DP IB Business Management: HL

Your notes

1.2 Types of Business Entities

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Private & Public Sector Businesses

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Private & Public Sector Businesses

- It is useful to **classify firms** into categories so that we can make comparisons between them
  - Public or private sector?
  - Legal ownership?
  - Sector of industry? (See Section 1.1)
  - For-profit or non-profit?

Public and private sectors

- **Public sector firms** are owned & controlled by the Government and usually funded through **taxation**
- **Private sector firms** are owned & controlled by other firms & private individuals (entrepreneurs and shareholders) and are usually funded by **owner's capital, borrowing and retained profits**
- **Privatisation** occurs when government-owned firms are sold to the private sector
- Many government owned firms have been **partially privatised**
  - The government retains a share in them so they can influence decision-making & receive a share of the profits e.g. the shares of Singapore Airlines are 55% government owned & 45% privately owned

Public Sector Firms	Private Sector Firms

▪ Their main goal is usually to **provide a service**
▪ Public sector firms can operate on a local, regional or national government level
  ▪ E.g. Transport for London (local); Agricultural State Service in India (regional); Caribbean Airlines (national)
▪ Governments are likely to retain ownership of organisations in the public sector for several reasons
	▪ The objective of most private sector organisations is **profit maximisation**
	▪ This often causes the private sector to be more **efficient** than the public sector with higher levels of **productivity**
	▪ Types of business ownership vary from **sole trader** to **partnerships** to **company shareholders**
	▪ Former public sector businesses (privatised) have become some of the largest companies in many economies
	  ▪ E.g. **British Telecom Plc** is one of the FTSE 100 leading companies in the UK

▪ They are **strategically important** to the country ▪ E.g. defence or justice systems ▪ They provide **essential** services ▪ E.g. water or electricity supply ▪ They are **merit goods** that may not be provided in sufficient quantities by private businesses ▪ E.g education or health services	▪ **Air India**, the country's national airline, was privatised and sold to Tata in 2021 as the Indian government seeks to reduce its commercial involvement in the economy

- In recent decades Governments around the world have tended to **move away from the centralised provision of services**
  - In **Cuba** small private sector businesses are now encouraged, although a large proportion of workers remain employed directly by the government
  - Political change in **Venezuela** has led to a rare example of an increase in the involvement of the state in the economy

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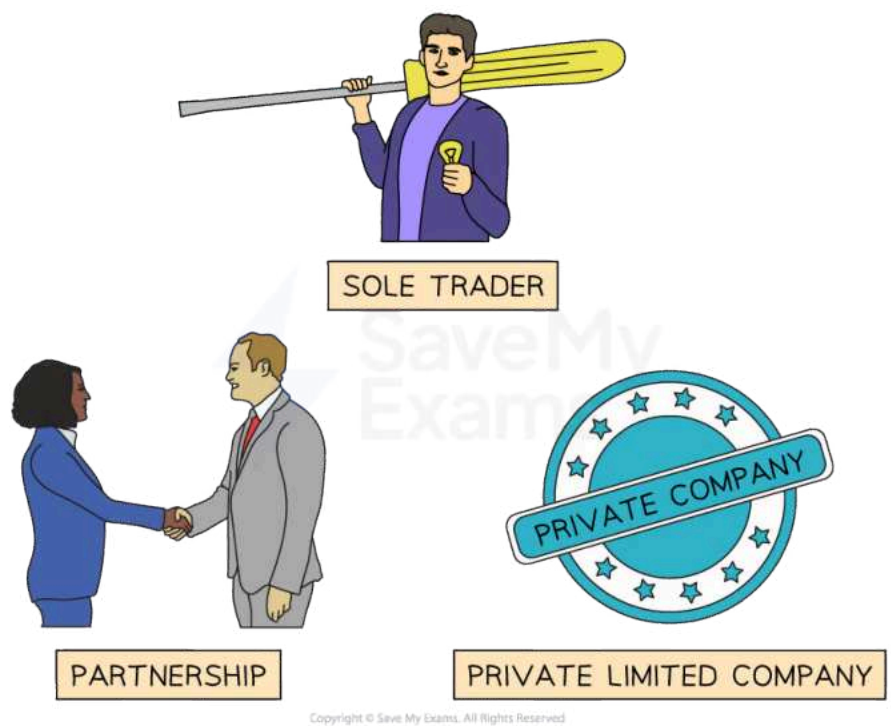
Types of For-Profit (Commercial) Businesses

Sole Traders and Partnerships

- When an entrepreneur starts a business, they will often start operating as a **sole trader**
- If a **group** of entrepreneurs set up a business they may choose to operate as a **partnership**
- Over time, they may change the form of business to **gain more funding** or **provide more security** for the owners by becoming a private limited company with **limited liability**

Diagram: ownership for small businesses



The different types of business structures available to small business owners

- Two of the most common forms of business at start up are **sole traders and partnerships**
- Each one of these forms has various **advantages** and **disadvantages** associated with the structure

An Explanation of Sole Traders and Partnerships

Sole Trader	▪ A business that has a **single owner** (although they may still hire employees)

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	▪ Sole traders often run their business alone and require a **varied skillset**	
	Advantages	**Disadvantages**
	▪ Easy and inexpensive to set up ▪ The owner has **complete control** over the business ▪ All profits belong to the owner ▪ Simple **tax** arrangements ▪ Decisions can be made very quickly so the business can react swiftly to market change ▪ High levels of **personal satisfaction**	▪ Unlimited liability, meaning the owner is **personally responsible for any debts** the business incurs ▪ Limited access to finance and capital ▪ Limited skill sets ▪ Difficult to take time off from the business

Partnership	▪ Two or more people join together to form a business
	▪ Good examples of this type of business include lawyers and accountants
	▪ A **partnership agreement** sets out the rules of the partnership such as
	  ▪ Dissolution of the partnership
	  ▪ How profits are to be distributed between partners
	  ▪ Voting rights of partners	

	Advantages	**Disadvantages**
	▪ Easy to set up and inexpensive ▪ Shared responsibilities and decision-making ▪ **More skills and knowledge are available** ▪ Increased access to finance and capital	▪ Unlimited liability ▪ **Potential for disputes** between partners as decisions need to be agreed ▪ **Profits are often shared equally**, regardless of the contribution ▪ It is difficult to transfer ownership

Privately-held Companies

- To overcome the personal **risks of unlimited liability** involved in running a sole trader or partnership, an individual or group of entrepreneurs may choose to form a **private limited company**
- There is a small **fee** payable to **incorporate** and register a private limited company (Ltd)
- **Legal guidance** is usually required to draw up the **Articles of Association**
  - These set out the rules of the business including **ownership** and **voting rights of shareholders**

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An Explanation of Private Limited Companies (Ltd)

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The ownership of the business is broken down into a specified number of shares
These shares can be sold by the owner, usually to friends and family or to venture capitalists
Decision-making often rests with the person appointed to run the company, often called the Managing Director or CEO
The business is a separate legal entity to its shareholders and can own assets in its own rights and is responsible for its debts
Private limited companies are often family-owned

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<tr><th>Advantages</th><th>Disadvantages</th></tr>
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Limited liability, meaning the owners are not personally responsible for the company's debts
Access to greater finance and capital as the company is considered to be more reputable
It is easier to transfer ownership by selling shares
Can have a professional image and reputation

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More expensive and time-consuming to set up
More complex legal requirements and regulations than sole traders
Annual financial reporting and auditing are required
Less privacy as external stakeholders can access some financial data
Shareholders have little control over the company as the founder or CEO usually imposes their agenda

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The importance of limited liability

- Limited liability r**educes the responsibility for business debts** to the amount a shareholder has invested

- Shareholders cannot be required to sacrifice their personal assets if the business fails
- This **lowers the risk** to investors and increases the potential for the business to raise finance through the sale of shares

Publicly-held Companies

- When a business is growing rapidly it may **require a significant amount of capital** to fund its expansion
    - To secure this funding, it may choose to transition from a **private limited company (LTD) to a public limited company (PLC)**
- This is a complex process with many legal requirements and involves undergoing a **stock market flotation**

Benefits of Becoming a Public Limited Company (PLC)

Access to Capital	Shared Risks	Increased Liquidity
▪ Significant amounts of capital can be **raised very quickly** ▪ This is often a more cost effective way to raise capital than borrowing money from banks or other lenders	▪ The risks associated with ownership are **spread among a larger group of shareholders** ▪ This reduces the financial risk to any individual	▪ A company's shares become more liquid (they can be bought and sold more easily) on a **public stock exchange** ▪ This can increase the value of the company's shares and make it **easier for shareholders to buy/sell** shares
Access to Greater Expertise	**Greater Public Profile**	**Succession**
▪ The company will have a **board of directors** made up of independent directors and representatives from major shareholders ▪ This can bring in **additional expertise/perspectives** which can help the company grow and expand	▪ Becoming a PLC can raise a company's public profile and **increase its visibility** with customers, suppliers, and potential investors ▪ This increased visibility can **help the company attract new business** and grow its customer base	▪ Shareholders can **sell their shares**, transfer ownership or pass them on to heirs ▪ This makes it easier to plan for the **long-term continuity** of the company

- Public limited companies are subject to **greater degrees of scrutiny** and are **expensive to run**

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    - Detailed **annual accounts** must be made publicly available
    - The **media** often reports on strategy, major decisions and changes in executive structure
    - **Legal** and **accounting costs** will be significant
- The top three **initial public offerings** as of March 2023 are:
    - The Saudi Arabian oil company, **Saudi Aramco,** raised $29.4 billion in its IPO in December 2019
    - The Chinese e-commerce company **Alibaba Group** raised $25 billion in its IPO in 2014
    - The Japanese telecommunications company, **SoftBank Corp**., raised $23.5 billion in its IPO in 2018

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Examiner Tips and Tricks

When evaluating the best form of business to be used in a particular situation (or if a business should change its form), the decision needs to consider any evidence provided about the business owner, the product, the nature and size of the market, the funds required, and the level of profitability.

For example, a business which generates sales of $30k a year is unlikely to be ready to become a public limited company, but it may well benefit from transitioning from a sole trader to a private limited company.

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Types of For-Profit Social Enterprises

For-profit Social Enterprises

- A social enterprise is a business or organisation that aims to **generate revenue** and **achieve social, environmental or cultural objectives**
- It combines the principles and practices of traditional business with a **focus on addressing social issues** and creating positive social impact
- Social enterprises typically reinvest a significant portion of their **profits back into their mission** rather than maximising profits for shareholders

Social enterprises in the private sector

- Social enterprises in the private sector look to **make a profit** whilst improving one or more aspects of **society** such as environmental, education, or health concerns
- Many social enterprises aim to **create jobs**, improve **social mobility** or provide **opportunities for marginalised groups**
- A proportion of profits is invested into achieving these **social aims**

Evaluation of Social Enterprises

Advantages	Disadvantages
▪ Social enterprises often develop **creative and innovative** solutions to social challenges ▪ By generating revenue social enterprises can become **financially self-sustaining** ▪ This financial independence reduces their reliance on donations and grants, making them less vulnerable to political and economic change ▪ Social enterprises **create jobs** which supports **economic development** particularly in developing communities ▪ They often provide training and employment which can lead to increased social mobility and better quality of life	▪ Achieving **financial stability** can be difficult, especially during the initial stages ▪ Balancing a social mission with making money can be a delicate balancing act ▪ Social enterprises have to navigate complex **legal frameworks** and t**ax structures** ▪ It may be difficult to quantify and **measure the success** of social enterprise activities ▪ Social enterprises may find it **difficult to grow**

▪ Social enterprises work with a wide range of **stakeholders**	▪ Obtaining additional finance to **expand into new markets** or reach a larger audience is likely to be difficult

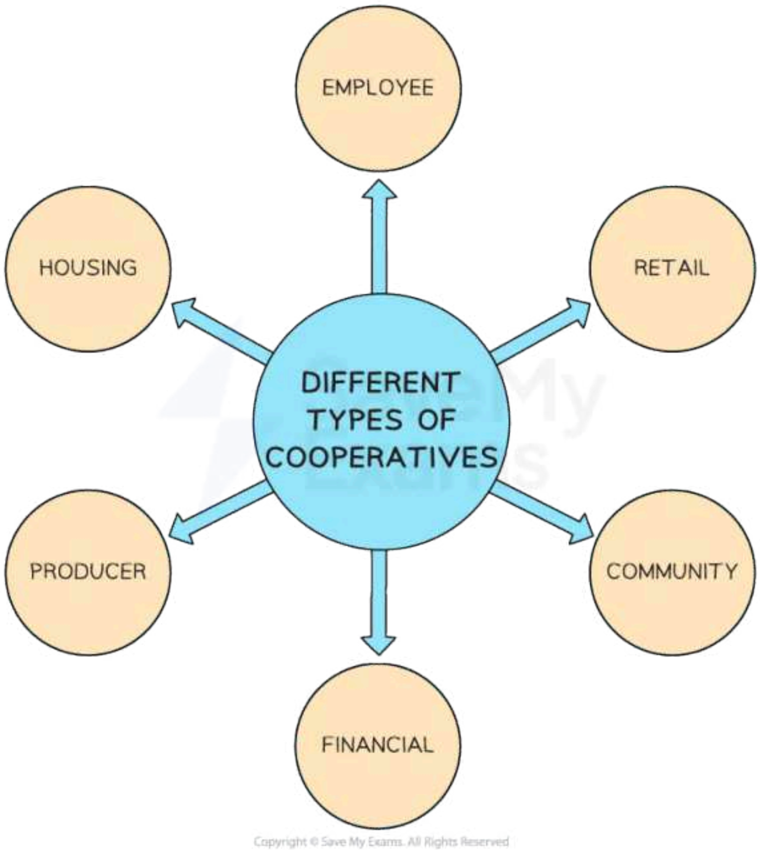
Social enterprises in the public sector

- In the public sector a range of organisations provide s**ocially-focused services** with the **aim of making a profit** or surplus
  - Services are often **provided to other public sector organisations, communities** or government departments

Cooperatives

- Cooperatives are a form of for-profit social enterprise that are **owned and run by and for their members** with the principle that **working together** means more **power**
  - Each member owns **one share** and has **one vote** on key decisions
  - **Profits** are either **shared equally** between members or **reinvested** for their benefit
- Although cooperatives are often celebrated as businesses that take a broader approach to business than the generation of profits and provide some key social benefits they do have some drawbacks:
  - **Decision-making** in cooperatives can be time-consuming, as members have the right to have a say
  - When a member leaves a cooperative, their **share is relinquished** and they receive no further benefits
  - **Disagreements** can occur when members possess differing social and commercial objectives

Diagram: types of cooperatives



Different Types of Cooperatives

Employee Cooperative	Community Cooperative	Retail Cooperative

▪ **Owned equally by workers** within the business ▪ Each employee has a vote in business decisions ▪ **Profit is shared equally** between employees ▪ E.g. *Flaskô* in Brazil, which was purchased by its employees in 2003	▪ Owned by members of a **local community** ▪ **Members usually contribute time** as well as finance to the cooperative ▪ Profit is commonly reinvested to continue providing socially valuable products ▪ E.g. *Hour Exchange Portland* in the USA, a **time-bank** organisation	▪ A group of independent retailers come together and **operate under one brand name** ▪ **Buying power is increased** and marketing costs are shared ▪ E.g. DIY retailer *ACE Hardware* in the Philippines
Producer Cooperative	**Financial Cooperative**	**Housing Cooperative**
▪ Groups of manufacturers **work together** during the production process ▪ Sharing and **maximising the use of expensive capital equipment** is often a key aim ▪ Producer cooperatives are **common in agriculture** ▪ E.g. *The German Wine Group* cooperative brings together small wine producers in the country's main wine-producing regions	▪ Organisations that provide financial services to individuals that may not otherwise qualify for standard banking products ▪ Often **focused on a particular community** ▪ Social aims take precedence over profits ▪ E.g. in the UK, *Medway Credit Union* provides loans and savings facilities to those living with challenging circumstances	▪ Organisations that **provide housing** for members ▪ Members collectively own and benefit from socially cohesive and **lower cost dwellings** ▪ E.g. Almost 30% of housing in Poland is owned through housing cooperatives with *Spółdzielnia Mieszkaniowa* in Warsaw being one of the most well-known housing cooperatives

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Types of Non-Profit Social Enterprises

Non-profit Social Enterprises

- A non-profit social enterprise is an organisation that combines the characteristics of both a **non-profit organisation** and a **social enterprise**
- Non-profit social enterprises pursue a **social or environmental mission** while using business strategies to generate revenue and achieve financial sustainability
  - These organisation rarely make a surplus or profit
- Two of the **main forms of non-profit social enterprises** are non-governmental organisations (NGOs and Charities

Non-governmental organisations (NGOs)

- NGOs operate locally, nationally and/or internationally and are **independent of government**
  - These are typically **voluntary**, community-based organisations which do not aim to make a profit but seek to meet a need or **provide a service**
- NGOs are typically financed by a combination of **government funding and donations** from businesses or private individuals
- With a community based emphasis, they are able to
  - Engage in **small scale projects,** giving control to community stakeholders
  - Draw on local skills
  - Encourage sustainability & remove the need for **aid**
  - Tackle **environmental sustainability** using local knowledge & resources
  - **Lobby** governments to support their cause
- NGOs have played a major role in many **LEDCs** and their **aid often comes with fewer conditions** or expectations than that provided by overseas development agencies
  - Examples of NGOs include *Oxfam International*, *Save the Children International* and *Amnesty International*

Charities

- Charities have a **specific purpose** defined by law and are subject to **strict regulations** governing their activities

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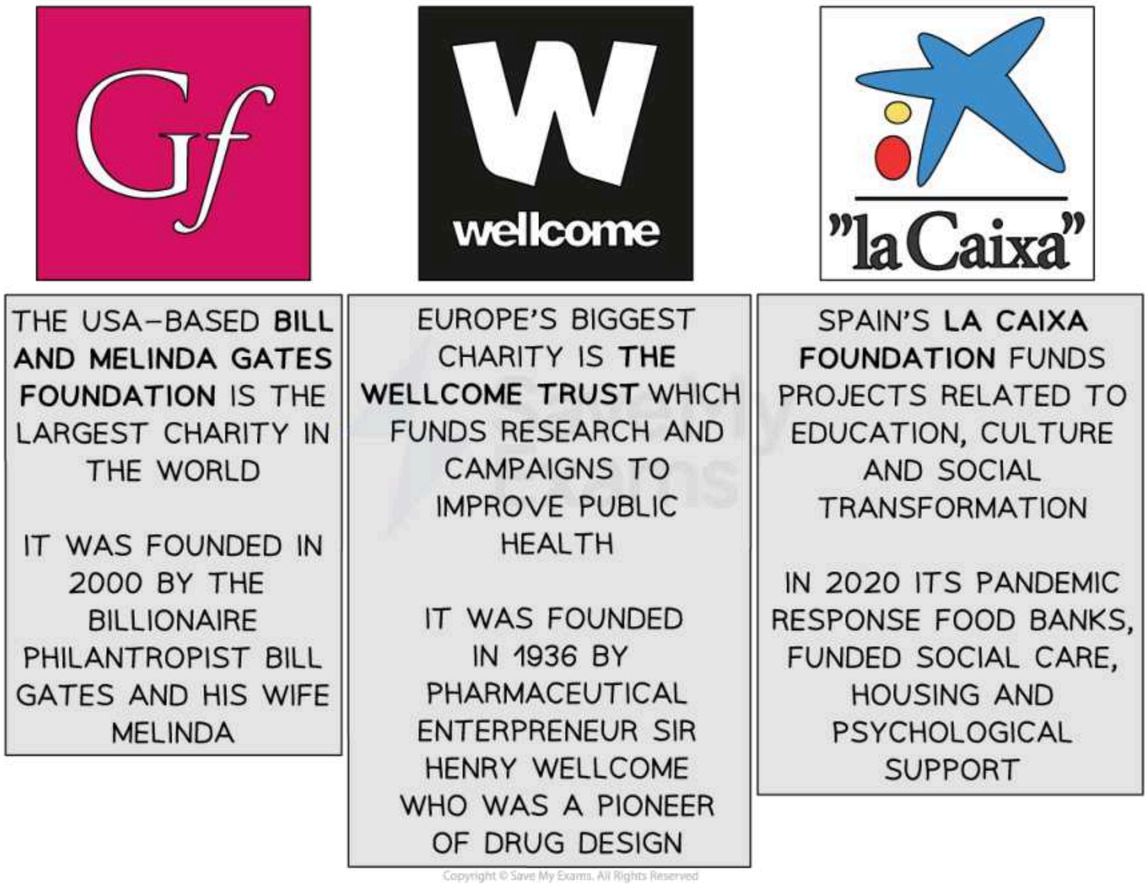
- They primarily rely on **donations** from individuals, corporations and governments and often actively **fundraise** and engage in **campaigns** to attract donations

Diagram: a selection of international charities



Examples of charities around the world

- The terms NGO and charity are often used interchangeably and there are variations in their definitions and usage between countries or regions

An Evaluation of Charities and NGOs

Advantages	Disadvantages
NGOs and charities can gain support for particular needs from a very wide audience including the **global public** and many wealthy governments	The country or group receiving the charitable support or aid can become overly dependent on it

▪ They often have **specialists working for them** who provide **in country support** so as to increase the efficiency of their aid ▪ They conduct research, gather data and as a result often make **highly specific project proposals** aimed at directly improving the standard of living ▪ NGOs and charities can help develop **human skills** in the countries in which they work and this helps to break families out of poverty	▪ The scope of what an NGO or charity can do may be limited or only **focussed on one segment** of the population e.g children ▪ Salary levels of senior managers of NGOs and charities is often closely examined and **spending decisions sometimes attract negative media attention** ▪ Funding for NGOs and charities can be **irregular** which makes financial planning difficult

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Examiner Tips and Tricks

Make sure that you fully understand the differences between charities and NGOs.

Whilst they are both types of non-profit organisation, charities are regulated by national Charity Commissions and have a relatively narrow scope of operations.

NGOs can also be charities - but not always. Oxfam and Médécins sans Frontières are both registered as charities in several countries but operate as NGOs in other countries around the world, particularly where the domestic **third sector** is underdeveloped.