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M06 Basic Characteristics and Establishment of the Company, Start-up

Study material

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Contents

List of Figures

Introduction

The establishment of a new business is a process that has a significant impact on its future success. A new entrepreneur needs to prepare his business and gets over the relatively complicated process. This study mat to provide general information about it. The first chapter deals with the position of the business in the economy. The reader gains knowledge about an impact of a business environment, forms of business ownership, and basic information about start-ups. In the second part, the reader finds a description of the process of business establishment. The next chapter provides an introduction to financial management. It is a crucial issue for new entrepreneurs, especially for those, who do not have an education in economics. The last chapter describes business financing emphasizing new approaches suitable for new small and medium enterprises.

Keywords

- Business, Economic system, Start-up, Financial management, Venture capital, Crowdfunding.

Introduction to Business

Business is any commercial activity that earns money when goods or services are provided to customers. Goods are tangible items manufactured by businesses. Services are intangible offerings of businesses that can't be held, touched, or stored. Consumers consume goods and services to satisfy their needs. Consumers who buy goods and services from businesses are called customers. Customers aren't only consumers, but also other businesses, which also need to satisfy their needs. They need equipment, materials, etc.

Economic System and Business

Business isn't a closed entity without any relations. Business is a part of the economic system and interacts with its environment on daily basis. The economic system consists of several types of entities that affect the business. The first type of entities are other businesses, that can be suppliers, customers, competitors. Consumers are the second important group. They buy our products (goods and services), but they also provide a labour force which is extremely important in each business. The government, as a third important entity affects business in many areas, such as legal or political areas.

Figure 1: The Dynamic Business Environment
Source: Lawrence, 2018

The business environment can be divided into internal and external. The internal environment consists of owners, managers, workers, and customers. All of these is fully under the control of owners and managers. They choose suppliers, employees, products they sell and where they sell them. On the other hand, the external environment is beyond the control of management.

Business owners and managers must continuously study the environment and adapt their business accordingly. The structure of the external business environment is shown in Figure 1. One of the most important external influences is economic influences. Fluctuation in economic activity leads to business cycles that affect businesses and individuals in many ways. A growing economy causes a low unemployment rate and high income. It is necessary to consider other economic variables, like inflation, interest rates, and taxes which stimulate or curtail the level of economic activity. Supply and demand are forces that affect prices and the volume of sold products. The political climate, government activity, the types of laws, political stability are other forces that affect business because they make the general environment in which business operates. Demographic factors can affect business success because if there aren't enough potential customers in the target group of consumers, the business isn't able to make a profit. Therefore, it is necessary to study the demographic structure of the market and develop products that satisfy consumers' needs. Consumers' needs depend on their age, gender, education, location, etc. Social factors influence what, how, where and when people purchase products and services. They are often subjective, difficult to predict and depend on their lifestyle. New technologies stimulate economic growth. A successful product can lose its market share because of new technologies. Therefore, businesses must monitor new technologies and innovate their products to maintain their market share. In the current globalised world, business is affected not only by its home country but by the global economic environment, too. Many businesses sell their products in several countries, so they must consider the environment in all these countries to be able to react to changes in demand, politics, etc. The deterioration of the economic situation in one country can spread over the world and affect businesses in different countries.

Forms of Business Ownership

At the beginning of the own business, there is usually a good idea and some cash. But before someone starts his own business, it is necessary to answer some questions about business organisation. One of them is to run the business alone or in partnership. Both have advantages as well as disadvantages. A **sole proprietorship** has several **advantages**:

- Easy and inexpensive to form with few legal requirements suitable for small companies and start-ups,
- Profits all go to the owner which increases profitability,
- Direct control of the business without any consultations with someone else,
- In many cases freedom from government regulations,
- No special taxation, profits are taxed as personal income,
- Easy of dissolution, e.g., sell the business or close the business at any time.

All these advantages make sole proprietorship a suitable form for new business. But we can't forget about several **disadvantages** of that form of ownership:

- Unlimited liability, which means that the business owner is personally responsible for all debts the company incurs,

- Difficulty raising capital, a sole proprietor is viewed as high risk,
- Limited managerial expertise, the success of sole proprietorship depends on the skills and talent of the owner,
- Trouble finding qualified employees because sole proprietor cannot offer same pay and benefits as larger companies,
- Personal time commitment,
- Unstable business life, the life span of a sole proprietor can be uncertain because of his interest, health, retirement, etc.,
- Losses are the owner's responsibility.

A sole proprietor is often a temporary choice at the beginning of business life and as the business grows, the owner needs more capital, employees and therefore may decide to take in one or more partners.

A **partnership** is an association of two or more individuals who agree to operate a business together for profit. There are two types of partnership: general and limited. In the case of a general partnership, all partners share in the management and profit and each partner has also unlimited liability. A limited partnership has two types of partners: general partners and limited partners. General partners have unlimited liability and limited partners have limited liability, but they don't take part in day-to-day management. They help to finance business.

The main **advantages of partnerships** are:

- Ease of formation like a sole proprietor,
- Availability of capital, because more people mean more funds and less risk for outside lenders,
- Diversity of skills and expertise, partners can combine their skills and knowledge,
- Flexibility in their response to changes in a business environment,
- Usually, no special taxes,
- Relative freedom from government control.

There are also some **disadvantages of partnership**:

- Unlimited liability in case of general partners,
- Potential for conflicts between partners,
- Difficulties in profit sharing,
- Difficulties in exiting or dissolving a partnership.

When a business owner wants to limit his liability, the ideal solution is a **corporation**. A corporation is a legal entity subject to the laws of the state in which it is formed. A corporation can own assets, enter contracts. Unlike sole proprietorships and partnerships, a corporate's life is separate from its owner, who is not personally liable for its debts. The main **advantages** of the corporate are:

- Limited liability of its owner,
- Ease of transferring ownership without affecting the corporation,
- Unlimited life of the corporation, not affected by the owner's health, interest, etc.,
- Tax deductions, such as operating expenses which reduce its taxable income,
- Ease of attracting new capital.

Despite many advantages, there are three main **disadvantages** of the corporate business form:

- Double taxation of profits, corporate must pay income taxes and the dividend paid to stockholders are often taxed as personal income,
- Formation can be expensive,
- More government restrictions.

An interesting form of a business is **franchising**, which consists of a franchisor and a franchisee. The franchisor is a company supplying the product or service concept and the franchisee is an individual or a company selling that product or service in a certain geographic area. The franchisee pays a fee to the franchisor for his know-how. They conclude a contract, called a franchise agreement, which allows the franchisee to use the franchisor's business name, trademark, and logo. **Advantages** of franchising are:

- The ability for the franchisor to expand on new markets,
- The ability for the franchisee to use recognized name, product, and operating concept,
- Assistance and training for the franchisee from the franchisor,
- Financial assistance for franchisee.

Franchising also has some **disadvantages**:

- The franchisor has less control over its franchisees,
- Franchising can be costly for the franchisee because of fees paid to the franchisor,
- The franchisee loses operating freedom.

Start-up Definition

A well-known definition of a start-up is that it is an organisation built to search for a repeatable and scalable business model. That definition is also used by the European Start-up Monitor. The main idea of the start-up is to promote innovative products or services with a growth perspective. Start-ups are called “gazelle companies”, meaning growing young ventures that are built to create wealth. The Start-up concept is often associated with the business in the digital economy, but there are also other industries, such as medical technology or education, in which start-ups flourish.

The successability of start-ups is very low. Many start-ups fail in the very early stages and less than one-third of them turn into companies. There are several reasons for that, such as lack of finance, team management problems, lack of enough business knowledge, technology lack, etc.

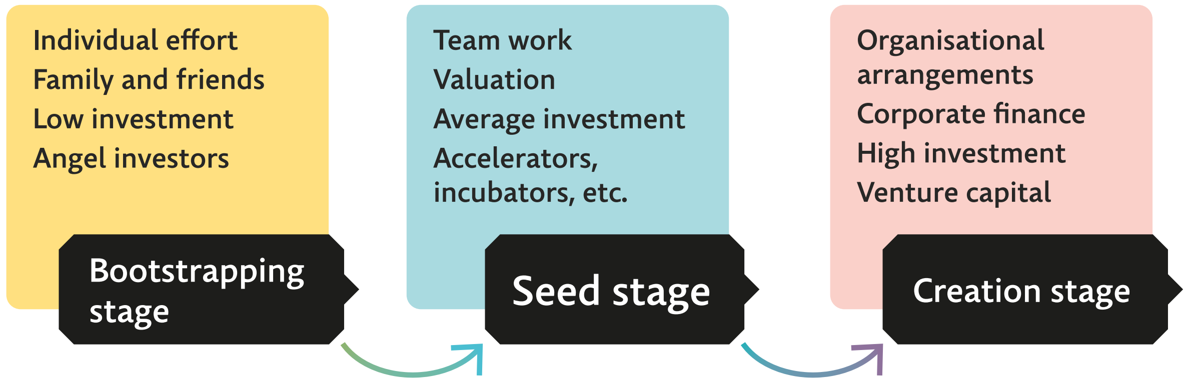

Figure 2: Lifecycle of start-ups
Source: Salamzadeh and Kesim, 2015

The lifecycle of a start-up consists of three steps, which are depicted in Figure 2. The first stage is called Bootstrapping stage, in which the entrepreneur initiates a set of activities to turn his idea into a profitable business. It is very risky for him because of the uncertainty of his future success. He works on the new venture idea, makes a team, uses personal funds, and asks family members and friends for their investment in the idea. The purpose of this stage is to position the venture for growth by demonstrating product feasibility, cash management capability, team building and management, and customer acceptance. In the second stage, called the Seed stage, the entrepreneur works in his team, develops prototypes, enters markets, seeks support mechanisms, such as accelerators and incubators. A great number of start-ups fail in this stage because they are not able to find support mechanisms for their business. Successful start-ups move to the third stage, called the Creation stage. In this stage, the company sells its product, enters markets, and hire first employees.

Start-ups must face several challenges. The first group of challenges are financial challenges. In the beginning, the entrepreneur usually does not have enough money to build his business. It is very risky for traditional lenders which do not want to lend him money. The second group of challenges are human resources. Start-ups normally start with one founder and some cofounders. Later, it needs more experts and for its success, it is necessary to find and persuade them about the possibility of success. This process is so critical to success and if the founder lacks enough knowledge of the field, the start-up might fail due to human resource management issues. The next important challenges are associated with support mechanisms, which play a significant role in the lifecycle of star-ups. These support mechanisms include angel investors, hatcheries, incubators, science and technology parks, accelerators, small business development centres, venture capitals, etc. The last group of challenges involves environmental elements, such as limitations in the markets, legal issues.

How to Set Up a Business

Nowadays, starting a business is not easy due to several factors, e.g., competition, the size of the market you are about to enter, legislation, etc. Before starting a business, it is advisable to think about what product or service you will provide. This issue can also be viewed from several perspectives:

- To provide products and services that are established on the market, but whose demand is high and is expected to be constant or growing in the future,
- To provide new products and services for which there is no market, but there is a precondition for rapid market creation (due to the lack of competition, you will act as a monopoly in the market),
- To provide products and services to the existing market, with the application of innovative elements, thus innovating the product and thus gaining a competitive advantage in the market.

In determining the strategy of which product to provide, the size of the market, respectively the size of foreign markets, as well as the production costs of the product in each country must be considered.

Once you have established a strategy for providing which goods, you need to consider the legislative aspect of the country in which you plan to start your business. The most important legislative aspects include:

- Business forms regulated by the relevant law,
- Requirements for choosing a particular business form,
- Tax system regulated by the relevant law,
- The complexity of the tax system,
- Other legislation affecting the administrative and business environment in each country.

Legal Forms

When choosing a form of business, there is recently the opportunity to choose from several forms of business, from self-employed (or known as sole-trader) to various forms of legal entities. However, what needs to be pointed out, especially in the region of Central and Eastern Europe, the freelancer is sometimes misinterpreted as an entrepreneur who does not have to have any form of business and therefore does not register with any official authority of that state. The business of a country is usually defined directly by law, which can generally be said to define business as a continuous activity conducted in the name of the person concerned (whether natural or legal), at its own risk, to make a profit. If an entrepreneur decides to do business in the form of a natural person, the manner of doing business of such a person is regulated by the Trade Licensing Act. If the entrepreneur decides to do business in the form of a legal entity, the method of doing business is regulated by the Commercial Code. It is possible to see a conflict in the perception of a natural person – a freelancer who, in the belief that he does not need to act following any legal regulation, commits violations of any law and is therefore not properly registered in any official authority. Only in such a case does the law of a country in Central and Eastern Europe allow you to be truly a so-called freelancer if you do not perform the activity consistently but only exceptionally. In this case, it can be considered as income from casual activities, which is not considered as business. Therefore, to start a business properly, it is necessary to familiarize yourself with the applicable legislation of the country in which you plan to start a business.

When doing **business as a natural person**, we can most often encounter the following forms:

- Self-employed person,
- Trade-based business,
- Businesses based on a special law.

Compared to the forms of business of a natural person, a **legal entity** offers a greater variety of forms of business:

- Limited Liability Company,
- Joint-stock company,
- Simple stock company,
- Public company,
- Limited partnership,
- Cooperative,
- Civic association, a non-profit organization doing business based on a trade license.

If you plan to do business on a larger scale, a more suitable option is a legal entity, as it takes potential customers more seriously, it provides a form of anonymity for the entrepreneur. At the same time, the person who owns the company is liable for the company's liabilities to a certain extent, it rarely guarantees the company's liabilities indefinitely.

When choosing a suitable form of the legal entity, it is of course necessary to evaluate the area in which you plan to start your business. In general, a limited liability company is the most widespread form of business, especially for small and medium-sized enterprises. Compared to other forms of legal entities, it is also advantageous in terms of the size of the input capital, the extent of liability for the company's liabilities, the time required to establish the company, the number of persons required to join the company (one person is sufficient), administrative burden, and so on.

Process of Starting Business

After determining the business plan, the accumulation of initial capital, the choice of form of business must be registered with the relevant official authorities. For the most part, it can be assessed that in the region of Central and Eastern Europe, a natural person (so-called "sole proprietor" or "self-employed") – entrepreneur registers at the district office, where the office in question issues him a certificate of business. Subsequently, the natural person – entrepreneur registers with the relevant tax authority, to comply with tax regulations.

From the point of view of a legal entity, the registration procedure is similar. In the first step, he needs to receive a certificate of business from the district office, where the district court then enters the company in the commercial register, thus officially establishing the company. A second step is also to register with the relevant tax authority, to comply with tax regulations.

Currently, when using a bank account for business purposes, it is recommended to set up a separate bank account with an individual, which will be used only for business purposes. In the case of a legal person, it should be noted that for business activities and related banking operations, the operations in question must be carried out exclusively from a bank account held in the name of the company and not in the name of a natural person authorized to act on behalf of the company. This is a serious problem, especially for small businesses that do not separate private finance from corporate finance.

Legal Obligations and Registrations

The definition of sole proprietor according to the legislation is that it is a continuous activity, operated independently, on its name, under its responsibility, to make a profit under the conditions laid down by law. There are **three conditions of a sole proprietor**:

- Reaching 18 years of age,
- Legal capacity,
- Correctness.

Registrations of the sole proprietor differ among countries, but we can generalise them into the following steps:

- Founding and registering the sole proprietor to get the identification number, the trade license,
- Health insurance registration,
- Social insurance registration,
- Registration on the Tax Office to obtain the tax identification number.

The process of registration of a Limited Liability Company is usually like that in the case of the sole proprietor.

Financial Management

Financial management deals with the financial aspects of the enterprise. Its main content is organising and managing financial processes. All decisions and processes reflect in costs and revenues. Financial management significantly depends on the enterprise's aims. In the past, making a profit was considered to be the main goal of the company. In the present, there are two concepts. The first concept is called the ownership principle, which considers the main goal of the company to increase the market value of the company for the owners. The second concept is called the participatory principle. Based on that concept, the main goal of the company is to maximize the market value of the company, which respects the constraints arising from the interests of other business participants.

It is necessary to explain the concept of the market value of the company. The market value is a real value (fair value) for which the company can be sold or exchanged. It can be different from the book value, which results from accounting as a difference between the credit and debit sides.

Achieving the main financial goal is also ensured by formulating partial goals, there are three the most common used:

- Rentability, ability to make a profit,
- Solvency and liquidity as the ability to ensure timely payment of due liabilities,
- Stability, ability to ensure required rentability, solvency and liquidity under ever-changing conditions.

Financial management consists of four main parts:

- Financial planning,
- Financial decisions,
- Organisation of financial activities,
- Financial analysis and control.

The main task of financial planning is to formulate financial goals following the main goal of the company. These financial goals depend on estimated sales and production volume. Financial decision consists of strategical decisions related to the company's environment and operational decisions related to the company. Financial decisions are based on risk quantification. The organisation of financial activities ensures that taken financial decisions to be applied. Financial analysis and financial control aim to evaluate how financial goals are reached and to estimate financial health in the future.

The main task of financial management is to ensure that the main goal of business and financial activities is achieved. The financial management must perform partial tasks:

- Raise the necessary capital,
- Ensure the efficient allocation and use of capital,
- Divide financial results and record and analyse financial processes.

Importance of Economic Mindset for an Entrepreneur

Most new entrepreneurs think usually about their profit when starting their own business, but the importance of a business is much more complex. Entrepreneurs affect the economy and society in many ways. The first important impact is **boosting economic growth** by introducing innovative technologies, products, and services. Entrepreneurs who bring innovations to the market offer a key value-generating contribution to economic progress. The second impact of entrepreneurs is an **increase in competition**. By establishing new businesses, entrepreneurs intensify competition for existing businesses, which leads to lower prices and greater products. Entrepreneurs need a labour force to make products or provide services that have **a positive effect on employment**. Employees are paid a wage, which increases their disposable income. That fact leads to their higher consumption, increase in their quality of life and in general in causes **economic growth**. New businesses bring new technologies, and they can produce more products or services using fewer inputs (labour, capital). Therefore, they **increase productivity**. To generalise, we can say that new entrepreneurs **encourage structural changes**, which means that old industries without the ability to adapt to new conditions are pushed out of the market.

Financial Basics for Business

In that part, the most important financial terms are defined. An amount invested by the owner is called **capital**. It is usually invested at the beginning when a new business is established but also can be invested later, e.g., when the business grows. The **assets** denote all resources used in the business to generate future income. Assets are divided into long-term assets, such as real estate, machinery, licences, etc., and short-term assets, such as supplies (materials, goods, products), cash, etc. Assets are financed from own sources (capital from owners, profit from previous periods) or from external sources, called liabilities. **Liability** is the amount a company owes, such as loans, mortgages, bonds, etc. **Revenues** are the sales plus any other income received from sources such as interest, dividends, and rents. **Costs** are monetary values of consumption of a company's production factors associated with its business activities. They arise at the time of consumption. It is necessary to distinguish between costs and expenses. **Expenses** express the reduction in cash, and they arise at the time of payment. There are two main types of classification of costs.

The first cost classification is by nature:

- Material cost, costs of material used to produce a product or service,
- Labour cost, includes salaries and wages paid to employees,
- Expenses, there are other than material or labour costs.

The second cost classification is about the cost centre:

- Direct cost, cost associated with a unit of operation,
- Indirect cost, not traceable to any individual product.

Financial statements are the most important source of information about the company. A **balance sheet** lists all the assets of a business and all its financial resources at a given point in time. The first group of assets are fixed assets, which are divided into tangible and intangible assets. **Fixed assets** are those, which are not destroyed during the production cycle. They retain some value denoted as depreciation or amortisation. **Tangible assets** are lands, buildings, machinery, etc., **intangible assets** are, e.g., brands, patents, licences, etc. **Current assets** are assets that tend to "turn over" during the production cycle, belong there, e.g., inventories, receivables, marketable securities, etc. **Financial resources** consist of capital provided by shareholders, plus retained earnings, so-called **shareholders' equity**; and **liabilities**, which are borrowings of any kind that the company may have arranged. Another classification of financial resources is long-term and short-term resources. Long-term capital consists of shareholders' equity and long-term debt. Short-term resources are known as current liabilities. The structure of the balance sheet is presented in Table 1.

Tangible fixed assets	Shareholders' equity
Intangible fixed assets	Long-term debt
Current assets	Net working capital
	Current liabilities

Table 1: The Balance Sheet model of the firm

Source: Lawrence, 2018

A company's assets and resources must be exactly equal. This is the fundamental principle of double-entry accounting. When an item is purchased, it is either capitalised or expensed. If it is capitalised, it will appear on the asset side of the balance sheet, and, if expensed, it will lead to a reduction in earnings and thus shareholders' equity. The double-entry for this purchase is either a reduction in cash (i.e., a decrease in an asset) or a commitment (i.e., a liability) to the vendor (i.e., an increase in a liability). According to the algebra of accounting, assets, and resources (equity and liabilities) always carry the opposite sign, so the equilibrium of the balance sheet is always maintained.

In general, long-term resources should be used to finance fixed assets and short-term resources to finance current assets. That equality is difficult to achieve in practice, which is why we encounter two situations. The first situation is if long-term resources are greater than fixed assets, which means that part of the long-term resources is used to finance current assets. That part of the long-term capital is called net working capital. It is more appropriate for the company to use long-term resources to finance current assets than to use short-term resources to finance fixed assets. It is because short-term capital will be due earlier than fixed assets can earn money.

The second important financial statement is the income statement. The income statement provides an overview of revenues, expenses, corporate income tax and net income (or net loss).

The final information in an income statement is the net profit (or net income) or the net loss. It is calculated by subtracting all expenses from revenues. If revenues are more than expenses, the result is a net profit. If expenses exceed revenues, it results in a net loss. Several steps are involved in finding net profit or loss. First, the cost of goods sold is deducted from net sales to get the gross profit. Then total operating expenses are subtracted from gross profit to get the net profit before taxes. Finally, income taxes are deducted to get the net profit. It is very important to recognize that profit does not represent cash. The income statement is a summary of the firm's operating results during some period. It does not present the firm's actual cash flows during the period.

Cost Calculations, Cash Flow and Taxes

Many product-based companies use cost per unit calculation. In the case of service-based companies, it is used rarely. Cost per unit expresses how much money a company spends on producing one unit of the product. It gives information on how successful a company is. To calculate costs per unit, it is necessary to determine fixed and variable costs and to know the volume of production. The formula for cost per unit is given by equation (1).

$$Cost\ per\ Unit = \frac{Total\ fixed\ costs + Total\ variable\ cost}{Total\ units\ produced} \tag{1}$$

Cost per unit can help to decide about the product price. That approach is called cost-based pricing. As its name says, it uses costs calculation to set the price of the product. A profit percentage or fixed profit figure is added to the cost of an item, which results in the price at which it will be sold. There are several methods of cost-based pricing. The most used is cost-plus pricing. A fixed percentage of the expected return is added to the total cost of goods sold. This percentage combines with the total expenses associated with producing, storing, distributing, or selling products and give an appropriate selling price. Cost-plus pricing is calculated by the formula (2).

$$Price = cost\ per\ unit + expected\ \%\ of\ return \tag{2}$$

The main advantage of cost-based pricing is that a company can be assured of always covering production costs and generating profit. It can be used for new products when the market price is not yet available. The main disadvantage of that method is that it results in the price is different from the price suitable for the market. The price given by the cost-based pricing method can be too high or too low. The second disadvantage is that this method does not force a company to decrease its costs. The problem may occur even when unplanned expenses appear.

In general, cash flow is the amount of cash that comes in and goes out of a company, e.g., everyday purchases, payment of a salary, automatic transfers, loan repayments or the receipt of bond coupons. All these flows are presented in the cash flow statement. Cash flows can be classified as one of the following processes:

- Activities that form part of the industrial and commercial life of a company:
  - Operating cycle,
  - Investment cycle.
- Financing activities to fund these cycles:
  - The debt cycle,
  - The equity cycle.

The simplified cash flow statement is presented in Table 2. It consists of operating cash flow, investing cash flow and financing cash flow. Operating cash flow describes money flows involved directly with the production and sale of goods from ordinary operations. Investing cash flow reports how much cash has been generated or spent from various investment-related activities in a specific period. Financing cash flow shows the net flows of cash that are used to fund the company and its capital. Financing activities include transactions involving issuing debt, equity, and paying dividends.

	Cash flow statement	2022	2021
	EBITDA		
	Change in inventory		
	Change in account receivables		
	Change in account payables		
	Change in fiscal and social debts		
	Financial items (excl. interests)		
	Exceptional items		
	Gross operating cash flow		
	Interest paid on borrowings		
	Corporation tax		
	Net operating cash flow		
	Acq. Or fixed assets		
	Disposals of fixed assets		
	Grants		
	Investments in financial assets		
	Disposals of financial assets		
	Investing cash flow		
	New borrowings		
	Repayments of borrowings		
	Capital raise		
	Dividend		
	Financing cash flow		
	Change in cash		
	Cash position – at the beginning		
	Change in cash		
	Cash position – at the end		

Table 2: Simplified cash flow statement

Source: Vernimmen, 2005

Positive cash flow means that the company's inflows are higher than outflows, which means that the company's liquid assets are increasing, and the company will be able to pay its liabilities.

Corporate Income Tax, or corporation tax, is a direct tax levied on the profits of a company, specifically applicable to the profits earned by companies considered separate legal entities from the individuals that own them. It is mostly levied at the national level, but it also has international implications. To avoid double taxation of the same profits in different countries, governments have been responding with bilateral or multilateral policies to allocate the taxation of these profits between themselves. From the economic point of view, there has been significant discussion about who really pays corporate income tax. Are they shareholders, employees, customers, or anybody else? As in other areas of the economy, there is no agreement among economists.

Calculating **corporate income tax** is often complex, varies from country to country, changes regularly over time, with a wide range of statutory rates applied. In general, the base for calculating corporate income tax is profit. Subsequently, profit is adjusted by countable and deductible items. **Countable items** are expenses that must be counted to the profit because they are not tax-deductible expenses. There belongs, e.g., representation expenses, catering costs, gifts to business partners, assets used for private purposes, etc. These items increased a tax base. An example of **deductible items** can be a difference between tax depreciation and accounting depreciation. If accounting depreciation is lower than tax depreciation, this difference is a deductible item, which means, it reduces the tax base.

Basics of Financial Analysis

In general, **financial analysis** is an analysis of economic activity, where we can consider money and time. Analysis can be realised at the micro-level (e.g., company) or macro-level (e.g., sector). Based on the available data, we recognise internal and external financial analysis. **The external financial analysis** uses published data and **internal financial analysis** is based on internal, not published data. Financial analysis studies the financial situation in the company. It enables a comprehensive assessment of the level of financial management, market success, efficiency, rentability, external factors, and estimate future development based on the historical data.

Based on the time orientation, financial analysis is divided into ex-post analysis and ex-ante analysis. **The ex-post analysis** explains the current financial and economic situation using historical data. The aim of it is to formulate suggestions for the future. **The ex-ante analysis** aims to predict future financial situations using data from the past.

Information from the financial analysis can be used by internal and external users. **Internal users** are users from within the company, such as management and employees. **External users** are banks, creditors, investors, government, business partners, etc.

The main goal of the financial analysis is to give the most realistic view of the financial situation of the company. It identifies the strengths and weaknesses of the company. There are six functions of financial analysis:

- Analytical and evaluative – analyses and evaluates company's financial situation,
- Qualifying – explains processes and events in numbers,
- Cognitive – allows knowing the financial situation,
- Informative – is the source of information for internal and external users,
- Control – provides information for control mechanisms,
- Developing – allows improving processes.

The financial analysis consists of three steps:

- Preparation of the financial analysis,

- Performing the financial analysis,
- Use of the outputs of the financial analysis.

It is necessary to prepare the financial analysis in detail. Firstly, the aim of the financial analysis must be determined. It means, what the reason for the financial analysis is, who will the outcome of the financial analysis use. Then, the timetable of the financial analysis should be set. A very important part of the preparation is to select methods and indicators. The second step of the financial analysis is its realisation, which means data processing, calculating selected indicators and interpreting results. In the last step, measures should be taken based on the results.

The methods of financial analysis are divided according to the following criteria:

- The nature of the information sources:
    - Fundamental analysis – is based on the data from financial statements and studies relations between variables,
    - Technical analysis – uses mathematical and statistical methods,
- The complexity of algorithmization:
    - Qualitative analysis – uses knowledge of a qualified expert,
    - Quantitative analysis – based on the calculations,
- According to the theoretical and methodological basis:
    - Basic methods – analysis of status indicators, differential indicators, flow indicators, ratio analysis,
    - Advanced methods – statistical tests, correlation analysis, regression analysis, discrimination analysis.

Financial ratios are mostly used indicators of financial analysis. They allow getting a quick overview of the main financial characteristics of the company and comparing it to other companies. It is possible to use them to analyse time series and they are often used as inputs in sophisticated mathematical models. To achieve reliable results, it is necessary to combine financial ratios using knowledge about the company's processes and the company's environment.

Financial ratios can be divided into five groups:

- Short-term solvency,
- Activity,
- Financial leverage,
- Profitability,
- Value.

Ratios of short-term solvency measure the company's ability to meet recurring financial obligations (that is, to pay its bills). To the extent that a company has sufficient cash flow, it can avoid defaulting on its financial obligations and thus avoid financial distress. Liquidity measures short-term solvency and is often associated with networking capital, the difference between current assets and current liabilities. Recall that current liabilities are debts due within one year from the date of the balance sheet. One source from which to pay these debts is current assets, therefore the current ratio should be monitored. The **current ratio** is a liquidity ratio that measures a company's ability to pay short-term obligations or those due within one year. The current ratio is calculated by equation (3).

$$Current\ ratio = \frac{Total\ current\ assets}{Total\ current\ liabilities} \tag{3}$$

Total current assets are all the assets of a company that are expected to be conveniently sold, consumed, used, or exhausted through standard business operations with one year. There are also called short-term assets. Total current liabilities are a company's short-term financial obligations that are due within one year or a normal operating cycle. A ratio under 1.00 indicates that the company's debts due in a year or less are greater than its current assets expected to be converted to cash within a year or less. A current ratio of less than 1.00 may seem alarming, although different situations can negatively affect the current ratio in a solid company. The current ratio can be also too high, which is also undesirable because the company has too much money which is not involved in the business process.

The **quick ratio** measures the company's ability to pay short-term liabilities by assets that are quickly convertible into cash, called quick assets. It is expressed by equation (4). Inventories are the least liquid current assets and are not a part of quick assets.

$$Quick\ ratio = \frac{Quick\ assets}{Total\ current\ liabilities} \tag{4}$$

A very short-term look at solvency is given by the **cash ratio**, which takes into consideration only cash. The cash ratio is calculated by equation (5).

$$Cash\ ratio = \frac{Cash}{Total\ current\ liabilitie} \tag{5}$$

Activity ratios are constructed to measure how effectively the company's assets are being managed. The **total asset turnover** ratio is determined by dividing total operating revenues for the accounting period by the average of total assets. Operating revenues are the total cash inflow from the company's primary income-generating activity. The total assets turnover is given by equation (6).

$$Total\ assets\ turnover = \frac{Total\ operating\ revenues}{Average\ total\ assets} \tag{6}$$

Average total assets are calculated as an average of total assets at the beginning of the year and the end of the year. If the total asset turnover ratio is high, the company is presumably using its assets effectively in generating sales. If the ratio is low, the company is not using its assets up to their capacity and must either increase sales or dispose of some of the assets. The total asset turnover ratio differs across industries.

Financial leverage measures whether a company relies on debt financing rather than equity. Measures of financial leverage are tools in determining the probability that the company will default on its debt contracts. The more debt a company has, the more likely it is that the company will become unable to fulfil its contractual obligations. In other words, too much debt can lead to a higher probability of insolvency and financial distress. On the positive side, debt is an important form of financing and provides a significant tax advantage because interest payments are tax-deductible.

The **debt ratio** is calculated by dividing total debt by total assets. We can also express it as the debt-to-equity ratio and the equity multiplier (that is, total assets divided by equity). Debt ratios provide information about the protection of creditors from insolvency and the ability of the company to obtain additional financing for potentially attractive investment opportunities.

The **interest coverage** ratio is calculated by dividing earnings (before interest and taxes) by interest. This ratio emphasizes the ability of the company to generate enough income to cover interest expenses. A large debt burden is a problem only if the company's cash flow is insufficient to make the required debt service payments, which is related to the uncertainty of future cash flows. A company with predictable cash flow has more debt capacity than a company with highly uncertain cash flows.

As mentioned above, a problem with the interest coverage ratio is that it does not measure the cash available to pay interest. Non-cash items like depreciation and amortization have been deducted. Accordingly, depreciation and amortization are added back to arrive at EBITDA (earnings before interest, tax, depreciation, and amortization). The **cash coverage ratio** resolves this problem and is calculated by equation (7).

$$Cash\ coverage = \frac{BIT+(Depreciation+Amortisation)}{Interest\ expense} \tag{7}$$

Profitability is one of the most difficult attributes of a company to measure. In a general, accounting profit is the difference between revenues and costs. Unfortunately, it is difficult to know when a company is profitable. For example, all new products require large start-up costs and, therefore, produce low initial profits. Thus, current profits can be a poor reflection of true future profitability. **Profit margin** is computed by dividing profits by total operating revenue. It expresses profit as a percentage of total operating revenue. The most important margin measure is the net profit margin. In general, profit margins reflect the company's ability to produce a product or service at a low cost or to sell it at a high price. Profit margin is not a direct measure of profitability because it is based on total operating revenue, not on the investment made in assets by the firm or the equity investors.

One common measure of managerial performance is the ratio of income to average total assets, both before tax and after-tax called the **return on assets**.

The return on equity (ROE) ratio is defined as net income after interest and taxes divided by average common shareholders' equity.

The simplest way to set a company's value is to use **the market price** of its shares. It is usually possible only for companies with shares traded on the stock exchange. In an efficient stock market, market prices reflect all relevant facts about the company, thus revealing the true value of the company's underlying assets. One of the most popular indicators is the **price-earnings ratio (P/E)**, which is the ratio of the market price for a share to its current annual earnings per share. The value of the company can be also expressed as **dividend yield**, which is given as a ratio of the dividend per share to the market price for the share.

New Approaches to Enterprise Financing

As it was mentioned in the previous chapters, gaining enough money is crucial for business success. For the entrepreneur, it is necessary to set optimal capital structure to secure business growth and financial stability. There exist several sources to finance the business. Most starting entrepreneurs look for traditional sources, such as their capital or traditional bank loans and other loans. Nowadays, he can use modern new approaches which can help him to start his business.

Traditional Debt Finance

Traditional debt finance is the most common source of external finance for many small and medium enterprises (SMEs). A straight debt instrument is an unconditional claim on the borrower, who must pay a specified amount of interest to the creditor at fixed intervals, regardless of the financial conditions of the company or the return on the investment. The interest rate may be fixed or adjusted periodically according to a reference rate.

The literature distinguishes **transaction lending**, based primarily on "hard" quantitative data, and relationship lending, largely based on "soft" qualitative information. When transaction landing uses financial statements on the side of the borrower, it is called **financial statement lending** and is based on the strength of the borrower's financial position. The second type of transaction lending is **small business credit scoring**, which is based on the personal history of the owner. **Relationship lending** gathers information through contacts with the enterprise, the entrepreneur, its banking relationship, including loans, deposits, and other financial products.

For the lending bank, there are specific challenges, which result from asymmetric information. Asymmetric information is a greater problem in the case of SMEs than in larger companies. The financial statements of SMEs are not usually audited, and they have no obligation to make public disclosure of their financial reports. Other problems for banks are associated with the possibility that loans may be used in other ways than those for which it was intended.

The solution can be assets-based finance, which includes asset-based lending, factoring, leasing, etc. Unlike traditional debt financing, a company obtain funds based on the value of specific assets, rather than on its credit standing. The company can gain money faster and under more flexible terms. That method is suitable for companies with a lack of credit history.

Venture Capital

Venture capital belongs to private equity financing, which provides capital to the private company whose shares are not freely tradable in any public stock market. In the case of private equity, investors participate fully in the entrepreneurial risk of the business. Compared to other forms of external finance, the investor accepts more risk and expects a higher return. Investors provide capital over a medium to long-term horizon, usually 3 – 10 years. The investor's objective is to make a profit by "exiting" once the firm increased its share value. "Exit" can be realised by selling investors' shares or buying back them by the other shareholders.

Private equity is divided into venture capital and other private equity. **Venture capital** is targeted at new and early-stage companies. In the case of venture capital, investors are usually pension funds, insurance companies, hedge funds, and wealthy individuals. These investors aim for the opportunity to earn a high rate of return. There are also funds specialising in venture capital. These funds can be private or public. Public funds aim to support research, development, and innovation; therefore, they fund new innovative businesses. These funds are financed from public finance and profit from previous investments.

Crowdfunding

Crowdfunding enables to obtain external finance from a large audience, rather than a small group of specialised investors, such as banks, business angels or venture capitalists. In that case, everyone invests a small amount of the funding requested. Crowdfunding is usually realised by the Internet. The entrepreneur describes his business activities in detail and informs about the requested amount and funding conditions. The main innovation of this method is that entrepreneur seeks funding directly from a large audience.

Crowdfunding is not only about financing. It can share information with the large public about the business plan, new product or service, etc. It can be useful when obtaining feedback to improve the product or service. Crowdfunding can be also helpful in the process of future commercialisation. Types of crowdfunding depend on the internet platform, type of company, etc. In general, we recognise five types of crowdfunding:

- Donations, contributors donate funds,
- Reward or sponsorship, contributors receive a pre-defined reward, e.g., a small token of appreciation,
- Pre-selling or pre-ordering, contributors help to produce some product and then receive an early version of the product or some discount,
- Lending, investors lend some amount and receive interest,
- Equity, a privately held company offers securities to the public and investors obtain a share in the business.

In recent years, crowdfunding has been the object of important regulatory attention. The regulatory efforts have aimed to ease the development of this financing channel while addressing concerns about transparency and the protection of investors. Several EU member states provide a clear framework for the crowdfunding industry. On the other hand, there are countries, in which equity crowdfunding is permitted, e.g., the United Kingdom.

Conclusion

The establishment of a new business is a complex process that requires an entrepreneur's knowledge of different areas, such as economy, law, marketing, etc. For the future success of the business, a new inexperienced entrepreneur needs to use all possible support mechanisms to gain this necessary knowledge. The establishment of a business is risky, and many new businesses fail during that process. This study material provided a brief introduction to the process of business establishment.

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