Lesson Six

Financing a start-up; Locating a Business, and Employing People

Aims

The aims of this lesson are to enable you to:

- appreciate the different ways a start-up business could be financed
- understand the factors that influencing where a business is located
- say why and when it may be necessary to employ people

Context

These topics are introduced with reference to business start-ups and will also be covered in more detail later in the course.

Marcousé, *Business Studies for A Level* (4th edn), Units 7, 8 and 16.

Oxford Open Learning

Types of Finance

All businesses need finance to get up and running, even if they are run from home! Business organisations operate on two main types of finance: long-term finance and short-term finance. Long-term finance refers to the provision of finance for a period of longer than 10 years, whereas short-term finance is for periods of less than 3 years. It is important to understand both the functions and the sources of these two types of finance.

Long-term finance

Long-term finance is used for the acquisition of fixed capital assets, e.g. land, buildings, plant and machinery. Sources of long-term finance include: shares, debentures, long-term loans and mortgage loans.

Short-term finance

Short-term finance is used for current expenditures such as running costs and purchasing materials. A major source of short-term finance is the bank overdraft with most overdrafts for businesses being almost continually 'rolled over'. Other important sources of finance are trade credit and, where businesses have credit customers, debt factoring.

Medium-term finance

Businesses may also resort to the provision of medium-term finance for a period of between 3 to 10 years. Medium-term finance is used for the acquisition of such assets as high-tech machinery or equipment, computer hardware/software, office machinery and transport vehicles.

Two major sources of medium-term finance are hire purchase and leasing. These two methods/sources of finance can be used as alternatives to acquiring an asset by outright purchase and thereby avoid the pressure on cashflow/working capital which outright purchase incurs.

Sources of Finance

Internal Finance

Retained profits. A firm's profit, after tax, is an obvious source of finance for any business once it is up and running. Profits can be used to finance current expenditure, and/or profits can be 'ploughed back' into a business to finance capital expenditure. A large proportion of business finance in the UK is funded internally from profits. Such internal finance has the advantage that no interest payment, or even repayment, has to be made.

Sale of assets. Sometimes businesses will sell off assets to raise funds. This can be part of a deliberate policy when, say, a business is planning to change to a new business activity, or, an action which the business has been forced into because it is not able to raise funds from other sources.

Long-term Finance

Long-term capital can be raised from external sources in the form of share capital or loan capital.

Share capital

For a limited company this is likely to be an important source of funds. Different types of shares can be issued, the most common perhaps being ordinary shares. Ordinary shares are sold at an issue price; they have both a nominal value and a market price (if quoted). Ordinary shares are normally irredeemable, and ordinary share capital is often referred to as permanent capital. Ordinary shares are also known as the equity shares/capital; they carry voting rights of, normally, one vote per share. The ordinary shareholders are the owners of the company. There is no guaranteed/fixed dividend on ordinary shares; the shareholders receive a variable dividend, the size of which depends upon how much profit is made and how much the directors decide to distribute.

Loan capital

Sources of loan capital include:

Debentures. These are really loans to the company; the holders of debentures are creditors, not owners of the company, and do not have voting rights. The rate of interest on debentures is set at a fixed rate, and they are redeemable at a specified maturity date.

Debenture holders have preferential claims against the company over payment of both interest and capital. The interest paid is tax deductible and therefore the true rate of interest to the company is less than the stated rate of interest if the company is profitable. Debentures can be issued as secured against a company's assets, or unsecured as floating debentures. There is more risk to the company in issuing in issuing debentures than shares, since interest must be paid irrespective of the profitability of the company.

Mortgage loans. Only limited companies can sell shares or debentures. Unincorporated enterprises often raise long-term finance by taking out a mortgage. A mortgage is a long-term loan where the lender takes land or property of the borrower as security for the loan.

Long-term loans. Banks and finance houses can provide long-term loans of 10-20 years for business and commercial uses. There are also industrial loan specialists which tend to cater for firms which have difficulty in raising funds from conventional sources. One example is *Investors in Industry* which provides loan capital for medium-sized enterprises.

Venture capital. This is an equity investment in an unquoted company. Venture capitalists and institutions provide a source of funds for unquoted small and medium-sized enterprises. They invest by buying an equity share in up-and-coming companies which have high growth potential. Venture capitalists range from private, wealthy investors to professional/corporate venture capital funds such as *Investors in Industry*.

Another source of finance is known as a **business angel —** someone who invests their own money in the business venture.

A developing company needs to make a considered choice between loan capital, share capital and the reinvestment of profits. The balance between the first two is called the **capital gearing** of the company.

Activity 1

A sole trader, Sabab has decided to set up an internet-based business selling digital equipment e.g. satellite dishes and recording equipment for home users. Sabab needs to buy stock to start his business and needs approximately £12,000 to get himself up and running. He thinks he should be able to repay this within 3 years and can provide some security. He is looking to keep his costs low so will be running the business from his bedroom at home. He will be storing the stock at his home and adding to his household insurance to keep the goods secure. He will be posting the goods direct to the customer. If he could find a suitable business partner, this would help Sabab.

Recommend to Sabab at least two different sources of finance that would be appropriate for his venture.

We will now look more closely at what happens when a company decides to try and raise capital through a share issue, and through debentures.

The Issue of Shares

When a company decides it needs more capital and wishes to make an issue of shares it has to go through a certain procedure. Firstly, it must check that according to the terms of its registration at Companies House, (its Memorandum of Association), it is authorised to issue that number of shares. At registration, companies state the level of authorised capital they think they will need and pay stamp duty on that figure.

Obviously, a firm that thinks it will remain small with perhaps only £10,000 of capital does not want to obtain an authorised capital of £1M and pay stamp duty on the whole £1M. But, at the same time, if it is liable to need £1M worth of capital there is no point in asking for an authorised capital of £100,000 and then going back and asking to have it increased as the total stamp duty it would have to pay would be higher than it would have had to pay on original capital of £1M.

So, when they wish to issue shares firms check that they have sufficient unissued capital which is authorised. If they do not, then they must submit an alteration to their Memorandum of Association to Companies House that requests an increase in authorised capital.

The next stage is to decide how many shares they want to issue and at what price. For the majority of companies in this country, the nominal value of a share is 25p. Even though exams widely quote nominal value at £1, the majority of companies still have the 25p shares for nominal value. But this does not mean that the company has to sell the shares at the issue price. Like everything else, the market responds to price as a controlling mechanism on supply and demand.

In the case of a share issue, the supply is fixed by the company and they will therefore want to set the price at such a level that the number of shares demanded will be equal to, or marginally greater than, the shares supplied. If they set the price too low then more shares will be demanded than are available and the company legally is not allowed to increase the number of shares issued once the original figure has been set. They cannot, as it were, respond to a high demand factor.

If, however, they set the price too high, then not enough people will want to buy the shares and the issue, unless it has been **underwritten** (see below), will fail and the company will have incurred the cost of attempting to issue the shares and gained no benefit. So the pricing of shares is vitally important.

If shares are issued at a price above that of the nominal value the amount of excess is known as a **share premium**. Where they are issued at nominal value then the phrase used is that the shares have been issued at **par** and where the shares are issued at less than the nominal value, and then they are issued at a **discount**.

This latter case will only occur where the shares are issued to existing shareholders at a discount to encourage them to increase their investment and the company will, at the same time, use retained profits from previous years to make good the amount of deficit. For example, if a 25p share was sold at 20p, the company would use 5p of past profits to add to the capital fund so that the capital went up by the full nominal value. In that way the interests of creditors are protected since the share value has always been subscribed in one way or the other to the firm.

Having decided on the number of shares and the price, the company will then issue either a prospectus or more usually, a "statement in lieu of prospectus". These statements will be issued in at least one national newspaper and include an explanation of why the issue is required, a copy of the latest available accounts for the business concerned, and details of the exact number of shares being issued, the price and when the amount is payable. It will also state the closing date for applications from people who wish to buy the shares.

Issuing Houses and Underwriters

Occasionally, a company handles a share issue itself, but it is more usual for a large company to go to one of the merchant banks, known as an issuing house, and ask it to handle the issue; so the issuing house will put out the statement in lieu of prospectus, receive applications, handle all the administrative work, and may even underwrite the issue.

Where the requests for shares are in excess of the number available, it is the company's choice as to which of the applicants will be given shares. Normal practice for most companies is to favour the small shareholder and cut back on the number of shares given to those who applied for a large quantity. During the privatisation of previously nationalised industries, the government made this as a definite policy because it wanted as many people in the country as possible to be shareholders in the belief that this would encourage public interest in the well-being of the national economy.

Provided the share issue was underwritten, or the number of shares asked for is at least as many as those issued, the issue is deemed successful and the proceeds from the application money and the money paid on allotment are then handed over to the company by the issuing house. In return, the issuing house will take a commission fee payable as a cost of issuing shares.

When you consider the cost of underwriting commission, the issuing house's commission, and preparation and issue of the statement in lieu of prospectus, it is evident that a public issue of shares is not worthwhile unless you are asking for a considerable sum of money. In practice, it is very rare to see a request for a new issue of shares for anything less than £100,000.

The Stock Exchange

Dealings in the Stock Exchange take place on the shares after they have been issued. The issuing house will have arranged with the Stock Exchange for what is known as a placement. This means that the Exchange has agreed that transactions of buying and selling shares in that particular company can take place on the Stock Exchange. The way in which shares are bought and sold on the Stock Exchange will be considered in more detail in a later lesson, together with more detailed notes on banks and insurance.

Debentures

As noted above companies may also issue debenture stock. Debentures are in fact loans made by people to the company rather than shares in the company. Most debentures have a security on the company's assets, and the most frequent form is **a floating charge**.

Keyword

A **floating charge** is a security interest between the lender and the borrower. These are usually issued to cover stock, vehicles, plant or even money owed to a supplier.

Thus, the assets of a company can be dealt with in the normal way by the directors, buying and selling machinery as necessary. Should there be a default on payment of the loan interest, however, the debenture holders (or their trustee) can, in the technical term, “crystallise” the charge. At this point the company cannot sell any further fixed assets until the arrears of interest have been made up, or the trustee is satisfied by the repayment of the debentures completely.

Debenture holders therefore have a much greater level of security in the money they lend to a company than a shareholder, but they only receive the level of interest that has been agreed, whereas the shareholders’ dividend might rise to a higher level if there has been a good year’s trading. Most debentures have a fixed term of life and are repayable at the end of that term.

A company may repay them out of past profits retained although obviously in that case the profit would need to have been retained in the form of cash, but it is more likely that they will be repaid by a fresh issue of debenture capital. In this way the company is able to keep in touch with interest rates and borrow their capital at the cheapest price to the company that is available on the market.

Short-Term Finance

Debt Factoring

Share capital, loan capital, or even venture capital may be the answer to problems of long-term finance, but many businesses are often concerned with short-term cash flow problems, perhaps because trade is seasonal e.g. the sales of lawn mowers, expenditure erratic, or it takes a long time to persuade debtors to pay up. Problems of liquidity may not be as disastrous as they once were due to the modern practice of debt factoring. This term refers to the selling of trade debts. The speedy transformation of debts into money in the bank can be a valuable tool of financial management.

Many businesses have a long list of debtors who have not yet paid their bills. Perhaps they have failed to settle within the agreed period (e.g. 28 days), and it is not clear when they are finally going to pay. Some may never pay. If a company with debtors urgently needs cash on a short-term basis, factoring will allow them to pass on those debts, not for their full value but for an agreed percentage. The factoring organization will eventually collect most of the debts, usually for more than they have paid out.

Bank overdraft

A simple overdraft at the bank may tide a company over until its cash situation improves, although banks charge considerable fees if such overdrafts are not pre-arranged.

Leasing

It may be possible for a firm to "lease back" items of equipment which have previously been bought.

Private funding

Owners of a business may simply inject cash from private funds on the basis that it will be repaid shortly.

As long as a business has an underlying profitability, it is likely that it will be able to survive short-term cash flow problems.

Government Grants

At various times over the last 30 years, government grants to industry have been made available. These range from increased capital allowances which reduce the tax on profit for a company to actual payments to companies for setting up industries in different parts of the country. Investment grants vary from year to year in the form in which they are presented but they are generally given by the government to promote their policy towards industry.

Government policy is normally one of promoting industrial growth in areas of high unemployment. The government's aim is to recover the grant, not from the firm to which it has been made, but out of the decline in the need to meet unemployment payments to those who have now obtained work. Grants for investment may be linked to the level of investment or to the number of jobs created and each individual grant would be checked by the Civil Service for the likely results that would come from the grant.

The way in which grants are made varies from year to year. The Chancellor's Budget speech sets out the pattern for grants to industry.

Sources of finance available to different categories of business

Let's look at sources of money available to different types of business. Not just what kind of business they are, but also how they function, what back–up services are necessary, and how the firm can use them to obtain money.

The Sole Trader

For a sole trader the principal source of money is, of course, his or her own savings. Sole traders, by definition, own the business themselves and are therefore the principal source of capital to the firm.

Even a sole trader may have alternative sources, however. In Lessons Three and Five we looked at the system of franchising which is one way a sole trader can obtain capital necessary to start a business. He or she acts, as it were, as a resident manager for a larger organisation which puts up the capital in order for the franchisee to start in business, but then leaves him as his own independent boss to make a profit (or perhaps show a loss).

Rather more frequently, however, the secondary source of finance for a sole trader is the bank. At some stage in their existence, many small firms borrow money from the bank by way of an overdraft; in some cases they may also have a small business loan. An overdraft is quite simply the bank's agreement for a client to take more money out of the account than has been put in. It is, at least officially, a day-to-day arrangement in which the bank has the right to recall the overdraft at one day's notice. In practice, of course, banks seldom act in this fashion although they may advise a trader that the level of overdraft must be reduced over a reasonable period of time.

A business loan is slightly different from an overdraft in that it is set up for an agreed period. Until that period is up, and as long as the interest or capital repayment scheme is met, then the trader is in the secure position that the bank cannot ask for the total loan to be repaid.

Some firms may be able to negotiate a grant guaranteed by the government under one or other of the small business schemes.

Fairly strict conditions must be met before these are granted. Some traders hold the view that the amount of increased paperwork and government interference is more than the grant is worth.

Finally, of course, as with all businesses, a sole trader may obtain money from suppliers. It should never be overlooked that ordinary **trade credit** is a source of money. Whether this comes from suppliers or from employees is irrelevant. If an employee is paid monthly this will normally mean that salary is paid at the end of the month after he or she has done a month's work. In the retail trade, a trader may have used that work to obtain sales and been paid in cash. That cash can cover wages before they are paid.

Similarly, when a supplier lets a trader have goods on one month's credit, and the trader sells the goods for cash before the month is up, then effectively the trader never has to find the money to buy the goods at all since he pays for them out of the proceeds of the sale. Such traders are in the fortunate position that they can increase their level of turnover without increasing their level of working capital.

Partnerships

Partnerships are in a very similar position to the sole trader and obtain finance in the same ways although, of course, original capital can come from all the partners and not just from one sole trader. It is also possible that the collective security the partners can offer may mean that the business receives more favorable treatment when it approaches a bank for a loan.

Limited Companies

Like the sole trader, limited companies can obtain finance from the bank and from trade credit. However, their principal source of finance is their **shareholders**. A company can approach people and ask them to invest money in the company as shareholders. Public limited companies are able to do this on a wider network than private ones, although the actual distinction between the two in terms of numbers of shareholders became less distinct following the 1981 Companies Act.

Shareholders have the advantage that, if they agree to buy shares, their liability for the company's debts is limited to the amount of money they agreed to pay for the shares. Accordingly, if you buy 100 £1 shares at par value (see below) of £1, once you have paid the £100, they cannot come and ask you for any more money even if the company goes into liquidation.

Limited liability for the shareholder is a very real advantage for those who do not want to risk their complete fortune. There is, however, a disadvantage for the shareholder in the private limited company in that having invested money, it can be very difficult to get it money back as there is no market for second hand shares for private companies.

There is a market for shares in public limited companies, however, and this can act as a source of new funds: because shares can be re-sold at a later date, people will be more inclined to buy them.

Not for Profit Business

Some businesses are set up as not for profit, charitable organisations or social enterprises and they have different objectives to businesses whose main aim is to make a profit.

An example of a not for profit business is WGIRLS – this business "believes that all women and children regardless of race, religion or financial situation, deserve access to quality education, healthcare, strong, positive influences for themselves and their children, and a safe and loving home". It provides support and events for other organisations that also share their mission.

Government grants and loans are available for not for profit organisations and tax advantages for charities.

Now read Marcousé, *Business Studies for A Level* (4th edn), Unit 16.

Activity 2

Carry out some research on the internet to find out how not for profit businesses and social enterprises can be funded.

Note your findings below.

	Not for Profit Business Funding Social Enterprise Funding

The Business link website provides a range of information relating to how businesses can be funded.

Once finance is in place a business will need to choose where to locate. You should be aware, however, that the location decision, although not yet taken, will form part of a business plan and may be one of the factors contributing to a drive for business funding. As with many other aspects of starting a business, location and sources of finance are not separate issues, but interact closely.

Locating a Start-Up Business

As well as planning a financial structure for a new business, an entrepreneur also needs to think about where he (or she) is going to locate it. For a very small enterprise, this might simply be a back bedroom, but we will assume here that something more substantial is required.

Factors to consider include:

- technology;
- costs;
- infrastructure;
- the market;
- government intervention;
- qualitative factors.

The relative importance of these factors varies according to the type of business. Let's look briefly at each.

Technology

Access to technology is essential for many small businesses, especially if they intend to specialise in a particular kind of product and want to experiment in the marketplace without huge investment in machinery. This might include access to a local printer's, or expert IT support, for example to build a website.

Some start-up businesses want to buy their own technology straight away, but there may a lack of space. Are the premises big enough to house the production facility, or will it be more economical to "out-source" the production, i.e. pay someone else to do it?

Costs

The costs of different premises are critical to the business. Property is usually rented by the square metre and prices vary hugely according to the location. In the middle of London, the cost per square metre might be ten or even a hundred times as high as the cost in remote areas. The more remote the location, however, the more difficult it may be to recruit staff, find customers or transport goods to market.

There are also different grades of premises. Hi-tech office space is much more expensive than low-grade industrial space or storage space, so an entrepreneur needs to consider exactly what the premises are *for*.

Infrastructure

The infrastructure of a location also has a significant bearing on the cost of renting or buying premises. This includes access to all kinds of services and technology, including electricity, gas, broadband, roads and railways. In the nineteenth century, mills were sited next to canals and vice versa. If heavy goods need to be transported on a regular basis, it may be important to find a location close to the motorway network. It may be necessary to consider whether lorries can drive up to and park right next to the premises, and so on. High tech businesses need to consider the reliability and speed of broadband connections, as well as the availability of support from the supplier when problems arise.

Market

Businesses tend to locate themselves very close to the market they aim to serve. This is most obvious in the case of retailers who usually want premises (shops) on the high street of a town or city, or in edge-of-city shopping malls with extensive customer parking. There would be little point opening a newsagents' or a pizza takeaway service (say) in the middle of the countryside, miles from the nearest house. In general, the business aim regarding the location of a retail business is to come to the attention of a large number of local people who will be interested in what you have to offer.

As well as proximity to potential customers, it is necessary to think of the proximity of competing businesses. Would it be worth opening up a greengrocer's shop right next to a thriving supermarket, or an Indian restaurant right next to another Indian restaurant? Ideally, businesses should aim to provide a product or service for which demand currently exceeds supply, and that may vary from one town to another. In this context, it is also important to realise that some businesses do better when they are clustered together. High tech companies tend to favour business parks where they can depend on local suppliers and the availability of skilled employees.

Government

The government, in the UK or elsewhere, may also influence locational decisions. Local or regional development grants available as incentives to new businesses to set up in a particular place. Perhaps another kind of business has closed down and there is a large potential workforce available for employment. Such locations may be unattractive, however, in other ways. There may be planning issues to consider. A residential property cannot be turned over to business use without permission from the local authority, and this may or may not be granted. Even within industrial premises, permission may be required for a change of use. So it may be a case of looking for premises which are already being used for a similar type of business.

Qualitatative factors

There may also be a number of qualitative factors to consider. For instance, an entrepreneur may not want, for purely personal reasons, to move far from their existing home. So it may not matter that there are grants available to set up a business in a distant county – they want to stay where they are. Some business environments are simply more pleasant than others. If so, it may be easier to attract staff, and so on. Some premises are more *visible* than others, e.g. they are located on a corner where everyone must stop at the traffic lights. It may be worth paying twice as much to achieve that level of visibility.

Size

Every new business needs to consider all these factors very carefully, together with the related question of the size of the premises from which the business will operate. It would be uneconomic to pay for too much space and then not use some of it. Nor should the premises be so small that it does not allow for expansion. Businesses tend to change size very rapidly in their early stages so it may well be a case of renting modest premises at the outset rather than buying a property, so that it is relatively easy to move on to a different location.

Activity 3

Cadbury's (Kraft) is mainly located in Bourneville, Birmingham. For historic reasons It has not moved from this location. The roads to Cadbury's are narrow and at some distance from main motorways for transporting the goods across the UK and World.

Cadbury's are finding that deliveries in and out of the factory are in-efficient due to location and traffic in the locality. The operations manager has asked you to suggest a more suitable location in the UK.

Go online and find the location of Cadbury's in Bourneville.

Carry out some research and identify a suitable location for Cadbury's to move to in the UK.

Explain why you have chosen this location, and justify why this location would be more suitable for Cadbury's purposes.

Now read Marcousé, *Business Studies for A Level* (4th edn), Unit 7.

Activity 4

Please complete the revision questions on page 34, and B1 activity and B3 case studies on pages 35 and 36 of Marcousé, *Business Studies for A Level* (4th edn), Unit 7.

Once a business is up and running, it may have to consider employing people.

Employing People

Many small businesses start as just one person, a sole trader, but eventually the day comes when it seems necessary to employ staff. An **employee** is someone who works for a business, usually for an agreed wage/salary, often without owning any part of the business. It is also possible for an employee to own a share (or shares) in the business, in which case the employee takes on part of the role of the entrepreneur and may have a stronger interest in helping the company succeed.

Each employee should have a **contract of employment** which specifies hours to be worked, salary, holiday entitlement, whether the employee is employed full-time or part-time, terms of payment for sick leave and so on. This creates obligations for both the employer and employee and may be tested in an employment tribunal if problems arise, e.g. the employee behaves inappropriately, or the employer wants to discontinue the association.

Not everyone is employed **full-time**, i.e. eight or more hours a day, five days a week. A business might just need a **part-time** employee. It may take on **freelance workers** or sub-contracted staff for specific tasks at specific times. Freelance workers do not normally receive a specific salary at the end of each period (e.g. at the end of the month), rather they are paid for completing specific tasks.

Why employ people?

"If you want a job doing well, do it yourself!" is a common cliché and certainly it would be unwise for an entrepreneur to expect an employee to show quite the same level of commitment and motivation as they bring to the business themselves. So why take on employees? There are a number of common sense reasons:

- volume of work;
- seasonality;
- specialist skills.

The first is the most obvious. If a business is going well, there comes a point when the entrepreneur is physically incapable of doing everything that could, or should, be done. For instance, a dentist might find that she is so popular that she cannot deal with all the would-be-patients, or a plumber might find that he has too many call-outs.

Many businesses are seasonal to some degree – that is, the volume of work (or sales) rises and falls according to the time of year. One standard example is the ice-cream vendor who keeps his van in the garage through the winter because no one wants to buy ice-creams when it is cold and wet. Such businesses need more workers during the busy seasons than the quiet ones so it may well make sense to hire an employee for three months (June to August, say) and then get by for the next nine months before hiring someone else for the following period.

Sometimes employees duplicate roles that are already being performed (due to sheer volume of work), but more often their roles will be different. As a business grows, the entrepreneur usually finds that he or she does not have the specialist skills that are required in certain areas, and it is actually more economical to employ someone who *does* have those skills. It might just be someone to "do the books", that is, keep the accounts. Or you might need someone to design and manage your website, or go out and knock on people's doors. Someone may be needed to manage the business premises, act as receptionist, design new products, and so on. The possibilities are almost unlimited.

Types of Employee

Temporary

Employees may be temporary or permanent, according to the business's needs and the contract of employment. A **temporary contract** will stipulate a specific end-date, e.g. after three months. It may be that all necessary work will be completed by then, or it may be that the business wants to test out the employee before offering a "permanent" contract. But even permanence is relative – there are very few businesses which offer to employ someone for the rest of their lives!

Even part-time employees have considerable legal rights after they have been with a company for a while. Some employees may be employed on a **zero hours contract**. This is where an employee is not guaranteed any hours of work and is typically used in retail where the employer may need flexibility. The employee is paid for the hours they work, but this may vary each week.

Permanent

A **permanent contract** is simply one that does not have a specific end-date. Instead it will stipulate a period of notice for both sides, e.g. the employer may be entitled to say (at some point) that it will only continue to provide work for (and pay) the employee for a further three months. Similarly, the employee must give a period of notice if he or she wants to move on somewhere else. The longer an employee stays, the more difficult it becomes for the employer to discontinue the offer of employment. The employee may well become entitled to **redundancy pay** and other forms of compensation. We will look at the complexities of **employment law** in a later lesson.

Consultants, Advisors and Freelancers

Consultants and **advisors** are specialists in their field who usually work on a freelance basis. They might be paid by the hour for the services they provide. Once a specific contract has been fulfilled, the business normally has no further obligation to offer fresh work.

Freelancers in general may, or may not, have specialist skills and are employed for a specific job for which they are usually paid a fee. They are responsible for their own national insurance, tax and pension contributions, whereas a regular salaried employee will usually have tax and national insurance deducted from his pay-packet.

Advantages and Disadvantages of Employees

Advantages

The advantages of employing someone vary hugely from one business to another. Overall, the assumption must be that the **benefits** to the organisation of getting that person involved outweigh the costs. For instance, if a person costs £30,000 a year to employ and the business increases its turnover by £40,000 as a result, this generates extra revenue of £10,000. Unfortunately, the calculation is rarely as simple as that and most employees do not have a directly measurable effect on turnover and profit.

(Remember: Revenue is the amount of money that a business receives usually from the sale of goods and services. Profit is the amount of money that is left from their total sales once all costs have been deducted.)

Another advantage is the freeing-up of **time** of existing staff. Perhaps this will enable senior managers to concentrate on what they do best while being able to delegate less significant work. Every employee brings a different **skill-set**, different experiences and different kinds of expertise, all of which may contribute to the success of the business, either directly or indirectly. A business is also a **social** organisation and new employees may also make it a more pleasant place to spend one's time – or not!

Disadvantages

The disadvantages of employing someone include **cost** and **absences**. The cost is rather more than their take-home pay. It includes:

- Employers' National Insurance, a secondary form of tax which employers must pay for each employee;
- recruitment costs;
- the floor space that a member of staff will occupy (perhaps larger premises are needed);
- the equipment that will be used, e.g. a computer or a company car;
- training costs;
- possible maternity and sick-pay;
- pension contributions,;
- staff support costs (e.g. payroll, health and safety);
- general overheads, which tend to increase according to the size of the business.

Altogether this may well amount to double the actual salary.

Employee absence is a problem for many businesses. People get sick at inconvenient times and may be off sick for weeks or months at a time. An employer may be required to continue paying a salary for long periods even though they are receiving no benefit from it. Most entrepreneurs are never off sick (or, at least, claim that is the case) and they are amazed at how regularly their employees are incapacitated! So a good business will factor in this “hidden” cost before deciding to employ someone.

Employees also have a number of statutory rights, e.g. they can take time off during pregnancy, continue to be paid, and return to their job after the child is born, even though someone else has had to be taken on to “cover” for them. Fathers also have rights on a smaller scale. Employees are also entitled to a safe working environment, and an employer must be very careful not to be negligent in any way. It can also be awkward and expensive to dismiss an employee.

For all these reasons, employing the right staff at the right times is a matter of critical importance for any business, small or otherwise!

Full details of current employment terms, conditions, rights and procedures are available at:

http://www.direct.gov.uk/en/Employment/index.htm

Advantages and Drawbacks of employing Consultants

Advantages

Consultants are hired for a particular time or project and once the project is complete there is no requirement to employ them further. A consultant can be brought in to carry out a specific job that existing staff may not have the time or skills to complete. A consultant brings flexibility and they are typically highly skilled and experienced in their area of expertise.

Disadvantages

Employing a consultant tends to be expensive as they tend to charge a higher fee. A consultant does not know your business and therefore it make take them quite a while to get understand the wider context of the task they have been brought in to complete. At the end of the agreement the consultant may no longer wish to do any further work. Internal staff may wish to carry out the tasks and may resent the consultant.

Activity 5

Bowcup Interiors currently operates as a sole trader with Emma Bowcup as the owner. She currently rents premises in Syston, Leicestershire, and offers personalised interior design to local homeowners. This includes designing, planning and implementing the design. She currently employs Andrew, a decorator on a part-time flexible contract, who works as and when work needs to be done. However, Emma is struggling to keep up with demand, and due to new customer referrals she is having to turn work away. She has decided to advertise and recruit possibly one full-time member of staff, or a number of part-time staff to help out with the decorating, running the shop and managing the orders/invoices.

Emma asks you to:

1. explain three advantages of employing one member of staff full-time rather than a number of different people part time.

2. tell her about the disadvantages of employing one member of staff full-time rather than a number of different people part time.

Make a note of your answers in the space below.

Now read Marcousé, *Business Studies for A Level* (4th edn), Units 8 and 16.

Activity 6

Please work through Section A Revision Questions on page 40, and B2 Activity on page 41 of Marcousé, *Business Studies for A Level* (4th edn).

Summary

Lesson Six: Planning and Legal Structure.
This lesson has looked at the different ways a business can be funded, the advantages and disadvantages of employing staff and how factors affect the location of a business.

Self-Assessment Test: Lesson Six

Some of the following questions may require a little independent research.

1. List two advantages and two disadvantages of employing a member of staff on a full-time permanent basis.

2. List three legal obligations that an employer is responsible for when they employ additional staff on a part-time basis.

3. Joe is selling mobile phone apps over the internet and he is doing really well. He is working 15-16 hours a day tracking, maintaining and delivering orders through the internet to clients. On top of this he has to try and source new products. He is really struggling with his admin in particular recording payment and expenditure. Suggest to Joe the consequences of failing to employ someone to help him with his admin.

4. Apart from the salary, what are the hidden costs of employing someone?

5. Explain two advantages and two disadvantages of engaging consultants on a short-term project.

6. Describe how technology could affect the location of a pizza take-away.

7. List three factors to be considered when choosing a business location.

8. Explain why a business should locate itself close to its market.

9. What source of finance would be the most effective for a partnership looking for £150,000 to expand their business?

Suggested Answers to Activities

Activity 1

Sabab apply to a bank or a business angel for a loan. As a sole trader, he could ask his bank for a short-term loan to get him started. He has stated he could provide some security, and the money would be used to purchase assets.

Sabab could also consider share capital. The case study notes that he would be happy to work with a business partner, and therefore he could ask outside investors to invest and help with the day-to-day operation of the business.

Activity 2

A social enterprise or not-for-profit organisation could look at banks and building societies or donations from friends and family. They could also approach the following organisations:

- Community Development Finance Institution (CDFI);
- Adventure Capital Fund (ACF);
- Futurebuilders England;
- Bridges Community Development Fund.

Activity 3

Kraft/Cadbury's is currently located in the small village of Bournville situated on the outskirts of Birmingham. Although transport links to Birmingham are good and include the M5/M6 and M42, roads into Bournville itself are minor and badly congested at busy times of the day. There are many possible locations you could have chosen to move Kraft to, for example, Warrington, which is close to the M6 and is between both Manchester and Liverpool airports. Whatever location yuo have chosen, you need to justify why you think it was more appropriate. For example, if you chose Warrington your justification might include:

- better transport links;
- flying goods or staff into and out of either Manchester or Liverpool Airports;
- saving transport travelling time;
- saving costs on queuing on roads into Bournville;
- the local community in Warrington might welcome the change.

Some negative points might have been:

- Cadbury built the Bournville village and the houses are rented to workers in the factory;
- the ethos and spirit of the village would be lost.

Activity 5

One advantage of employing one full-time member of staff rather than a number of part-timers is that communication is sometimes less effective with part-time staff, whereas if someone is available full-time communication tends to be more efficient. Another advantage is that it may be easier to recruit one member of staff full-time. It may also be the case that a full-time member of staff would deal with each customer from start to finish, possibly offering better customer service.

A disadvantage of employing a full-time member of staff is that they may not have the range of skills for each task, whereas bringing in more than one member of staff means that you have more skills/experience available to you for decorating, administration and face-to-face dealings with customers.

Another disadvantage is that it can be more expensive to employ a full-time member of staff than part-time staff. If there is a decline in business full-time staff still need to be paid. If part-time staff work flexibly changes can be made to increase their work during busy periods of time, and reduce working hours when business is slack. Having several part-time staff can help reduce the workload of other members of staff, but one full-time member of staff will only be able to carry out so much work on their own. If the full-time member of staff is sick, then the business may suffer, but if part-time staff are employed one may be able to cover for another on a temporary basis.