

## **QUESTIONS**

### **Question 1 Giacomo and Guy**

1. Giacomo has been in business as a sole trader for several years running a hardware store. Guy runs a similar store in a nearby town. Guy has contacted Giacomo to see if he would be interested in forming a business partnership with him. His view is that there could be several advantages to running the two stores in partnership: for example, a larger business is in a much better position to take advantage of discounts and special bulk buy offers.

Giacomo and Guy meet to discuss the proposition. Guy suggests that, as the stores are of similar size and have the same profit level, the profits of the partnership should be split 50:50. Guy assures Giacomo that there's no need for any 'red tape': 'there's none of the form-filling you get with starting up a company'.

Giacomo asks you, a small business adviser, for some advice on the proposal. He is not quite clear on the legal status of a partnership, and wonders what formalities would be involved in setting up the partnership.

Advise Giacomo on the pros and cons of setting up in partnership with Guy.

### **Question 2 Hector**

Hector runs a business which manufactures lathes and other specialised tools. For some years now he has rented the workshop premises from which the business operates. However, he has recently received a letter from the local authority, informing him that his workshop is to be demolished to facilitate the construction of a new road. Hector's business has done reasonably well in recent years and he currently has no borrowings. He would like to buy a workshop unit. He reckons that, as prices of commercial property are increasing rapidly, it would be a good investment and it would save him having to pay rent.

Hector asks you for advice on the best way of financing the purchase of the workshop.

### Question 3 Jessica

Jessica is a small shareholder in a FTSE 250 listed company, Blunt Blain Trading plc. She has come to you with the following query:

'I've just been reading an article in the Financial Times which says that George du Bois, the chief executive officer of Blunt Blain, has had a salary increase of 35% this year. Frankly, I'm appalled. The company's profits have gone down each year for the last three years. In the most recent financial year there was a strike by some of the production staff because their request for a 4% wage increase was turned down by management. Since I read the article I've had a look at the company's most recent accounts, and in fact, it turns out that most of the directors have had pay increases well above the rate of inflation. I really think it's immoral when directors award themselves huge salary increases like this.

What can I do about the situation? I only hold 1000 shares out of 750 000 so I realise I don't have much of a voice in the matter, but I think shareholders should have some influence in what their company does'.

Required: respond to Jessica's query.

### Question 4 True or false?

A colleague of yours, who knows a little bit (but not enough) about business finance and accounting, has made the following statements recently. Comment on the extent to which they are true or false.

1. 'If you're interested in a particular company, it's a good idea to buy a few shares in it so that you get access to privileged information about what's going on'.
2. 'As a company shareholder you know you can rely on the accounts, because they're audited by experts'.
3. 'Even sole traders have to produce accounts and register for VAT.'
4. 'The good thing about being in a partnership is that you don't have to make any information available to the general public'.
5. 'Management accounting is really pretty much the same as financial accounting'.

6. 'If you want to train as a member of the Institute of Chartered Accountants in England and Wales, you'll probably train in a firm of professional accountants'.

## **ANSWERS**

### **Answer 1 Giacomo and Guy**

#### ***Advantages of setting up the partnership***

Guy may well be correct in suggesting that there are some commercial advantages in entering into a partnership. A larger business may indeed be able to obtain better discounts on bulk purchases. This could mean that the partnership could be more profitable than the individual sole trader businesses. It could also be in a better position to compete on price if there are price-cutting competitors. There could be advantages if Guy and Giacomo have complementary skills.

#### ***Disadvantages of setting up the partnership***

However, the proposal is really quite risky. Partners are responsible in law for the consequences of each other's actions. This can lead to unexpected problems even in situations where the partners know each other well. In this particular situation, Giacomo and Guy do not appear to know each other at all well. The fact that Guy wants to dispense with what he refers to as 'red tape' does not bode well. Although there is no legal requirement to have a written partnership agreement it would be of particular importance where the partners are not well acquainted with each other.

As well as the particular disadvantages of this proposed partnership there are more general disadvantages applicable to all partnerships. Partners bear unlimited liability and where business debts cannot be paid, the partners' own personal property may have to be sold to raise funds.

#### ***Formalities involved in setting up a partnership***

As noted above, there is no strict legal necessity for a partnership agreement, although it is usually advisable to have one drawn up and agreed. Starting up a company does involve form-filling, as Guy says, but it is a relatively straightforward procedure.

Partners are taxed as individuals on their share of partnership profits, and, apart from the additional complexities involved in calculating shares of the profits, there is little difference

between partners and sole traders in this respect. As in the case of sole traders, partnerships do not have to publish any financial information.

### **Answer 2 Hector**

The purchase of the workshop will benefit the business in the longer-term and so long-term finance is likely to be the most appropriate. A combination of the following sources of finance might be suitable:

- Existing business resources – if the business has a cash surplus that it does not currently need, this could be invested in the workshop
- Hector's own funds - he may be able to introduce additional capital into the business from his own savings
- Long-term borrowing – a mortgage loan taken out over a reasonably long period (of, say, 10 years) may be suitable. Hector will need to investigate the costs of borrowing and should plan carefully to ensure that the business can cover the outlay in loan repayment and interest.

### **Answer 3 Jessica**

In recent years there has been a great deal of criticism of listed company directors in respect of their remuneration. Critics often make the same points as Jessica. [NB look out for comment on this issue in the financial and general press]. Directors tend to argue, however, that they deserve the levels of payment they receive because their work is very demanding and requires unusual levels of skill, experience and commitment. Where the directors are successful in, for example, turning round a company that has been ailing, few people are prepared to criticise their remuneration levels. However, in the case of Blunt Blain, the company's profitability has been falling, and the criticisms may appear more justifiable.

What can Jessica do about this situation? The answer is: probably very little. Individual shareholders do not, as she says, have much say in remuneration or other matters. There is a formal vote on directors' remuneration at the company's Annual General Meeting (AGM), but in reality shareholders very rarely challenge the directors on this point (or indeed, on any point). Jessica is entitled to attend the AGM and she can vote against the acceptance of the remuneration package. She is also entitled to question the directors in the meeting. However, she is quite likely to be a lone voice; most shareholders are apathetic in exercising their rights and AGMs are mostly

not well attended. In a few isolated cases, shareholders have succeeded in upsetting the voting at AGMs but almost always, it is only the major institutional shareholders who have the opportunity to do this.

Of course, if Jessica really objects to the remuneration policies of Blunt Blain, she can vote with her feet and sell her shares in the company. Some investors do take an ethical stance in respect of investing. (Often it takes the form of avoiding investments in certain types of company, e.g. those involved in the manufacture of armaments or tobacco). Shareholder activism has become more prevalent in recent times, but nevertheless, in most cases the directors of companies are not seriously restricted in their activity and decision-making by the views of the shareholders.

#### **Answer 4 True or false?**

1. Shareholders are not entitled to privileged information about the company in which they invest. They receive copies of the financial statements, but these are publicly available in any case through the Registrar of Companies. This statement is false.
2. Some companies are required by law to have an audit of their annual accounts. However, in recent years, the requirement for company audit has been relaxed and nowadays small companies do not automatically have to have an audit. So, the statement is only partially true.
3. There is no absolute legal requirement for sole traders to produce accounts although most do so in order to provide relevant information for HMRC. Sole traders and other businesses must register for VAT once they have reached a certain revenue limit. So it is not quite true to say that sole traders must register for VAT. In summary, the statement is not wholly true.
4. Yes, this statement is correct.
5. Management accounting and financial accounting are quite distinct from each other. The statement is not true.
6. Yes; this statement is correct.