Section 2.1 Raising finance

31 Liability and finance

Definition

Every potential entrepreneur needs to know the financial risks being run when starting up. Debts are liabilities that can overwhelm a business owner's personal as well as business finances.

Linked to: Business objectives, Ch 25; Forms of business, Ch 26; Sources of finance, Ch 30.

31.1 Implications of unlimited liability

Unlimited liability means that the finances of the business are treated as inseparable from the finances of the business owner(s). So if the business loses £1 million, the people owed money (the **creditors**) can get the courts to force the individual owners to pay up. If that means selling their houses, cars, and so on, so be it. If the owner(s) cannot pay, they can be made personally **bankrupt**. Two types of business organisation have unlimited liability: **sole traders** and partnerships. They were covered in Chapter 26.

In Britain, the great majority of businesses have unlimited liability. Even though that means avoiding certain accounting costs, it still seems extraordinary that people are willing to take even a slight chance of bankruptcy.

> 'There are few experiences in life as painful and brutal as the failure of a small business. For a small business conceived and nurtured by its owner is like a living, breathing child. Its loss is no less traumatic than losing a loved one.'
>
> William Manchee, business author

Real business

In 2012, Creative Learning Software closed down. It had enjoyed ten years as a profitable business, designing and selling software to schools. Because its finances had always been cash flow positive, the proprietor never worried about limited liability. He had often said: 'I wouldn't give the accountants the satisfaction' (of auditing the published ltd accounts).

Unfortunately, the proprietor had not thought about *all* the potential liabilities. In 2011, a school sued the business because it claimed that Creative Learning Software had damaged the entire school computer network. The school demanded £100,000 compensation. But the small supplier couldn't afford that and therefore the proprietor became personally liable for the huge debts.

31.2 Implications of limited liability

Limited liability means that the legal duty to pay debts run up by a business stays with the business itself, not its owner/shareholders. If a company has £1 million of debts that it lacks the cash to repay, the courts can force the business to sell all its assets (cars, computers, etc.). If there is still not enough money, the company is closed down, but the owner/shareholders have no personal liability for the remaining debts.

The key implication is that limited liability can give owners the confidence to push their business forward to the next level. Expansion can be financed by bank loans without threatening the well-being of the owners' families. Without the legal protections of limited liability, economies would struggle to grow.

Despite this strength, limited liability has a downside. It gives huge scope for fraud. Proprietors can start a business, take customers' money, enjoy a fantastic lifestyle, then put the company into liquidation before customers receive the service they paid for. If such actions could be proved to be deliberate, they would constitute fraud. But there is little doubt that many scams go unpunished because it is hard to distinguish between fraud (illegal) and business incompetence (legal). This factor explains why most petrol stations display a sign saying 'company cheques not accepted'.

847769_31_Edexcel Business_198-201.indd 198 5/5/15 9:16 PM

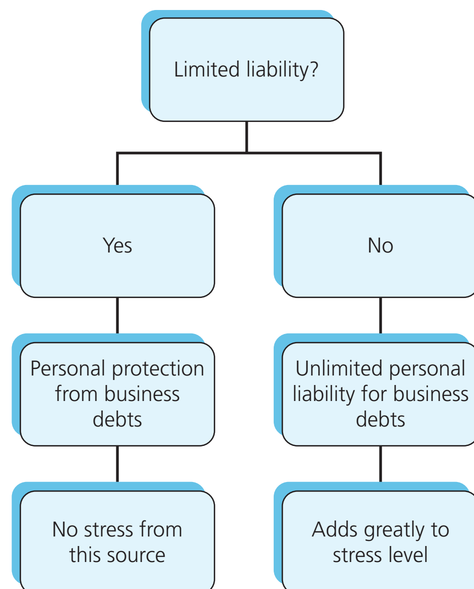

Figure 31.1 Logic chain: liability and stress

31.3 Finance appropriate for unlimited liability businesses

Unlimited liability businesses are, by definition, *not* companies. Therefore, they have no access to share capital (equity). So a sole trader or a partnership must be financed in one of the following ways:

- Owners' capital: in the case of a partnership, an agreement might be drawn up basing the proportionate ownership of the business on the amount of capital invested by each partner.
- Bank finance, either loan or overdraft: it is often easier for an unlimited liability business to obtain bank finance because even if the business fails, the bank can recoup its cash from the personal assets of the individual owners.
- Leasing: signing an agreement to rent a specific asset for a specific period (perhaps three years), therefore avoiding the cash drain caused by purchase.
- Trade credit: as with bank finance, supplier companies would often prefer to deal with a sole trader or partnership, as they know they can recoup any debts from the individual owners if the business fails.

It should never be forgotten, though, that the most important form of capital comes from within the business: from trading profit.

31.4 Finance appropriate for limited liability businesses

Companies have access to more types of finance than unlimited liability businesses. Both private and public limited companies have access to the following forms of finance:

- Share capital, part of which may be under the control of the founder and part sold on to family and friends (ltd) or more widely to the general public (plc).
- Bank finance: bank loans would typically need to be backed by specific collateral, especially for small companies (banks are wary of limited liability). Overdrafts will also need to be backed by security; for new small companies, it is highly likely that a bank would demand a personal guarantee by the founder shareholder.
- Angel or venture capital investment, both of which tend to be a combination of share and loan capital: so the founder suffers dilution of control over the business and the company will probably find that the loan capital is at a much higher interest rate than an ordinary bank loan.
- Peer-to-peer or crowdfunding: both these sources tend to keep control more effectively in the hands of the founder.
- Leasing and trade credit are both open to limited liability companies.

For limited companies, even giant plcs, the biggest source of capital for expansion comes from within the business: from trading profit.

847769_31_Edexcel Business_198-201.indd 199 06/05/15 9:33 PM

Five whys and a how

Questions	Answers
Why would anybody start a business with unlimited personal liability?	Beats me too! But the majority of UK business have unlimited liability, as proprietors believe there are tax advantages and dislike the extra fiddle and admin costs of running a company.
Why might it be easier for a partnership to raise finance for expansion than a sole trader?	Simply because the partnership has more than one owner, i.e. there are more pockets to dip in to.
Why might suppliers refuse to give credit to a new small company?	A company, by definition, has limited liability. So suppliers are wary of giving credit when, if the company fails, there is no way to recoup the cash from the business owners.
Why don't companies buy assets outright? Surely it is cheaper in the long run than leasing?	It is, it is. But many firms are so strapped for cash that they take a long-term hit from leasing to gain improved short-term cash flow.
Why do companies pay dividends when the profit they make is so important for financing growth and avoiding debt?	Shareholders expect an income from their investment; only early-stage, fast-growers such as Snapchat can get away with paying no dividends.
How expensive is it to run a company instead of a sole trader?	Not *that* costly. You can form a company for little more than £100, and the ongoing accounting costs are around £1,200 a year.

31.5 Liability – evaluation

There is a case for placing limited liability among the key factors that have led to the wealth of the western world. Without that legal protection, the industrial revolution of the nineteenth century could not have happened. Therefore, it is usually the case that unlimited liability businesses are small and plan to stay small, whereas those that are formed into companies have greater ambitions. Ultimately, the businesses that in recent times have gone from start-up to billion-dollar sale in a year or two have all been limited liability companies.

> 'Capitalism without bankruptcy is like Christianity without hell.'
>
> Frank Borman, airline chief executive

For those dealing with businesses, either as a supplier or as a banker/lender, the advantages of a company structure are offset by a huge downside: the risk of the company putting itself into voluntary liquidation – leaving the creditors with nothing. As elsewhere in business, morality matters. Some businesspeople lack the moral compass needed to ensure that they are being fair to everyone they deal with.

Key terms

Bankrupt: when an individual is unable to meet personal liabilities, some or all of which can be as a consequence of business activities.

Creditors: those owed money by a business – for example, suppliers and bankers.

Limited liability: owners are not liable for the debts of the business; they can lose no more than the sum they invested.

Sole trader: a one-person business with unlimited liability.

Unlimited liability: owners are liable for any debts incurred by the business, even if it requires them to sell all their assets and possessions and become personally bankrupt.

31.6 Workbook

Revision questions

(25 marks; 25 minutes)

1. Explain in your own words the risks involved in starting a business that has unlimited liability. (4)
2. Outline why the liabilities involved as a business partner might be even more of a worry than for a sole trader. (4)
3. Outline two circumstances in which a supplier might give credit to a newly formed limited company. (4)
4. Explain why a sole trader cannot raise share capital. (4)
5. From your general knowledge, give three examples of public limited companies. (3)
6. An aunt is about to start a business and asks you to advise on whether to start as a sole trader or a private limited company. Please do so. (6)

847769_31_Edexcel Business_198-201.indd 200 5/5/15 9:16 PM

Data response

A recent report to parliament shows the remarkable growth in business start-ups in recent years. Figure 31.2 shows the net growth in start-ups (births *minus* deaths) per year, plus the percentage of small businesses that employ other people. In 2001, 33 per cent of small businesses were employers; by 2014, this figure had fallen to 24 per cent. In 2014, then, 76 per cent of small businesses were sole proprietors (in effect, self-employed). The data for businesses employing other people is measured using the graph's right-hand scale (rhs).

The report did not provide information on how many of the new business were sole traders, partnerships or private limited companies.

Questions

(20 marks; 25 minutes)

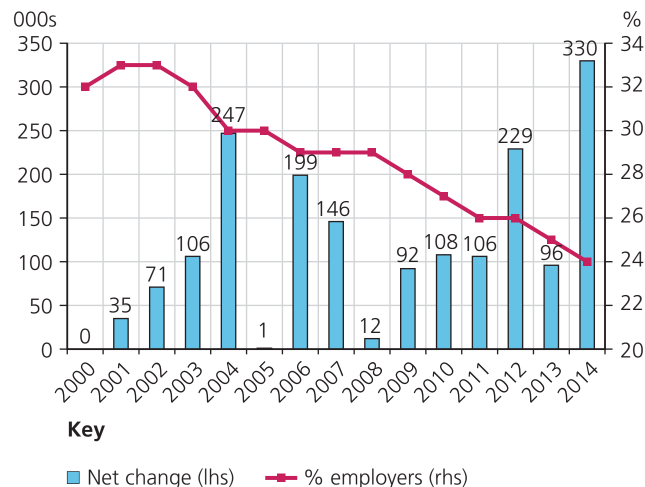

Figure 31.2 Net growth in UK business start-ups (source: Parliamentary report, November 2014)

1 Assess two possible reasons why the rate of net new business start-ups jumped in 2014. (8)

2 Assess the importance to the UK of the decline in the percentage of small firms that employ any staff. (12)

Extended writing

1 As part of your plan to open a new restaurant, you establish Prime Ribz Ltd as a private limited company. Examine the financial issues that may arise in your first year and evaluate which issue might prove the most difficult. (20)

2 Your parents have decided to open a greengrocer selling only organic produce. They plan on making it a 50/50 partnership. Evaluate whether this business idea is wise. (20)

847769_31_Edexcel Business_198-201.indd 201 5/5/15 9:16 PM