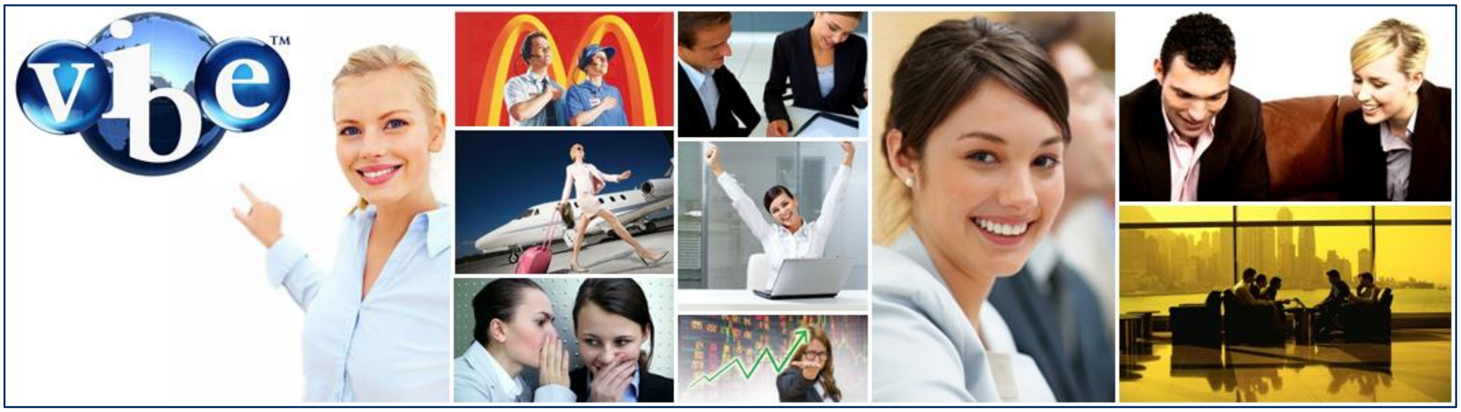
IB Business Management

1.2 Types of Organisation – Summary Notes



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Businesses can be formed and trade under many different legal identities. For example two friends could form a partnership or a private limited liability company, depending on which type of organisational structure best suits them. Each of the different legal structures the organisation could be formed and trade under has different qualities and different advantages and disadvantages.

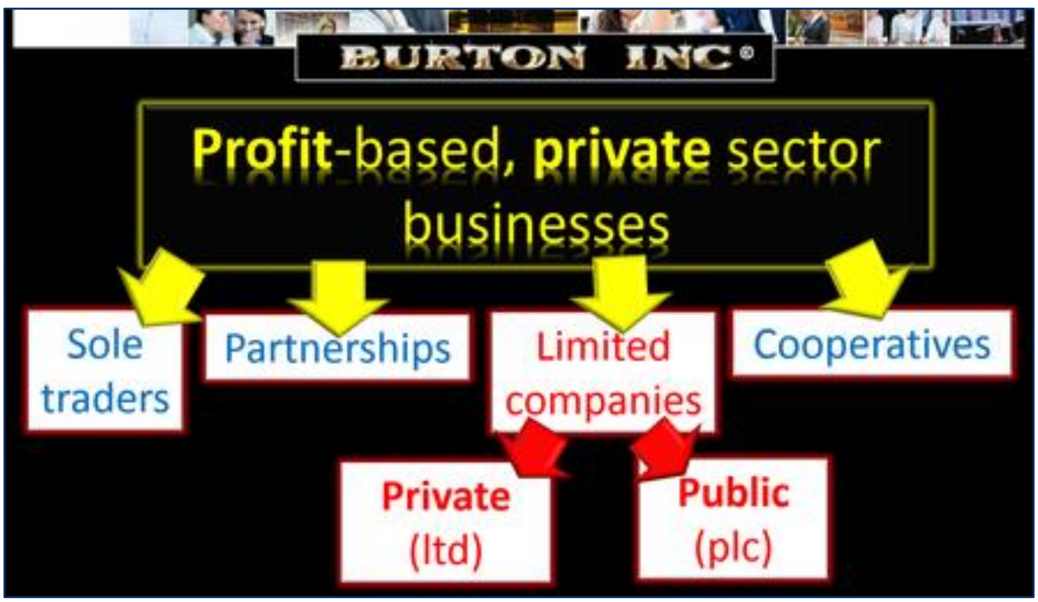

Figure 1: The main types of legal structures for profit-based, private-sector business organisations

TYPES OF ORGANISATIONS – THE DIFFERENT TYPES OF LEGAL STRUCTURES

	Sole trader
Description	A sole trader is an individual who is the owner of this or her own business. The owner also runs and controls the business and is the sole person held responsible for its success or failure.

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Ownership and Control	Sole proprietorships are the most common type of business ownership. Examples include self-employed painters and decorators, plumbers, mechanics, restaurateurs and freelance photographers.
Management	Sole traders may work alone or they may employ other people to help run business.
Capital	Sole proprietorships are usually small family-run businesses that can be set up with relatively little capital. Start-up capital for a sole trader is usually obtained from personal savings and borrowings.
Sources of Finance	Limited sources of finance. Ti may be difficult to raise finance to establish the business. Sole traders may find it difficult to secure any funds beyond their personal savings.
Legal status	One important legal point about sole traders is that the business is unincorporated. This means that the owner is legally as the business – he or she is treated as a single entity.
Liability of owners	Unlimited liabilities. This means that there is no limit to the amount of debt that a sole trader is legally responsible to pay if the business fails.
Advantages	Few legal formalities exist, meaning that sole proprietorships are quiet easy to set up The sole trader is the only owner and therefore receives all of the profits made by business. Being your own boss can also bring about its advantages. These include not having to take orders from anyone else, flexibility in working practices such as being to dictate your own working hours. Sole traders can also provide personalized services to their customers. Sole traders enjoy privacy as they do not have to make their financial records available to the public or other interested parties.
Disadvantages	**A sole trader has unlimited liability** **Limited sources of finance** **High risks**- sole proprietorships have the largest risk of business failure. Even the successful ones usually face intense competition due to the vast number of sole traders that exist. **Workload and stress**- Sole traders largely depend upon the abilities and commitment of the owner. Sole traders more often than not have to do their own accounts, marketing, human resources and management and operation management. **Lack of continuity**- the running of a business may be jeopardized if the owner is not present.

	Higher costs of production- A sole trader is not able to exploit the benefits of large scale production.
Formation Procedures	No legal procedures

	Partnerships
Description	Two or more partners carrying on a business in common with a view to make a profit (e.g. architects, engineers).
Ownership and Control	It is owned by two or more people, and up to 20 (this may vary from country to country).
Management	This is managed by the partners.
Capital	Capital from partners (Partners can pool funds together to make more funds).
Sources of Finance	▪ Savings ▪ Loans ▪ Retained profits. ▪ Also from partners that do not actively take part in the running of the business (silent partners or sleeping partners)
Legal status	A legal contract is drawn up known as a deed of partnership or a partnership deed (partnership agreement). This likely to include: ▪ The amount finance contributed per person ▪ The roles, obligations and responsibilities of each partner ▪ How profit or losses will be shared ▪ Conditions for new partners ▪ Clauses for the withdrawal of a partner ▪ And procedures for ending partnership.

Liability of owners	▪ At least one partner must have unlimited liability, as partnerships are unincorporated business. ▪ Unlimited liability is where the owners are personally liable for the business departments. ▪ Normally everyone has a share of the liability (jointly and severally liable). ▪ Sleeping partners have limited liability.
Advantages	▪ More financial strength because of more investors in business. ▪ They benefit from division of labour and specialisation. ▪ Partnerships do not have to publicise their financial records.
Disadvantages	▪ Partners have unlimited liability. ▪ Decision making in partnerships is likely to longer. ▪ A lack of continuity may still exist if a partner dies or leaves the firm ▪ There must be a huge amount of mutual trust within a partnership. ▪ Many partnerships may still face difficulties in raising capital.
Formation Procedures	▪ Introduction of cash and/or assets by partnerships. ▪ Creation of a Partnership Agreement-states terms by which partnership will run, e.g. profit distribution.

COMPANIES

- Companies are businesses that are owned by their shareholders.
- Companies are incorporated businesses meaning that there is a legal difference between owners of the company (the shareholders) and the business itself.
- Companies have **limited liability** which means that the business owners (shareholders) are not personally liable for business debts. Therefore the owners will not have to sacrifice their personal assets if the business is unable to repay all its liabilities. Often companies are called limited companies to clarify the fact that it has limited liability
- A board of directors is elected by shareholders to run the company on their behalf. They are elected because of skills and expertise and are in charge of the day to day operations of the business.
- The more shares a person has in a business, the more influence they have in business decisions as each share counts for one vote.

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There are two types of limited companies:

A Private Limited Company is a company that can only raise share capital from friends and family, not the general public. Directors can maintain overall control over the business as they control the trading of shares in their company. Owners (shareholders) of private businesses have more of a say as there are less shareholders so more influence over business decisions. It is relatively less expensive to start a private limited company rather than a public one however private companies do not tend to be able to raise as much finance as public limited companies.

A Public Limited Company is a company that is able to advertise and sell its shares to the general public via the stock exchange. They must carry the letters PLC after their name to indicate that it is a Public Limited Company. A disadvantage is that there is a dilution of control as the company has more owners (and voters) which thereby weakens shareholders' ability to control the business. Public companies often raise more share capital than private companies. They are also exposed to takeover bids from other investors that seek to purchase a majority stake in the business.

Formation Procedure

There are two documents that must be produced by both private and public limited companies and submitted to the appropriate authorities before they can start trading.

- The Memorandum of Association: This includes the fundamental details of the company such as name, its main purpose, its registered address and the original amount of share capital invested. Is a relatively brief document.
- Articles of Association: This stipulate s the internal regulations and procedures of the company. Details will include issues such as rights, roles and power of the bo0ard of directors and shareholders. Administrates issues are also covered such as the Annual General Meeting. There is also likely to be a section on how profits are distributed.

Once these documents are approved and an application fee has been paid a verification of incorporation is issued to the firm. This license recognizes the business as a separate legal unit from its owners and allows the business to start trading as a limited company.

Company Terminology

- **Flotation**: An Initial Public offering (IPO) occurs when a business first sells all or part of its business to external investors. Floating a company allows it to be listed on the stock exchange and this helps top generate additional sources of finance.

There are three reasons why investors tend to buy shares in a limited company

- **Dividends**: Companies usually pay dividends tot there shareholders biannually/ the dividends represent a share of the profits. The more shares that a shareholder owns the higher the total payment.
- **Capital growth**: Stock brokers and investment bankers argue that over the medium to long term, shares outperform the return from savings in a bank account. Over time the value of shares may increase or decrease and the shareholder can then sell the shares at higher price thereby making a financial gain. This gain is known as capital growth.
- **Voting power**: Shareholders who hold enough shares in a limited company can become a major influence in the management and operation of the company. This reason is generally held by people who are risk takers and possess high entrepreneurial spirit.

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Advantages:	**Disadvantages:**
Public limited companies can often raise vast sums of money for financing their investment projects. The money raised through selling shares become permanent capital, meaning that it does not have to be repaid, unlike loans.	Financial information must be provided to all shareholders. Only a summarised set of accounts is required, although this can prove to be a time consuming and expensive exercise – auditors have to be paid and annual reports have to be published and distributed.
Interest does not have to be paid; instead, shareholders are paid a dividend (but only if the company makes a profit.)	There is far more bureaucracy involved in the setting up and running of a limited company, such as the need to produce a memorandum and articles of association.
As companies have limited liability, it is easier for them to attract both private and commercial investors. The lower the risk to inventors, the more likely they are to invest their money.	For shareholders, dividends are only paid out if the business makes a profit. Even if profit is made, the board of directors may decide to retain a large proportion of the profits for financing investment projects; this then leaves less profit than can be distributed as dividends to shareholders.
Benefit from continuity. Since there is a legal difference between the business and its owners (a concept known as the divorce of ownership and control), should anything happen to one owner, the business does not need to cease trading but can continue as a separate entity from that owner.	Large organisation suffers from communication problems. As the firm becomes larger, services and relationships may become more impersonal to both customers and employees.
Due to their larger scale business, companies can benefit from economies of scale. E.g. it is usually cheaper for a company to borrow money than it is for sole proprietorships or partnerships. This is because commercial lenders see limited companies as less of a financial risk; most banks would probably not hesitate to lend large multinational companies such as Nike and McDonald's money to finance their expansion plans. If a competitive rate of interest was not offered, these companies may turn to a rival of the lender for financing.	
Limited companies can hire specialist directors and mangers to run the firm as there is no need for the owners to be directly involved in the daily running of the business.	
Directors of a company generally own a large amount of hares in the business. Although this may give them significant voting power, it also means they have an incentive to perform well in order to achieve capital growth (higher share prices) and dividends from the shares.	

FOR PROFIT SOCIAL ORGANISATIONS

<table>
<tr><th></th><th>Cooperatives</th></tr>
<tr><td>Description</td><td>Firm owned, controlled, and operated by a group of users for their own benefit. Each member contributes equity capital, and shares in the control of the firm on the basis of one-member, one-vote principle (and not in proportion to his or her equity contribution).

NB. Whereas partnerships are limited to 20 partners in most countries, cooperatives can have thousands of members.

Common types of cooperative include:
Financial cooperatives, for example, credit unions are a type of cooperative banking institution that provides banking and lending services to its members.
Housing cooperatives own real estate, such as condo projects and apartment buildings.
Worker's cooperatives are owned and governed by the employees of the business. They operate in all sectors of the economy providing workers with both employment and ownership opportunities.
Producer cooperatives, for example, retail cooperatives involve small retailers banding together to be more competitive with large retailers by sharing advertising costs and buying as a group for high volume discounts.
Consumer cooperatives are owned by the people who buy the goods or use the services of the cooperative. Consumer co-ops may sell consumer goods such as food, or provide housing, or electricity. Other co-ops such as community crèches provide childcare services.</td></tr>
<tr><td>Ownership and Control</td><td>Each member contributes equity capital, and shares in the control of the firm on the basis of one-member, one-vote principle (and not in proportion to his or her equity contribution).</td></tr>
<tr><td>Management</td><td>The cooperative is managed by its members.</td></tr>
<tr><td>Capital</td><td>Each member contributes equity capital, owns shares in the organisation and is paid dividends out of profits in addition to their usual remuneration</td></tr>
<tr><td>Sources of Finance</td><td>Equity capital from cooperative members, retained profits and long-term bank loans.</td></tr>
<tr><td>Legal status</td><td>A cooperative is a legal entity owned and democratically controlled by its members. Cooperatives may take the form of companies limited by shares or by guarantee, partnerships or unincorporated associations.</td></tr>
<tr><td>Liability of owners</td><td>The liability of the owners is dependent on the form of organisation: limited liability companies, partnerships or unincorporated associations.</td></tr>
<tr><td>Advantages</td><td>Easy to form
No obstruction for membership
Limited liability</td></tr>
</table>

	▪ Service motive (e.g., members are working for the good of the cooperative and not already wealthy shareholders) ▪ Democratic management ▪ Stability and continuity ▪ Economic operations (e.g., economies of scale – purchasing economies may be achieved) ▪ Surplus shared by the members
Disadvantages	▪ As cooperatives are formed to provide a service to their members rather than a return on investment, it may be difficult to attract potential members/shareholders whose primary interest is a financial return. ▪ There is a usually a limited distribution of surplus (profits) to members/shareholders and some cooperatives may prohibit the distribution of any surplus to members/shareholders. ▪ Even though some shareholders may have a greater involvement or investment than others, they still only get one vote. ▪ Active and direct involvement of members/shareholders in the cooperative. ▪ Requires continuous cooperative education programs for members. ▪ Management may be inefficient as many cooperatives are managed by their non-specialist members. Further, strategic decisions may require the vote of a membership quorum.
Formation Procedures	The formation of a cooperative is dependent on the form of organisation: limited liability companies, partnerships or unincorporated associations. Some countries have cooperative-specific procedures.

COOPERATIVES

MICROFINANCIERS

Microfinance is defined as **financial services for poor and low-income clients**, especially **microcredit**, offered by different types of service providers. In practice, the term is often used more narrowly to refer to loans and other services from providers that identify themselves as '**microfinance institutions**' (MFIs). These institutions commonly tend to use new methods developed over the last 30 years to deliver **very small loans to unsalaried borrowers**, **taking little or no collateral**. These methods include group lending and liability, pre-loan savings requirements, gradually increasing loan sizes, and an implicit guarantee of ready access to future loans if present loans are repaid fully and promptly.

More broadly, microfinance refers to a movement that envisions a world in which low-income households have permanent access to a range of high quality and affordable financial services offered by a range of retail providers to finance income-producing activities, build assets, stabilise consumption, and protect against risks. These services include savings, credit, insurance, remittances, and payments, and others.

How do borrowers use microcredit loans? Many microcredit borrowers have microenterprises – unsalaried, informal income-generating activities. However, microloans may not predominantly be used to start or finance microenterprises. Scattered research suggests that only half or less of loan proceeds are used for business purposes. The remainder supports a wide range of household cash management needs, including stabilising consumption and spreading out large, lumpy cash needs like education fees, medical expenses, or lifecycle events such as weddings and funerals.

Most MFIs started as not-for-profit organisations like NGOs (non-governmental organizations), credit unions and other financial cooperatives, and state-owned development and postal savings banks. An increasing number of MFIs are now organized as for-profit entities, often because it is a requirement to obtaining a license from banking authorities to offer savings services. For-profit MFIs may be organized as non-bank financial institutions (NBFIs), commercial banks that specialise in microfinance, or microfinance departments of full-service banks.

PRIVATE-PUBLIC PARTNERSHIPS (PPPS)

A public–private partnership (PPP) is a government service or private business venture which is funded and operated through a partnership of government and one or more private sector companies.

A PPP involves a contract between a public sector authority (state, local or national governments, for example) and a private sector organisation (e.g., a firm), in which the private organisation provides a public service or project and assumes substantial financial, technical and operational risk in the project.

In some types of PPP, the cost of using the service is borne exclusively by the users of the service and not by the taxpayer (for example, a toll road will be financed by the users of the road). In other types, capital investment is made by the private sector on the basis of a contract with government to provide agreed services and the cost of providing the service is borne wholly or in part by the government.

In projects that are aimed at creating public goods like in the infrastructure sector, the government may provide a capital subsidy in the form of a one-time grant, so as to make it more attractive to the private investors. In some other cases, the government may support the project by providing revenue subsidies, including tax breaks or by removing guaranteed annual revenues for a fixed time period.

There are usually two fundamental drivers for PPPs:

- Firstly, PPPs are claimed to enable the public sector to harness the expertise and efficiencies that the private sector can bring to the delivery of certain facilities and services traditionally procured and delivered by the public sector.
- Secondly, a PPP is structured so that the public sector seeking to make a capital investment (e.g., a much needed bridge) does not incur any borrowing. PPP borrowing is incurred by the private sector organisation and as such is an "off-balance sheet" method of financing the delivery of new or refurbished public sector assets.

A PPP is likely to have a social basis (e.g., providing education facilities, roads, water and electricity), yet an organisation is likely to enter the partnership because it as seen as a profitable venture. As **a social enterprise**, the main features of a PPP include:

- While profit is important it is not likely to be the priority.
- There is collaboration between the private sector organisation and the local community.

NON-PROFIT AND NON-GOVERNMENTAL ORGANISATIONS

NON-PROFIT ORGANISATIONS

- An establishment that is run professionally, without profit as the main objective
- Aim to provide a service or promote special causes

- The term 'non-profit' does not mean that the company does not make a surplus. Their profit is returned back into the business for the benefit of its members.

NON-GOVERNMENTAL ORGANISATIONS

- Operates in private sector, therefore it is not owned or controlled by the government
- They differ from other private sector businesses because their aim is not to make profit. Instead they are made to benefit others in society. (Also known as **Private Voluntary Organisations**)
- There are two types of NGOs: **Operational** and **Advocacy.** Operational NGOs are established from a given objective or purpose, usually relief-based and community projects. Advocacy NGOs takes a more aggressive approach to promote or defend a cause.

CHARITIES

- Type of registered non-profit organisation, with a main aim of collecting donations from individuals and organisations in order to support a cause beneficial to society.
- They do not sell anything to customers, so they need advanced marketing strategies to attract donors.
- Some charities are very large and run by a group of managers and trustees, similar to that of a limited company's board of directors.
- Some managers and employees will be paid, others are volunteers.
- Although they are non-profit, they strive to make a **surplus**.

Surplus = Revenues – Costs

Advantages:	Disadvantages:
Provide financial support for welfare of society	Lack of profit may cause major problems
Exempt from paying income or corporation tax	Trustees receive no financial benefit
Donors may get income tax allowances on the funds they have donated to the charity	Charities must register before they can commence activities
Charities can also register to be limited companies to protect employees and management with limited liability	Financial activities must be recorded and reported to a governing body set up by the government. This is to prevent misuse of charitable donations which is known as charity fraud.
	Limited liability charities protect the owners and workers. This also means those who run the charity are not help liable for debt. This is another degree of charity fraud.
	Charities only survive on donations, and tend to be the first to lose

PRESSURE GROUPS

- Non-profit organisations established by members to address a special interest of the group
- Their aim is to win public and media support from their actions
- Try to influence government legislation, such as introduction of national minimum wages laws, support low income earners, gain access to resources (e.g. Arctic drilling), etc.