing department and the finance department. Above all, they will expect to be paid on time. In return the business will gain a strong and reliable supply chain resulting in overall business success.

Finance providers. This group will include banks, which will lend money to the business. They will expect detailed financial statements (a statement of profit or loss, a statement of financial position and a cash flow forecast. These must be provided before the loan is made and also during the period of the loan. They will expect access to KPIs and above all they will expect to receive regular interest payments. In return the business will receive strong support and a beneficial relationship. Many banks supply professionals to discuss how the business can grow.

The government and other regulatory bodies. The government will expect the business to comply with various laws and regulations. Particularly those concerned with labour, the environment, health and safety and governance (see later in this book). The government agencies (particularly His Majesty's Revenue and Customs (HMRC)) will require businesses to pay taxes accurately and on time. The taxes will include income tax, National Insurance, VAT and (in the case of limited companies) Corporation Tax. The government looks on businesses to contribute positively to the economy, provide employment, and engage in activities that support the broader goals of society.

Professional bodies. Individuals who work in the business may belong to a professional body. Indeed, many readers of this book will be a member of the Association of Accounting Technicians (AAT). The professional body will expect the business and its employees to adhere to the standards and best practice set by them, It will expect the business and its members to carry out regular Continuing Professional Development (CPD) to ensure that their knowledge and skills remain up-to-date. The professional body will have powers to discipline its members should they not comply with the rules and standard practice. In return the professional body will offer help and support to its members while membership will often enhance the reputation of the business and/or the individual members.

The general public. The public will expect the business to act ethically and contribute to the community by volunteering or community development. They will expect the business to create jobs and contribute to the economic development of the region through paying taxes and supporting local suppliers. There is an expectation that they will ensure environmental preservation.

Power and interest of stakeholders

The power and interest of stakeholders in a business can vary significantly, depending on their influence and the level of interest they have in the business's activities.

High power, high interest

These are the most important stakeholders for a business to engage with. They can directly influence the business's success and are also highly interested in the company's activities. Examples will include shareholders, major customers, investors or key business partners. A business should keep these stakeholders closely engaged and satisfied. Regular communication and involvement in decision-making are essential.

High power, low interest

These stakeholders have significant influence but may not be as interested in the day-to-day activities of the business. However, their decisions or actions can greatly impact the business. Examples will include government bodies, regulators, or large institutional investors. These stakeholders should be kept informed, but not overwhelmed with too much detail. A business should ensure that their needs are met, and their influence is managed.

Low power, high interest

These stakeholders care a lot about the business but may not have much power to influence decisions. Although they can't directly affect the business's outcomes, they can be important for reputation and operational success. Examples will include employees, local communities, or small customers. These stakeholders should be kept informed and engaged. Their loyalty or satisfaction can indirectly affect business performance, such as through customer recommendations or employee productivity.

Low power, low interest

These stakeholders have little influence and low interest in the business. While they are not directly impactful, it's still important to monitor their position to ensure they don't become more influential. Examples will include casual consumers, minor suppliers. Minimal effort is required here. These stakeholders should be monitored but the business shouldn't spend too much time managing them actively.

Stakeholders attitude to risk

There is a certain amount of risk for any stakeholder. For the investor the business may not perform as well as expected; for the finance provider, the business may not be able to afford its repayments; and for the customer, the goods or services may not be up to the required quality.

How much risk a stakeholder is prepared to risk is called the stakeholders' attitude to risk. Their attitude to risk generally falls into three categories: **risk averse, risk neutral** and **risk seeking.** Sometimes stakeholders' attitude to risk conflict. For example, shareholders are more likely to be risk seeking. They are likely to seek high returns on their investment by putting pressure on the directors of a business to make riskier decisions. The shareholders know that they can lose no more than their investment. However, the directors are more likely to be risk averse, knowing that if things go wrong, they could lose their job, their income and their prestige.

How much risk a stakeholder is prepared to accept will be influenced by three factors:

Risk appetite. This is how much uncertainty the stakeholder is prepared to take on. For example, a financial investment business may be looking for higher returns which usually comes from investing in volatile markets where the risk of losing money is high, but the potential for greater returns is also high. On the other hand, a customer is likely to have a much lower risk appetite. They will not buy goods or services where there is a chance that they will be of poor quality.

Risk tolerance. This is the amount or degree of risk that the stakeholder can withstand. A financial investment business may invest only 20% of its money in high-risk assets, or a manufacturing business may only risk 30% of its income from a new untested product.

Risk threshold. This is a specific point at which the risk becomes unacceptable and intervention is required. For the financial investment business this may be when a single investment loses 10% of its value so they will sell off the investment, or for a manufacturing business it may be the point at which sales fall below 40% of what was expected when they will discontinue the product.

Customers are usually risk averse. They aren't prepared to accept that the goods or services will be of a poor quality, although they may be more willing to accept a small risk if a substantial discount is given.

Suppliers are also risk averse. They are not likely to risk supplying a business which can't pay for the goods they receive.

The government is probably the most risk averse of all. The government will certainly not risk that the business can't pay its taxes.

Finance providers will be risk averse. They won't lend money to business without checking that they are more than likely able to pay them back with interest.

Owners and shareholders tend to be less risk averse. They will want to see the maximum return from their investment. This means that they will have a reasonable appetite for risk, but they will also have a threshold above which they will cut their losses.

Chapter Summary

- There are two main sectors of business: the private sector and the public sector.
- A sole trader is entitled to all the profits of the business but is personally responsible for any losses.
- A partnership is where a group of individuals come together to form a business. They share the profits of the business but are also jointly responsible for any debts. A partnership can become a limited liability partnership where each member is liable for any debts only up to the amount of their investment.
- A limited company is a business which is quite separate from its owners. It will have at least one shareholder and one director (which could be the same person). Directors run the business on behalf of the shareholders. Shareholders take the profits of the business as dividends according to the proportion of their investment. Limited companies must register with Companies House.
- Charities are run by trustees. They must register with the Charity Commission.
- Service businesses differ from manufacturing businesses due to certain features: intangibility, experience-based, inseparability, perishability and heterogeneity.
- Businesses can find funding from: equity, debt and working capital.
- Stakeholders can be internal or external. They will have differing attitudes to risk.

Practice Questions

Chapter 1

1.1

Which of the following statements are true and which are false about operating a business as a sole trader?

Statement	True/False
A sole trader is entitled to all the profits the business makes.	
A sole trader can start a business without registering with any authority.	
A sole trader can potentially lose only the money invested in the business.	
A sole trader cannot employ people.	

1.2

Which of the following statements are true and which are false about operating a business as a limited company?

Statement	True/False
A limited company must have at least one shareholder and one director.	
A director of a limited company cannot also be a shareholder.	
A director is entitled to all the profits of a limited company.	
A private limited company cannot offer shares on the stock market.	

1.3

Which of the following statements are true and which are false about operating a business as a partnership?

Statement	True/False
In legal terms, an LLP is quite separate from its members.	
A partnership can have no more than twenty partners.	
A partnership must draw up a partnership agreement / members agreement.	
Partners or Members of a partnership must pay Income Tax and National Insurance on their own share of the profits.	

1.4

Which of the following statements are true and which are false about operating as a Charity?

Statement	True/False
A charity can become an incorporated organisation.	
Charities have trustees who are responsible for running the organisation's activities.	
An incorporated charity must register with Companies House.	
To become a charity, an organisation must have a valid purpose as listed in the Charities Act.	

1.5

List FOUR differences between a manufacturing business and a service business.

1. ____

2. ____

3. ____

4. ____

1.6

Select the most appropriate funding method for each of the following situations.

Situation	Funding method*
A large plc wishes to expand its operations into the USA and needs extra funding for premises and other associated costs.	
A small retail business, with a healthy bank balance, wishes to redecorate its shop.	
A manufacturing business wishes to buy a new production machine costing £10,000. It expects the machine to last 5 years.	
A small manufacturing company needs funds for raw materials due to an unexpectedly large order from a customer. The money will be repaid as soon as the customer pays.	

Select from: Bank Loan, Bank Overdraft, Share Issue, Working Capital.

1.7

A business has developed a new piece of software which has the potential to revolutionise the industry but involves significant technological and marketing uncertainties. Given the following stakeholders, identify their most likely attitude to risk and explain why.

CEO (Chief Executive Officer or highest-ranking director).

Customers

Shareholders