Chapter 3

Some fundamental early decisions

This chapter will help you decide whether to buy an existing business or sign up to a franchise, rather than starting from scratch. It will also examine the pros and cons of working from home and conclude by helping you decide the most suitable legal form for your business. Topics covered are:

- Buying an existing business
- Franchise
- To work from home or not to work from home?
- The most suitable legal form for your business
  - Sole trader
  - Limited company
  - A partnership
  - Limited Liability Partnership (LLP)
- Our personal experiences

Buying an existing business

Much of this book advises on starting a business from scratch, but there is of course the alternative of making the move into self-employment by buying an existing business. This may suit someone in a hurry and with capital, and there may be other reasons too. One of them could be that, so long as you do your homework and choose carefully, you will be getting something that you know works. It will have a good business model and deliver predictable, satisfactory results. On the other hand it may not be doing this and you might believe that you can do better. If it is not doing well, you should be able to get it cheaply and this may make it attractive.

There are a number of things that can go wrong. You will probably be buying goodwill and the benefits could turn out to be illusory. Some customers may not transfer their loyalty to you in the way that you expect, especially if they had a particular bond with the previous owner. This can apply to staff as well. Either or both might resent changes that you intend to make.

It is important to know why the present owner is selling and it might not be easy to find out, although the reason may seem obvious and indeed be obvious. Such things as death, illness and retirement come to mind, but regardless of what you are told there might be something known to the seller but not to you. This could be, for example, a forthcoming development in the trade that will make the business uncompetitive, or the impending arrival of a powerful competitor.

Businesses for sale are widely advertised in newspapers, suitable publications and websites. Two of the many useful websites are www.daltonbusiness.com and www.uk.businessesforsale.com. When you have located a serious prospect the next stage is to look at the premises, stock and assets (if any) and ask numerous questions. What these questions are will depend on the business and individual circumstances. You will certainly want to see several years accounts, if they exist. They may not be audited but you will probably take some comfort if they have been prepared by a reputable accountant.

You will almost certainly involve an accountant and a solicitor to advise you. This will add to the cost but it would very probably be a false economy not to do so. The accountant will advise on interpreting the accounts and suggest (if relevant) searching questions on such matters as stock valuation and the adequacy of the bad debt reserve. Do not forget that a person planning to sell a business has an obvious incentive to adopt the most favourable view on such matters. The solicitor will also suggest questions and may advise on such things as leases and staff employment contracts. It may seem tedious and could irritate the seller, but it is for your benefit.

How should a business be valued? This is an inevitable question and one to which it is impossible to give a definitive answer. Unless it is a forced sale (and arguably even then) a business is worth what a willing buyer is willing to pay to a willing seller. What it ought to be worth is not of major consequence. This is something that you must remember if you seek to sell a business at some time in the future. Having said that, the following are indications of two possible methods of valuation. You and your advisers must decide which one is most appropriate, or decide to reject both of them and proceed in a completely different way.

Asset-based method

As the name suggests, this method takes account of the value of the assets being acquired and it is obviously of most relevance when the assets are significant. You must decide whether it is realistic to value the assets at book value or whether some other basis should be adopted. If used in isolation, this method takes no account of goodwill and future profits.

Earnings-based method

This method uses a multiple of the net profits as the basis. It is usual to add back depreciation, interest, the salary or drawings of the owner and tax. The chosen multiplier is used and fixed assets added to the result. For example:

Annual profit after adding back depreciation, interest, the salary or drawings of the owner and tax	£30,000
Chosen multiplier	4
Fixed assets	£15,000

The valuation would be £120,000 (4 x £30,000) + £15,000 = £135,000. Put another way the valuation would be the value of the fixed assets plus four times the annual earnings. It is obviously important that the £30,000 figure be reliable, typical and sustainable. It could, for example, be the average of the last three years results. It may be unrealistically high if the owner has used creative accounting to make the last year's profit look good. There is another possibility that should perhaps in a few cases be considered. It is not unknown for owners or staff to surreptitiously (and illegally) extract cash from a business without putting it through the books. This has the effect of depressing the stated profits below the true figure. If this has been done, the business may be worth more than the formula would indicate.

After reaching a view on an acceptable valuation of the business the next step will be to negotiate with the seller. It is likely, but not certain, that the seller will be asking for a price higher than he or she is willing to accept, rather as a person selling a house may be willing to consider offers. This is a matter for negotiation and it is probable that your solicitor and accountant will make a valuable contribution. The seller will be receiving advice in the same way. Your advice will not be to agree the price, which has to be a matter for you, but to advise and help structure the deal fairly and to your advantage. For example, the contract may require the seller to give certain warranties, and part of the payment may be deferred and made conditional on projected profit figures being achieved.

Franchise

The British Franchise Association and many franchisors claim lustily that franchising can be very attractive, that the failure rate is less than for business start-ups in general and that bank finance may be more readily available than for business start-ups in general. All these claims can be true and a franchise may deserve serious consideration, though there can be problems that should not be overlooked.

There are more than 800 franchises available in the UK and you will certainly recognise some of the names. Prontaprint, Thorntons, McDonald's and Body Shop come readily to mind and there are many more. The investment required may be as much as several hundred thousand pounds for a major outlet for a very well known franchisor, but it can be less than £10,000 in some cases.

One advantage of a good and well-chosen franchise is that you become part of a proven operation that is known to work well, has high customer recognition and is very likely to deliver a satisfactory supply of sales leads and customers. The package gives you training, a helpline, stock (if appropriate), systems and much more. You pay a fee to join and an annual royalty that will probably be a percentage of your profit or turnover. You will probably get the exclusive right to operate in a defined territory.

One possible disadvantage is the converse of the advantages of the standard package. You will be required to strictly conform with the requirements of the franchise. You may have to wear a standard uniform and must set prices, buy stock, advertise, market your business etc as specified in the agreement. You will rapidly be reminded of this if, for example, you have a McDonald's franchise and decide that the ubiquitous logo would be more effective in purple rather than yellow. At best this may be irksome, even if it works well, and at worst it may stop you doing things that you correctly believe will help you improve your business. Something may work well in one part of the country but not in another. You should also remember that your exclusive territory will not protect you from competitors outside the franchise. For example, a McDonald's franchise will not be protected from a new outlet of Kentucky Fried Chicken.

It is probably worth getting information from the British Franchising Association (www.thebfa.org). It is the franchisors' body but you may well find it very useful. Another very useful source of information is the Approved Franchise Association (www.theafa.org.uk). Do talk to several franchisors and compare them. Do a lot of research and talk to a number of existing franchisees. Try to ensure that the franchisor is well-established, reputable and well-financed. You should be able to rely on them to deliver their side of the bargain in bad times as well as in good. It is strongly recommended that you use a lawyer with a special knowledge of franchises.

To work from home or not to work from home?

This is a key decision that must be made before commencing business, though a halfway house is starting from home with the intention or possibility of later moving to business premises. Of course for some the question does not arise because the nature of the business makes it very difficult or impossible to work from home. A shop obviously comes into this category and so may a manufacturing business or a business that requires a lot of storage space. It would also not suit a business that will make a lot of noise or otherwise be a nuisance to the neighbours, to say nothing of attracting the displeasure of the planning authorities.

On the other hand working from home is feasible for many venturing into self-employment, and technological advances are making it more and more common. This goes hand in hand with the trend for more employed people to work partly or wholly from home. Why then are commuter trains still so crowded? It is one of life’s great mysteries. Examples of people who successfully work from home are consultants and professional people such as accountants. It may be easier for people who work from home but are out a lot, such as electricians. The following are some of the advantages and disadvantages:

Advantages

- It will probably save a lot of money.
- It will save the time and money spent travelling to and from work.

- Some home expenses can legitimately be charged against the business. Details are given in Chapter 10.

Disadvantages

- It will reduce the living space available to you and your family.
- It may put a strain on family life.
- It may not give the professional image that you want to convey.
- It may be difficult to keep home life and family life separate.

So long as your home activities are not excessive it is unlikely that you will have to pay business rates. You must tell your insurance company that you are working from home as failure to do so could invalidate your house and contents policies. There will probably not be a problem but you must tell them. If members of the public will visit you at home, you should take out public liability insurance. You should tell your mortgage provider, if this is applicable. All these requirements are frequently disregarded and usually no harm results, but they should nevertheless all be done.

The following seven pieces of advice are designed to help you if you do decide to work from home. They are drawn from my experience and the experience of others, and are worth serious consideration.

1. You should try to have a separate office or work area. I realise that this may be difficult but it makes a big difference. It may be possible to work from a garage or shed, or even have a separate office or outside building specially built. If you have a very long memory indeed you may remember a television series called The Larkins starring David Kossoff. His American son-in-law was a

writer who, in an entertaining way, regularly screamed at the family because he could not work without distractions. This illustrates the need for a separate work area.

2. You must try to make friends and family realise that you are at work. They will think that you are available for socialising and errands, and distract you accordingly. You should tell them that interrupting you is the equivalent of interrupting you when you worked for an employer. If they would not have done it then, they should not do it now. In the case of family you might add that the money that you are earning is partly for their benefit. It will not be easy and you will have to keep doing it.
3. You should have a separate telephone and ensure that it is answered efficiently. Callers may be enchanted by a child answering a business call, but they might not.
4. If business visitors will come to your home, steps should be taken to make their experience as impressive as possible in the circumstances. It will not be good for business if visitors are frightened by a dog and distracted by a television blaring in the next room. For an occasional important visitor it might be worth hiring a meeting room or arranging to meet in an impressive hotel. A friend regularly meets clients over coffee and biscuits in five star London hotels. It is good for business, both he and the client enjoy it and the cost is tax-deductible.
5. You should decide a sensible division between work hours and non-work hours and try to keep to it.
6. Clients, customers and other business contacts should know what your working hours are and should be discouraged from contacting you outside them. Some still will of course. It helps having a

separate business telephone number and you can put a business-like recorded message on this when your working hours are over. It is probably what would happen if you worked for an employer, but you should not be so ruthless that you drive away trade. It might be a fine line.

7. If you have a separate office or work space, put reasonably good quality furniture in it, especially if you expect to spend a lot of time there. It will improve your life and probably your work too.

The most suitable legal form for your business

You could just start trading without giving any thought to the legal form that your business will take. This would make you a sole trader, which is very common and could be your best choice. Nevertheless, it is worth studying the various possibilities and considering the pros and cons of each. The following are the four most common options and are examined in detail.

Sole trader

This is the option taken by the majority of people who start a business. It has the merit of simplicity and the minimum of regulation, compliance and bureaucracy. You can in most cases just get going. It is important though that you notify HM Revenue and Customs within three months of starting, and register for VAT if your likely turnover is above the threshold or if it is in your interest to register voluntarily. Advice on this is given in Chapter 10. Although you can just start working it is very much in your interests to get the basics right – for example, having suitable stationery printed and organising a proper bookkeeping system. As a self-employed person your profits will be subject to income tax rather than corporation tax.

A significant disadvantage of being a sole trader is that you do not have the benefit of limited liability. This means that you are responsible for any losses and debts incurred by the business. This really does mean that your house and other assets are at risk, and that in the last resort you could be made bankrupt.

Limited company

A limited company is a legal entity that can sue and be sued in its own name, and it is distinct from its shareholders and directors who may or may not be the same people. As the name suggests it gives you the benefit of limited liability, and furthermore the liability can be limited to a very small amount. This gives you the considerable benefit of protecting your house and other personal assets if the business fails. If this happens, the amount that you have paid for your shares is lost but, assuming that the shares were fully paid, you have no further responsibility. This is, of course, in the absence of fraud. The amount of the share capital can be and often is, a nominal sum. 85 per cent of companies have an issued share capital of £100 or less. As a no doubt honourable person you might feel under a moral obligation to pay at least some of the creditors in the event of your business failing, but this is not a legal requirement. In practice limited liability might not be quite all that it seems. This is because banks, understandably, are likely to want security or personal guarantees before lending to a poorly financed company. Some suppliers might also ask for personal guarantees.

There is a certain cost and a certain amount of work in setting up a limited company, though less than is often supposed. You could register a new company at Companies House yourself, though this would almost certainly not be a good idea. Much better would be to buy an off the shelf company that has never traded from a company formation agent. This is likely to cost no more than £50 and you would get a 'bog standard' limited company with the name you want, yourself as director and a registered office address of your choosing. You could make any further changes yourself (to the articles for example) or the agent would do it for a fee. The website of the Association of Company Registration Agents is www.acra-uk.org and this gives a list and contact details of company registration agents who are members of it. Alternatively, for a larger, though probably not unreasonable charge, an accountant or solicitor would do the whole thing and give you exactly the company you want.

It is possible to have a truly one-person company. You can be the sole shareholder and sole director, and you do not have to have a company secretary. Subject to conditions and in the likely event that annual turnover is not more than £6,500,000, you do not have to have an audit. Unless you are well-informed there are risks in all this. It may be sensible to involve a professional such as an accountant or solicitor, perhaps as company secretary.

You have to send statutory accounts (usually annually) to Companies House and an annual return. Companies House makes no charge for the accounts but there is a filing fee of £14 for the annual return if it is submitted electronically. The charge is £40 if it is submitted on paper rather than electronically. You will probably have to pay to have your accounts prepared in the manner required for a limited company. Certain other documents may have to be filed at Companies House from time to time.

Having a limited company is a privilege and in return for that privilege you will be required to make a certain amount of information available to the public at Companies House. You no longer have to reveal the residential address of the directors, but other personal information must be given, date of birth and any former names for example. Your balance sheet and certain other information is available but, if it is a small company (up to £6,500,000 annual turnover subject to conditions) the profit figure does not have to be disclosed.

The company will pay corporation tax on its profits. You will pay income tax on the salary and dividends that you take from the company. There may be advantages in this because national insurance contributions are not payable on dividends, and also because you can time your salary and dividends. You can, for example, choose to smooth out good years and bad years, and perhaps avoid paying higher rate income tax in a good year. More details are given in Chapter 10.

There may be a further advantage in having a company. Many people think that a limited company has more status than a sole trader and some companies prefer to trade with companies. This really is extraordinary. Why should Roger Mason Limited, with limited liability and £100 share capital, be more respected than Mr Roger Mason, who is trading as a sole trader with unlimited liability? Nevertheless it is a common perception.

A Partnership

A general partnership has two or more partners acting together in a business capacity. They do not have to register the business (except with HM Revenue and Customs) and each partner pays income tax. The partnership can be structured in various ways. Perhaps all the partners work full-time in the business, but perhaps one is a sleeping partner who has provided funds but has little other involvement.

The personal relationships and the strengths and weaknesses of each partner are very important. Ideally the partners should get on well, all work hard, respect each other and have complementary strengths. For example, a person who is good with finance might form a good partnership with someone who is good at selling. Being cynical, unsuccessful partnerships can be bad for friendships, family relationships and even marriages.

It is not essential to have a formal partnership agreement, but it is strongly recommended. Some partners work informally sharing everything 50/50, which is fine until they fall out or something goes wrong. There should be a formal partnership agreement drawn up with legal advice. This may or may not be a long and detailed document, but it should cover such things as:

- How much capital does each partner put in?
- How are profits and losses divided?
- How are decisions made and what happens if the partners do not agree?
- How much work does each partner contribute?
- What happens when a partner wants to leave the partnership?

Each partner has joint and several personal liability for partnership debts, even if they were incurred by another partner. This should be cause for very serious thought.

Limited Liability Partnership (LLP)

A limited liability partnership has many of the features of a company, but it is a partnership with the flexibility that this confers. The partners pay income tax on their share of the profits. A major attraction is that, unlike a general partnership, the partners have limited liability, and are only liable for the amount that they have agreed to contribute if the partnership goes into insolvent liquidation.

A limited liability partnership must be registered at Companies House, and accounts and other information must be supplied to Companies House in the same way as a limited company.

Limited liability partnerships have their uses but limited companies are much more numerous. Most readers of this book are likely to prefer limited companies.

Our personal experiences

Neither my wife nor I have ever owned a franchise or bought an existing business. I have though several times advised on buying a business. On one occasion a colleague's wife asked for my advice when she was considering buying a shop. She had fallen in love with both the location and the products that it sold. I told her that it would have a detrimental effect on her family life, that the figures were horrific and that she would inevitably make a significant loss. She thanked me for the advice and bought it anyway. A year later she sold it because it was having a detrimental effect on her family life and had made a significant loss. I could say that this shows the soundness of my judgment, but my conclusion was so obvious that it would be wrong to make this claim. It would perhaps be fairer to admit a deficiency in my powers of persuasion.

Both my wife and I work from home and neither of us follows all of the advice in this chapter. I in particular disregard a lot of it. When I started I fixed my business hours, resolved to wear smart clothes in business hours, rigidly separated home life and business life and decided not to open Saturday's business post until Monday. All of this lasted about four days. I then abandoned it all and adopted the lifestyle that I have followed ever since.

I semi-work seven days a week and to a great extent mingle my business life with my family and social life. I take a lot of holidays and often take time out during the day, and I adopt different lifestyles from day to day. I am very disciplined when necessary but on other days I sometimes start work at 5.00 am and sometimes at 10.00 am. I often do relatively little in the day and work in the early morning and evening. Overall it adds up to a full commitment, possibly too full a commitment. It sounds a recipe for disaster but I enjoy it and it works very well for me. It would not be right for many other people, so perhaps you had better follow the advice in this chapter.