

Chapter 1 Introduction to business organisations and finance

Questions

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.

2. 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.

Answers

1. Giacomo

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.

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.