Chapter 3: Forms of business organisation

Almost every country consists of two business sectors, the private sector and the public sector. Private sector businesses are operated and run by individuals, while public sector businesses are operated by the government. The types of businesses present in a sector can vary, so lets take a look at them.

Private Sector

Sole Traders

Sole traders are the most common form of business in the world, and take up as much as 90% of all businesses in a country. The business is owned and run by one person only. Even though he can employ people, he is still the *sole proprietor* of the business. These businesses are so common since there are so little legal requirements to set up:

- The owner must register with and send annual accounts to the government **Tax Office**.
- They must register their business names with the **Registrar of Business Names**.
- They must obey all basic laws for trading and commerce.

There are advantages and disadvantages to everything, and here are ones for sold traders:

Pros:

- There are so few **legal formalities** are required to operate the business.
- The owner is his own boss, and has **total control** over the business.
- The owner gets **100%** of **profits**.
- **Motivation** because he gets all the profits.
- The owner has **freedom** to change working hours or whom to employ, etc.
- He has personal **contact** with customers.
- He does not have to share information with anyone but the tax office, thus he enjoys complete **secrecy**.

Cons:

- Nobody to **discuss** problems with.
- **Unlimited liability**.
- **Limited finance/capital**, business will remain small.
- The owner normally spends **long hours** working.
- Some parts of the business can be inefficient because of lack of**specialists**.
- Does not benefit from **economies of scale**.
- No **continuity**, no **legal identity**.

Sole traders are recommended for people who:

- Are setting up a new business.
- Do not require a lot of capital for their business.
- Require direct contact for customer service.

Partnership

A partnership is a group consisting of 2 to 20 people who run and own a business together. They require a **Deed of Partnership** or **Partnership Agreement**, which is a document that states that all partners agree to work with each other, and issues such as who put the most capital into the business or who is entitled to the most profit. Other legal regulations are similar to that of a sole trader.

Pros:

- More **capital** than a sole trader.
- **Responsibilities** are **split**.
- Any **losses** are **shared** between partners.

Cons:

- **Unlimited liability**.
- No **continuity**, no **legal identity**.
- Partners can **disagree** on decisions, slowing down decision making.
- If one partner is **inefficient** or **dishonest**, everybody loses.
- **Limited capital**, there is a limit of 20 people for any partnership.

Recommended to people who:

- Want to make a bigger business but does not want legal complications.
- Professionals, such as doctors or lawyers, cannot form a company, and can only form a partnership.
- Family, when they want a simple means of getting everybody into a business (Warning: Nepotism is usually not recommended).

Note: In some countries including the UK there can be Limited Partnerships. This business has limited liability but shares cannot be bought or sold. It is abbreviated as LLP.

Private Limited Companies

Private Limited Companies have separate legal identities to their owners, and thus their owners have limited liability. The company has continuity, and can sell shares to friends or family, although with the **consent of all shareholders**. This business can now make legal contracts. Abbreviated as Ltd (UK), or Proprietary Limited, (Pty) Ltd.

Pros:

- The sale of shares make **raising finance** a lot easier.
- Shareholders have **limited liability**, therefore it is safer for people to invest but creditors must be cautious because if the business fails they will not get their money back.
- Original owners are still able to **keep control** of the business by restricting share distribution.

Cons:

- Owners need to deal with many **legal formalities** before forming a private limited company:

- **The Articles of Association:** This contains the rules on how the company will be managed. It states the rights and duties of directors, the rules on the election of directors and holding an official meeting, as well as the issuing of shares.
- **The Memorandum of Association:** This contains very important information about the company and directors. The official name and addresses of the registered offices of the company must be stated. The objectives of the company must be given and also the amount of share capital the owners intend to raise. The number of shares to be bought b each of the directors must also be made clear.
- **Certificate of Incorporation:** the document issued by the Registrar of Companies that will allow the Company to start trading.

- Shares cannot be freely sold without the **consent of all shareholders**.
- The accounts of the company are **less secret** than that of sole traders and partnerships. **Public information** must be provided to the Registrar of Companies.
- **Capital** is still **limited** as the company cannot sell shares to the public.

Public Limited Companies

Public limited companies are similar to private limited companies, but they are able to sell shares to the public. A private limited company can be converted into a public limited company by:

1. A **statement** in the Memorandum of Association must be made so that it says this company is a public limited company.
2. **All accounts** must be made **public**.
3. The company has to apply for a **listing** in the **Stock Exchange**.

A **prospectus** must be issued to advertise to customers to buy shares, and it has to state how the capital raised from shares will be spent.

Pros:

- **Limited liability.**
- **Continuity.**
- Potential to raise **limitless capital.**
- **No restrictions** on transfer of shares.
- **High status** will attract investors and customers.

Cons:

- Many **legal formalities** required to form the business.
- Many **rules and regulations** to protect shareholders, including the publishing of **annual accounts**.
- Selling shares is **expensive**, because of the commission paid to banks to aid in selling shares and costs of printing the prospectus.
- **Difficult to control** since it is so large.
- Owners **lose control**, when the original owners hold less than 51% of shares.

Control and ownership in a public limited company:

The **Annual General Meeting (AGM)** is held every year and all shareholders are invited to attend so that they can elect their **Board of Directors**. Normally, Director are **majority shareholders** who has the power to do whatever they want. However, this is

not the case for public limited companies since there can be millions of shareholders. Anyway, when directors are elected, they have to power to make important decisions. However, they must hire **managers** to attend to day to day decisions. Therefore:

- Shareholders **own** the company
- Directors and managers **control** the company

This is called the **divorce between ownership and control.**
Because shareholders invested in the company, they expect **dividends**. The directors could do things other than give shareholders dividends, such as trying to expand the company. However, they might lose their status in the next AGM if shareholders are not happy with what they are doing. All in all, both directors and shareholders have their own **objectives**.

Co-operatives

Cooperatives are a group of people who agree to work together and pool their money together to buy "**bulk**". Their features are:

- All members have equal rights, no matter how much **capital** they invested.
- All workload and decision making is **equally** shared, a manager maybe appointed for bigger cooperatives
- **Profits** are shared **equally**.

The most common cooperatives are:

- **producer co-operatives**: just like any other business, but run by workers.
- **retail co-operatives**: provides members with high quality goods or services for a reasonable price.

Other notable business organizations:

Close Corporations:

This type of business is present in countries such as South Africa. It is like a private limited company but it is much quicker to set up:

- Maximum limit of 10 people.
- You only need a simple **founding statement** which is sent to the Registrar of Companies to start the business.
- All **members** are **managers** (no divorce of ownership and control).
- A separate legal unit, has both limited liability and continuity.

Cons:

- The size limit is not suitable for a large business.
- Members may disagree just like in a partnership.

Joint ventures

Two businesses agree to start a new project together, sharing capital, risks and profits.

Pros:

- Shared costs are good for tackling expensive projects. (e.g aircraft)
- Pooled knowledge. (e.g foreign and local business)
- Risks are shared.

Cons:

- Profits have to be shared.
- Disagreements might occur.
- The two partners might run the joint venture differently.

Franchising

The **franchisor** is a business with a successful brand names that recruits **franchisees** (individual businesses) to sell for them. (e.g. McDonald, Burger King)

Pros for the franchisor:

- The franchisee has to **pay** to use the brand name.
- **Expansion** is much **faster** because the franchisor does not have to finance all new outlets.
- The **franchisee manages** outlets
- All products sold must be **bought** from the **franchisor**.

Cons for the franchisor:

- The **failure** of one franchise could lead to a **bad reputation** of the whole business.
- The franchisee **keeps** the **profits**.

Pros for the franchisee:

- The chance of **failure** is much **reduced** due to the well know brand image.
- The franchisor pays for **advertising**.
- **All supplies** can be obtained from the franchisor.
- Many **business decisions** will be made by the franchisor (prices, store layout, products).
- **Training** for staff and management is provide by the franchisor.
- Banks are more willing to **lend** to franchisees because of **lower risks**.

Cons for the franchisee:

- **Less independence**
- May be **unable** to make **decisions** that would suit the local area.
- **Licence fee** must be paid annually and a **percentage** of the **turnover** must be paid.

<u>Public Sector</u>

Public corporations:

A business owned by the government and run by Directors **appointed by the government**. These businesses usually include the water supply, electricity supply, etc. The governments give the directors a set of **objectives** that they will have to follow:

- to keep **prices low** so everybody can afford the service.
- to keep people **employed**.
- to **offer a service** to the **public** everywhere.

These objectives are expensive to follow, and are paid for by government**subsidies**. However, at one point the government would realise they cannot keep doing this, so they will set different objectives:

- to **reduce costs**, even if it means making a few people redundant.
- to **increase efficiency** like a private company.
- to **close loss-making** services, even if this mean some consumers are no longer provided with the service.

Pros:

- Some businesses are considered **too important** to be owned by an individual. (electricity, water, airline)
- Other businesses, considered **natural monopolies**, are controlled by the government. (electricity, water)
- **Reduces waste** in an industry. (e.g. two railway lines in one city)
- **Rescue important** businesses when they are failing.
- Provide **essential services** to the people (e.g. the BBC)

Cons:

- **Motivation** might not be as high because **profit** is not an objective.
- **Subsidies** lead to **inefficiency**. It is also considered **unfair** for private businesses.
- There is normally **no competition** to public corporations, so there is **no incentive** to improve.
- Businesses could be run for **government popularity.**

Municipal enterprises

These businesses are **run by local government authorities** which might be **free** to the user and financed by local **taxes**. (e.g, street lighting, schools, local library, rubbish collection). If these businesses make a loss, usually a government **subsidy** is provided. However, to reduce the burden on taxpayers, many municipal enterprises are being **privatized**.