Chapter 2 – Types of Business Entities

What you should know-

- ✓ Distinction between the private and the public sectors

- ✓ The main features of the following types of organizations
  - Sole traders
  - Partnerships
  - Privately held companies
  - Publicly held companies

- ✓ The main features of the following types of for-profit social enterprises
  - Private sector companies
  - Public sector companies
  - Cooperatives

- ✓ The main features of the following type of non-profit social enterprise
  - Non-governmental organizations (NGOs).

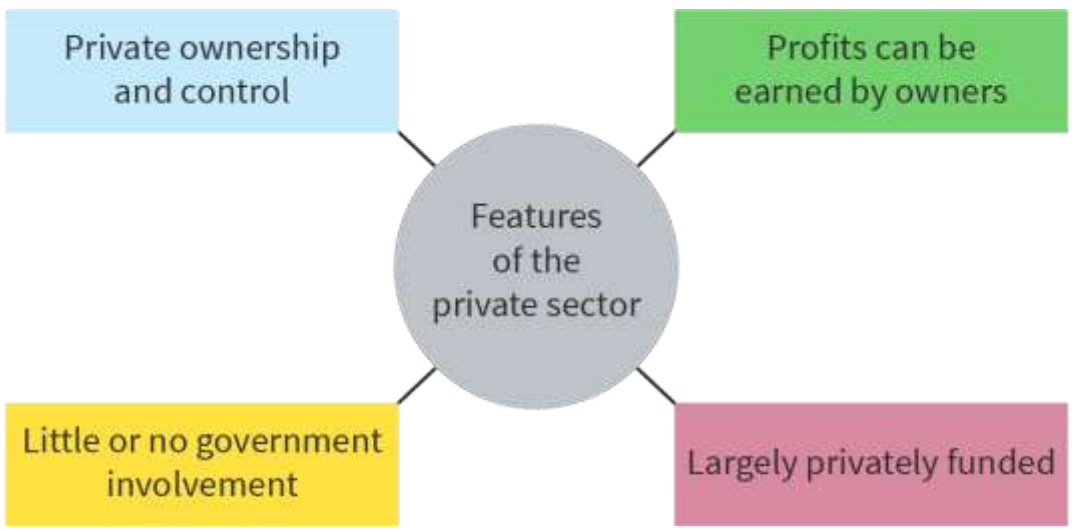
Distinction between the private and the public sectors

The **private sector** of the economy consists of businesses owned and run by private individuals and organizations. The main aim of most, although not all, private sector organizations is to earn profit. Private sector organisations charge a price for their products. Their products can only be accessed by those who are willing and able to pay the price. This enables private sector businesses to earn a profit, they operate independently of the government, although need to operate within the rules and regulations in the country. The private sector consists of sole traders, partnerships, privately held companies, publicly held companies.

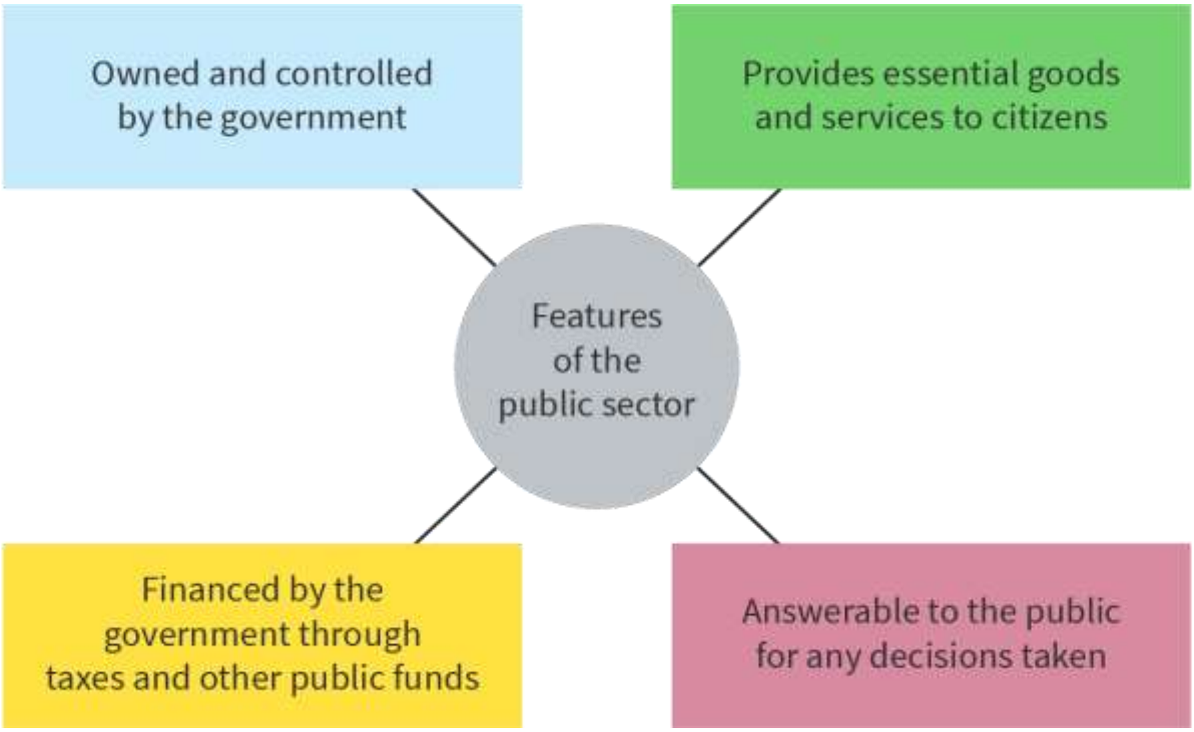
Good Tip 1!

Students often claim that the difference between business organizations operating in the private sector and public sector is that the former aims for profit whilst the latter aims to provide a service. Whilst this is not entirely incorrect, there are businesses that operate in the private sector that do not primarily aim to earn a profit for their owners. Examples include traditional charities and non-governmental organizations (NGOs)

So, frame like *the private sector of the economy consists of businesses owned and run by private individuals and organizations that usually aim to earn a profit for their owners.*



Public sector organisations are created, owned and controlled by the government. The public sector provides essential goods and services that would be unprovided or insufficiently provided by private sector. These services are often free of charge or delivered at very low fees and are usually funded through tax revenues The Public sector consists of health care, education, emergency services such as the police and fire services, National defence, Museums, Infrastructure.



Types of for-profit organization

A **sole trader** (also known as a sole proprietor) is a commercial for-profit business owned by a single person. Although this person can employ as many people as needed, the sole trader is the only owner of the business. The owner runs and controls the business and is the only person held responsible for its success and failure. <u>Examples of sole trader businesses include people who are self-employed, restaurant owners, freelance workers, fashion designers, tailors and interior decorators.</u>

Advantages of Sole trader	Disadvantages of sole trader
<u>Few legal formalities:</u> It is the quickest and easiest type of business to set up. Sole traders can avoid complicated and costly set-up procedures.	**<u>Unlimited Liability:</u>** a sole trader is treated as the same legal entity as the business, i.e. it is an unincorporated business. This means the sole trader has unlimited liability so is responsible for any debt owed to other individuals or organizations, even if this requires the owner to pay the debts from their personal belongings and assets

<u>Profit taking:</u> The owner receives all of the profits if the business succeeds. This gives an incentive to sole trader to work hard and to become successful.	**<u>Limited sources of finance:</u>** The finance to set up and run the business is generally provided by the owner (from personal savings) as s/he cannot easily access external sources of finance. Since access to external finance is difficult for most sold traders (because they represent a high degree of risk), expansion of the business is difficult.
<u>Quicker decision making:</u> decision-making is also swift as the owner does not have to consult anyone else and seek their permission to execute a decision	**<u>Workload and stress:</u>** The workload for a sole trader can be extremely high. There is no one else to share ideas or to ask questions, so all pressures, burdens and responsibilities fall on the owner. This means the sole trader often has to work very long hours
<u>Privacy:</u> Sole traders enjoy privacy as they don't have to make their financial rewards available to the general public. It only needs to publish its financial accounts to the tax authorities	**<u>Lack of continuity:</u>** There is a lack of continuity in the operations of the business if the owner is unwell, wishes to take a holiday or wants to retire. The latter is a main reason why many sole trader businesses struggle to continue.
<u>Personalized services:</u> They can provide personalized service to customers. Larger businesses might not have time to know all their customers, so their services often become generic	**<u>Limited economies of scale:</u>** As sole proprietorships are usually small businesses (such as a small convenience store owner), they are unlikely to be able to gain any economies of scale, perhaps because they cannot buy their materials or stocks (inventory) in bulk. This means sole traders pay more for their goods, their prices charged to customers also tend to be higher

Partnership**

A **partnership** is for profit private sector business owned by two or more individuals or partners. For an ordinary partnership, the maximum number of partners is usually capped at twenty owners, although this does vary from one country to another. Some organizations can have more than 20 partners, such as law firms and health clinics.

The vast majority of partnerships are **unincorporated businesses**, so at least one of the owners must have unlimited liability. In practice, it is usual for all the partners to share responsibility for any liabilities made by the partnership

Most partnerships sign a **Deed of Partnership (or Partnership Agreement)** as this helps to Resolve potential misunderstandings and disagreements. This formal contract between the Partners outlines:

- each of their responsibilities
- voting rights amount of finance contributed by each partner
- how profits are to be shared between the owners
- conditions for introducing a new partner
- Procedures of ending partnership

Advantages of Partnership	Disadvantages of Partnership
Financial Strength: Partnerships can raise far more finance than sole traders, especially as there can be up to 20 partners (subject to the laws in different countries) in the business. **Silent partners** (also known as **sleeping partners**) can provide additional capital without having any role in the actual running of the business.	**Unlimited Liability:** In general, partners have unlimited liability so are liable for any debts, fines, penalties or law suits against the business, even if this these were caused by another partner in the firm. However, sleeping partners are exempt from unlimited liability.
Specialization and division of labour: Partners can benefit from shared expertise, shared workload and moral support. For example, a law firm have partners who specialize in corporate law, divorce law and criminal law. Having partners enables the firm to benefit from having more ideas and different skills and expertise.	**Prolonged decision making:** Decision making is slower than with sole traders because there are more owners involved. This can also lead to disagreements and conflicts between the owners.
Financial Privacy: Sole traders enjoy privacy as they don’t have to make their financial	**Lack of harmony:** As the business has more than one owner, this can easily lead to

rewards available to the general public. It only needs to publish its financial accounts to the tax authorities.	disagreements and conflict between the owners, which can seriously damage the running of the business.
Greater efficiency and productivity. As partners specialize in different skills, **productivity** increases and helps **reduce costs.**	**Lack of continuity:** There is no continuity if a partner decides to leave the firm or if one of the partners die. This is because such cases would void the Deed of Partnership. There would be a time delay in setting up a new partnership agreement.

Corporations**

Companies (also known as **corporation)** are commercial for-profit businesses owned by many individuals, or groups of individuals, known as **shareholders.** The term shareholders can be taken literally, as these individuals each own a share of the business. The possession of a single share gives the shareholder the right to:

- vote at the Annual General Meeting, where decisions may be made regarding the management of the company
- receive a part of the company's profits in the form of dividends **if** these are paid (however not all companies pay dividends every year)

Corporations have **limited liability** This means that if the corporation incurs losses, its owners cannot lose more than the funds that they invested in the business. There is a complete separation between shareholders' personal assets and their ownership interest in the business. Even if the company goes into bankruptcy, creditors can only seize the assets of the corporation itself, not the personal possessions of its owners. It is the board of directors and the CEO (or managing director) who are responsible for the strategic direction of the company on behalf of shareholders

There are two categories of companies: **privately held companies** and **publicly held companies.**

Privately held companies**

A **privately held company** is privately owned company that can't raise share capital from the General public via stock exchange. Instead shares are sold to private family members and friends. These shares cannot be bought and sold without the prior permission from shareholders and Board of Directors, so that directors can maintain overall control of the company.

Shareholders enjoy **limited liability**. If the business fails or suffers losses, the personal assets of the shareholders are not at risk. They only suffer losses equal to the value of their shares (the money they have invested in the business).

Evaluation of Privately held company is discussed in the table below-

Advantages	Disadvantages
Control and ownership: Control and ownership is shared between a small group of people, usually family and friends. There is a better control as shares in a privately held company cannot be bought or sold without the agreement of existing shareholders.	**Prolonged decision making:** Privately held companies can only sell their shares to family, friends, and employees, with the approval of the majority of existing shareholders. This can make it difficult to buy and sell shares in the company. All shareholders need to discuss and agree on decisions
Greater access to finances: Companies can raise large amount of capital by selling shares to friends and family. There are no interest charges and shareholders are paid dividend only if the company erns a profit	**Expensive:** They are more expensive to operate than a sole trader or partnership. For example, there are higher legal fees and auditing fees (for checking and approving of the financial accounts).
Financial Privacy: These are private and are not made public, enabling the company to take a longer-term view on the development of the company.	**Profits:** Profits are shared between several shareholders.
Limited liability: Shareholders have limited liability, so cannot lose more than what they invest in the company. It is also easy to attract more investors as risk is relatively low for them.	**No trading:** Shares cannot be traded publicly to raise finances.

Publicly held companies**

Publicly held companies (or joint-stock companies) are limited liability companies owned by shareholders with the shares in the business being traded (bought and/or sold) on a public stock exchange (or stock market).

Also known as a **joint-stock company**, a publicly held company is owned by shareholders. The shares in such companies can be bought and sold by the general public, without prior approval of existing owners. When a company first sells its shares to become a publicly held company, it does so through an initial public offering (IPO) via a stock exchange.

Evaluation of Publicly held company is discussed in the table below-

Advantages	Disadvantages
Additional Finance: Additional finance can be raised through a share issue (the process of subsequently selling more shares in a company) Hence, it is easier for publicly held companies to obtain finance from a stock exchange to fund its growth and evolution by selling additional share capital.	**Lack of Privacy:** There is a lack of privacy because the general public have access to the financial accounts of publicly held companies. Limited liability companies must produce an Annual Report and Final Accounts, which includes details such as the reporting of profits (or losses) in the Profit & loss account, as well as the assets of the business and where cash has been spent during the last twelve months in the Balance sheet.
Limited liability: Shareholders have limited liability, so cannot lose more than what they invest in the company. It is also easy to attract more investors as risk is relatively low for them.	**High cost:** Publicly held companies are the most administratively difficult and expensive form of commercial for-profit business to set up and run. For example, there are high costs of complying with the rules and regulations of the stock market.
Bank Loan: It is also easier for large publicly held companies to borrow money from bank loans and mortgages, due to their lower level of risk for financial lenders.	**Loss of Control:** As the general public can buy and sell share freely, there is always a potential threat of takeover by the rival company that purchases a majority stake in the business.
Economies of scale: Due to larger size, companies can benefit from economies of scale (lower unit cost of production as the firm grows)	**Shared Profits:** Profits are shared between several shareholders.

Continuity: As with privately held companies, publicly held companies enjoy continuity even if a principal or major shareholder leaves the organization or passes away.	**Conflict:** between directors, Managers and shareholders for their personal benefits. For example, managers and directors might decide to improve pay and conditions to address concerns from the workforce but this could reduce the amount of funds available for dividends paid to the shareholders

- **Common mistake!**

  Whilst it is common in many countries for the government or local authorities to own shares in a publicly held company, it is technically incorrect to say that a publicly held company is "owned by the government".

  The term 'public' in *publicly held company* (or sometimes called a *public limited company*) refers to a business that has shares traded on a public stock exchange, i.e., shares in the publicly held company can be bought and sold by the general public. It does not refer to the **public sector** (the government).

For Profit Social enterprise

Social enterprise is revenue generating businesses with social objectives such as improving the environment, building better communities and developing social wellbeing as their core objectives. Such organizations focus on meeting social objectives (such as improving social and environmental well-being) rather than rather than primarily aiming to earn profit for their owners or maximizing shareholder returns.

They operate for two main goals-

- To achieve social objectives
- To earn revenues in excess of their cost

(profit follows as a consequence of its social and environmental goals, rather than as a result of its commercial activities.

There are three main types of for-profit social enterprises covered in the IB Business Management syllabus:

- Private sector companies
- Public sector companies
- Cooperatives.

Good Tip 2!

For-profit social enterprises are not traditional charities. Unlike traditional charities, for-profit social enterprises need to earn a profit (or financial surplus) in order to survive. This is because traditional charities rely on donations as their main source of finance.

Remember that social enterprises can be not-for-profit or for-profit. All social enterprises focus on meeting social goals and not only commercial business objectives.

Good Tip 3!

A social enterprise is not a legal structure, but a way of conducting business.

Social enterprises can be set up as for-profit businesses, such as limited liability companies or an NGO (non-governmental organization). However, what all social enterprises have in common - irrespective of their legal structure - is their mission, which is driven by a social cause.

Private sector companies

Private sector for profit social enterprise operate in a similar way like to traditional for-profit Businesses owned and run by private individuals and organizations, but they reinvest or donate any surplus to create positive social change. Furthermore, private sector for profit social enterprise sector earn their revenues and profit in socially responsible ways and uses the surplus to directly benefit the society or environment rather than distributing the profit to owners in the form of dividend payments. Examples of private sector for-profit social enterprises include:

- **TOMS Shoes**, known for giving away one pair of shoes (to those in need) for every pair the private sector social enterprise sells.
- **Change Please** - The British coffee chain with outlets in London and Manchester donates all of its profits to tackle the problems of homelessness.
- **Thaely** - A vegan footwear brand that manufactures sports shoes (sneakers) from waste plastic bags and bottles (each pair contains 15 plastic bags and plastic 22 bottles)

A further example is microfinance providers. **Microfinance providers** are for-profit social enterprises that operate as private sector companies. They offer a financial service to those without a job or on very low incomes. The aim of providing microfinance is to help entrepreneurs, especially women, struggling to finance their business start-ups to gain access to loans of a small amount with no requirement of collateral (financial security from its borrowers). Microfinance can give these people the opportunity to become self-sufficient and empower them to run their businesses. As with the majority of loans, interest is charged on the amount borrowed, although these are typically lower than what commercial banks would charge

Public sector companies

Public sector for profit social enterprises operate in a commercial-like way (selling goods and/or services in order to generate a financial surplus) but are owned and/or controlled by government authorities. They can be owned wholly or partially by the government. They help to raise much needed government revenues yet provide essential services that may be insufficient and undesirable if left solely to the private sector. Examples of private sector for-profit social enterprises include:

- National health service
- Educational establishments, such as schools, colleges, and universities
- Housing associations to provide social housing for people
- Postal services
- National Airlines

Quite often, the public sector is unable to provide the necessary resources and finances to operate an enterprise, so some of the funding required comes from the private sector. In such a case, a **public-private partnerships (PPP)** is established.

Features

- A PPP is a jointly established enterprise by a government and one or more private sector businesses
- A long-term contract between a private company and a government agency for providing a public asset or service
- The exact arrangements will differ from case to case and from country to country, but often involve the public sector having a majority share in the joint venture
- the public sector company exists to create employment and to reinvest profits (financial surplus) back into the business and the local community.

Cooperatives

Cooperatives are for-profit social enterprises that are owned and managed by their members, with the common goal of creating values for their members by operating in a socially responsible way. Examples are employee cooperatives, producer cooperatives, managerial cooperatives and customer cooperatives. All members participate in decision-making either directly by voting on important decisions or through representation, where members elect representatives to make decisions for them.

Farm owners can form a cooperative to negotiate lower prices on inputs such as fertiliser and seeds by buying in bulk, or by buying expensive equipment together to share.

Farm owners also negotiate higher prices for their outputs by working together to equalize power with large grocery retailers. Some may even organise their own credit unions, to offer farmers lower interest rate loans when needed.

Evaluation of Cooperatives

Advantages	Disadvantages
Cooperatives are **tax exempt** because the focus of the business is on serving the collective interests of its member-owners and the community (such as home care associations for the elderly).	As cooperatives are **not profit-driven**, it can be difficult to attract investors, financiers and member-shareholders
Cooperatives are **not difficult or expensive** to set	Similarly, employees and managers of cooperatives may **lack the financial motivation** to excel, due to the absence of a profit motive.
Similarly, as the owners have equal voting rights, the cooperative is more democratic so the members feel equally important to the success of the business. This is likely to lead to a **harmonious working environment.**	Most cooperatives have very **limited sources of finance** as their capital depends on the amount contributed by their members.
As cooperative strive to benefit their members and society, they often **qualify for government financial support**	Most cooperatives are **unable to hire a range of specialist managers** to run the business, due to the lack of financial rewards and sources of finance to remunerate their senior staff. This can limit the success of the cooperative.
There is **an absence of pressure from external investors and shareholders**, so the member-owners of the cooperative can run the business that best suits their own interests.	**Slower decision making** as decisions are likely to be slowed down (delayed) as all members of the cooperative work in a democratic way and are involved in decision making process. Every member has a voice in the organization.

Non-Profit Social Enterprise

As with a for-profit social enterprise, **a non-profit social enterprise** works to improve social or environmental outcomes. To qualify for non-profit status, organisations typically need to prove their social or environmental purpose to the government. They may receive all funding through grants and donations, or they may be involved in additional revenue-generating activities such as selling goods or services. Any surplus generated is required by law to be reinvested into the business to increase its impact, but they do not distribute any profits or financial surplus to their owners or shareholders.

Many private schools, public library, Museums, hospitals and cultural institutions are organized as non-profits, as are religious organisations, political parties, labour unions, professional organisations and some interest groups

Non-Governmental Organisations (NGO)

The main type of non-profit social enterprise is Non-governmental Organizations (NGOs). A **non-governmental organization** (NGO) is a type of non-profit social enterprise that operates in the private sector of the economy. Therefore, it is not part of a government organization. Instead, it is operated a voluntary group to promote a social cause, such as the protection of human and animal rights, protection of the environment, and development aid. They are usually funded by a combination of sources:

- Government grants or donations
- International organizations
- Charitable organizations
- Commercial businesses, as part of their corporate social responsibilities (CSR), and
- Private donors

Examples of NGOs are:

- OXFAM-Global poverty alleviation
- GREEN PEACE-Environmental Protection
- AMNESTY INTERNATIONAL- Huma Rights
- WIKIMEDIA FOUNDATION-Open information

KEY TERMS

- **Cooperatives** are for-profit social enterprises that are owned and managed by their members, with the common goal of creating values for their members by operating in a socially responsible way.

- **Companies** (also known as **corporation**) are commercial for-profit businesses owned by shareholders.

- An **initial public offering** (IPO) occurs when a company sells its shares on a public stock exchange for the first time.

- A **Deed of Partnership** (or **partnership deed**) is a formal partnership agreement or contract between the owners, which includes legal agreements such as the formal responsibilities of each owner, their voting rights, and how profits are to be shared between the partners.

- **Incorporation:** means there is a legal difference between owners of the company and business itself. This ensures that owners are protected by limited liability.

- **Non-governmental Organizations (NGO)**: A non-governmental organization (NGO) is a type of non-profit social enterprise that operates in the private sector of the economy., it is operated a voluntary group to promote a social cause, such as the protection of human and animal rights, protection of the environment, and development aid.

- The **private sector** of the economy consists of businesses owned and run by private individuals and organizations that usually aim to earn a profit for their owners.

- A **stock exchange** (or **stock market**) is a marketplace where shares in publicly held companies can be bought and/or sold, such as the New York Stock Exchange (NYSE).

- **Privately held companies** are limited liability companies owned by shareholders but the shares in the business cannot be advertised or traded on a stock exchange.

- **Silent partners** (also known as **sleeping partners**) are inactive owners of a partnership business, who provide additional capital without having any role in the actual running of the organization.

- A **sole trader** (or **sole proprietor**) is the single owner of a business organization, so makes all the decisions and takes all the risks in running the enterprise.

- The **public sector** consists of those organizations controlled by a regional and/or national government, with the main aim being to provide essential goods and services for the general public.

- **Publicly held companies** (or **joint-stock companies**) are limited liability companies owned by shareholders with the shares in the business being traded (bought and/or sold) on a public stock exchange (or stock market).

- **Microfinance providers** are for-profit social enterprises that offer a financial service to those without a job or on very low incomes.

- **Public-private partnerships** (PPP) are an example jointly established by a government and one or more private sector businesses.

- **Unlimited liability** means that if the sole proprietorship fails, the sole trader is personally held responsible for all the debts of the business. As there is no limit to the amount of losses, this means that the sole trader could lose their personal possessions to pay for the organization's debts.

- **Limited liability:** is the restriction on the amount of money that owners of the business can lose if the business goes bankrupt. Shareholders cannot lose more than amount invested in the company.

- **Social enterprise:** are business entities that generate revenue just like any business organization, but hold community objectives for the wellbeing of others in society, rather than primarily aiming to earn profit for their owners.

- **For profit-Social enterprise:** is revenue generating businesses with social objectives such as improving the environment, building better communities and developing social wellbeing as their core objectives. Such organizations focus on meeting social objective rather than primarily aiming to earn profit for their owners

- **Non-profit social enterprise:** operate in a commercial-like way but they do not distribute any profits or financial surplus to their owners or shareholders.