Lecture 6: The Company

In this lecture, we examine some of the practical issues you would face when going into business for yourself. This material is not covered in Fleischer. A good reference is ``Introduction to Canadian Business'' by M. Archer, published by McGraw-Hill in a series of editions, available in the SFU library at HD 70 C2 A7.

There are three forms of business organization: the single proprietorship, the partnership, and the corporation.

Single Proprietorship

This is the simplest form of organization. You and the business are financially indistinguishable; the company's money is your money. If you want to take $5,000 out of the company accounts for a ski vacation, you can do it. The downside is that the company's debts are your debts; if the company incurs debts, the debtors can come after you and take your house, your savings, and almost everything you have. Technically, you have `unlimited liability'.

A financial analysis may show that your business plans are potentially profitable, but you may nevertheless run into the problem of cash flow. This arises because you have to pay your workers and suppliers before you have a product to sell. So, even if your idea is profitable over the year as a whole, you need bridging funds to get over the initial debt. One solution is to delay paying for your supplies; however, the suppliers will charge a high interest rate -- up to 24% per annum -- for being made to wait. Or, you can talk to the bank. If you have no source of income other than your business, you do not look like a good risk to the bank, which knows that almost all small businesses fail within their first few years. So if they lend to you at all, it will be at a high rate to cover the risk.

Partnership

If you and at least one other person agree to work together, sharing profits and losses, you have a *partnership*. Under Canadian law, two people may be considered partners even in the absence of a formal contract.

A partner in a partnership may be a *general* partner, in which case he or she is responsible for all the debts of the partnership, or a *limited* partner, in which case their responsibility is limited to the amount of their original investment. At least one partner must be a general partner.

Forming a partnership multiplies the talent the firm can draw on, and multiplies its capital (though if none of the partners has any capital, this doesn't help much.) An established company may offer partnerships to

particularly promising employees, motivating them to stay by giving them a share in the equity.

On the other hand, partnerships can lead to disagreements. Once the partnership is formed, your partners are legally entitled to share in the profits, even if you've been doing all the work.

The Corporation

A corporation, or limited company, is a legal entity distinct from any of its employees or stockholders. It submits its own tax return and is taxed at the corporate rate.

Corporations are of two kinds, public and private. The difference is in whether the shares can be publically traded.

Once you decide to sell stock, you will probably need to recruit someone to market it for you. This would be an investment banking firm, and they will generally take a cut of the sale price to pay for their efforts -- how big a cut depends on how strong a bargaining position you have. If you are a big company, the banker may agree to *underwrite* your stock, that is, guarantee to buy all you have to sell.

There is no limit to how much stock you may decide to issue to yourself, in recognition of your contribution of talent to the corporation. However, you are required to provide an independent audit of the firm's accounts to stockholders. In the United States, the Securities and Exchange Commission oversees stock issues, and checks for misleading claims. (The Vancouver Stock Exchange is notorious for lax oversight.)

Tax Advantages and Disadvantages

Incorporating looks like a bad deal from the tax point of view -- before corporate profits reach your pocket, they get taxed twice, once at the corporate rate and once at your personal tax rate. Nevertheless, you can turn this to your advantage. If you are in a high tax bracket, your marginal tax rate may be higher than the corporate rate. And you don't pay any personal tax on your stocks, however much they increase in value, until you sell them. You are taxed on the proceeds from this sale at the capital gains tax rate, which may be lower than your income tax rate. Also, you can defer selling the stock until you have a year of low income -- possibly at retirement.

The advantages of incorporating include limiting your personal liability and acquiring capital. The disadvantages are that it costs money to incorporate, that you are obliged to disclose possibly sensitive company information in your annual report, and you risk losing control of the corporation to a takeover bid.

Accounting

The company needs to keep track of its internal cash flows and its state of financial health. This information must also be made available to potential stock purchasers, so they can make an informed decision. The two most important financial documents are the Income Statement and the Balance Sheet. Note the distinction between current assets -- cash, accounts receiveable, and inventory, which can be readily turned into cash -- and fixed assets, such as land and buildings. Similarly, we distinguish current liabilities, which are due this year, from long-term liabilities, which are due more than a year away.

Several diagnostic tests may then be applied to these data:

The *Current Ratio* is the ratio of current assets to current liabilities. The desirable level for its absolute value varies from one industry to another, but its year-to-year change indicates whether the business is getting into trouble.

Working Capital is the excess of current assets over current liabilities

The *acid-test ratio* is the ratio of cash and accounts receivable to current liabilities. The point of this test is that cash plus accounts receivable are immediately realizable as cash; inventory, the other item included in current assets, may be difficult to liquidate, and hence may give a misleading sense of security.

Lastly, the rate of return is an important diagnostic; but by this stage, we know all about that.

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