The firm

2.2.Types of firms: economic, organizational and legal criteria

At a glance

2.1. Concept of firm and firm goals
2.2. Types of firms: economic, organizational and legal criteria
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In the first part of the lesson we will discuss the role of the firm, several views of the firm such as the systemic and the accounting views and, finally, we will elucidate alternative firm goals. In addition, we will detail how to measure these goals.

The second part of the lesson describes several useful classification criteria of firms and, in particular, some common legal forms.

Lesson 2. The firm

2.2. Types of firms: economic, organizational and legal criteria

A. Economic and organizational criteria

Size

Economic activity

Geographical scope

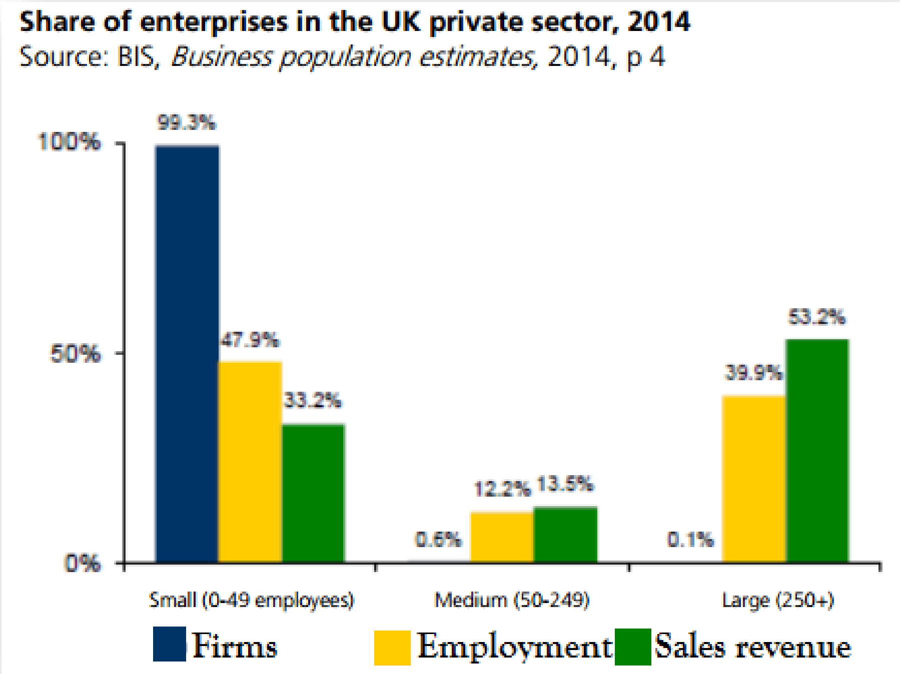
Ownership

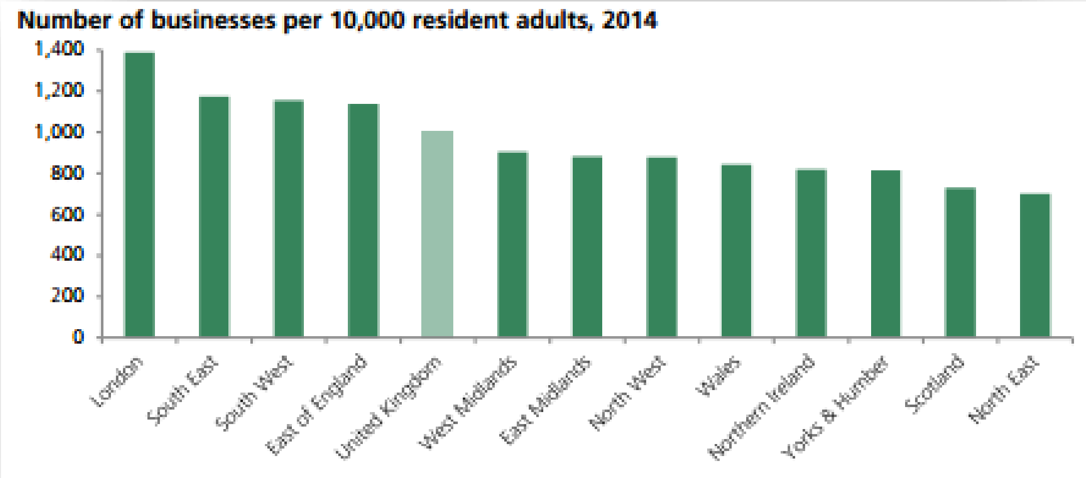
Classifying firms according to **size**

	Headcount	Turnover	Balance Sheet Total
Micro	<10	≤ €2M	≤ €2M
Small	<50	≤ €10M	≤ €10M
Medium Size	<250	≤ €50M	≤ €43M
Large	REST		

Criteria used by the European Commission (2003/361/EC) regarding the SME definition

Classifying firms according to **size**





Classifying firms according to **economic activity**

Primary sector

- Extracts or harvest products from nature
- Agriculture, mining, farming, fishing...

Secondary sector

- Manufacturing of finished products
- Automobile, chemical, construction, energy...

Tertiary sector

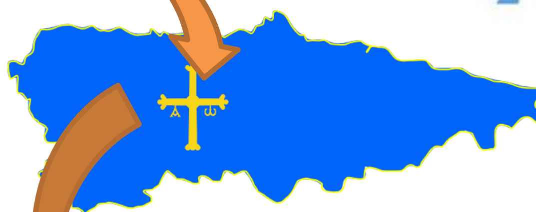
- Provides services to consumers and business
- Retailing, transportation, tourism, banking, healthcare...

This is a useful classification…
… but firm boundaries are not
constrained by sectors.

REPSOL

Classifying firms according to **geographical scope**

Local | Regional | National | Multinational



Electro innova

ALIMERKA

ALSA
Hacemos tu viaje más fácil

International Expansion *Process*

- Development of information technologies
- Reduction of transport costs
- Breaking barriers in the markets
- Advances in production processes

Classifying firms according to **ownership**

Private ownership	Mixed ownership	State ownership
Santander	RBS The Royal Bank of Scotland Group	Puerto de Gijón Autoridad Portuaria de Gijón
CAJA RURAL DE GIJÓN	RED ELÉCTRICA DE ESPAÑA	grupohunosa

Private ownership: private owners have the majority of capital

State ownership: public administrations have the majority of capital, and hence they control the firm

Mixed ownership: both private owners and public administrations

Classifying firms according to **ownership**

Aena Aeropuertos Españoles y Navegación Aérea

Telefónica

SEAT

Privatization Process (sale): aimed at increasing the profitability and competitiveness of the firm (reducing deficits).

STATE OWNERSHIP **MIXED OWNERSHIP** **PRIVATE OWNERSHIP**

Expropriation Process (compensation): for reasons of public utility or social interest.

Classifying firms according to **ownership**

Private company

A private company is a company owned by a relatively small number of owners which **does not offer or trade the shares to the general public** on the stock market exchanges.

Public company

A public company is a company that **offers its shares for sale to the general public**, typically through a stock exchange market.

DO NOT CONFUSE IT WITH A STATE-OWNED COMPANY!

B. Legal criteria

Sole Proprietorship

Limited Company

Co-operative

SOLE PROPRIETORSHIP

SPAIN: empresario individual

It is created (and owned) by a **single individual** who usually **undertakes the activity and manages the business**. If required, the owner can hire employees.

Company earning are treated just like the owner's income; likewise, any debts the company incurs are considered to be the owner's personal debts. That is, **liability is unlimited**.

It is the **simplest form** of business structure. It is also relatively **easy and inexpensive** to start and maintain.

Sole proprietorships choose between trading under their own name or registering a business name.

SOLE PROPRIETORSHIP

Pros

- Simple set up (Ease of formation)
- Complete control of the assets and business decisions
- Low reporting requirements (no public disclosure)

Cons

- Unlimited liability (risky venture)
- Heavy workload and responsibilities
- Limited financial resources
- Scale problems (*e.g.* limited ability to attract employees)

LIMITED COMPANY

SPAIN: sociedades capitalistas (sociedad limitada y sociedad anónima)

Unlike sole proprietorships and partnerships, a LC is considered to be a **legal entity** that is separate and distinct from its owners. Hence, it offers limited liability for owners, the shareholders.

LCs are created following a legal procedure that includes “filing articles of incorporation” and designing “corporate bylaws” that provide a roadmap for how the company will be run and how decisions will be made. Formation of LCs **takes more time and effort** than sole proprietorships and partnerships.

Capital is what decides the economic and political rights. **The capital is divided into shares**, so members/owners are known as shareholders. Each share is entitled to a cut of the profits and political rights of each shareholder to vote are proportional to the number of shares owned.

Limited companies are **common business vehicles** in most jurisdictions.

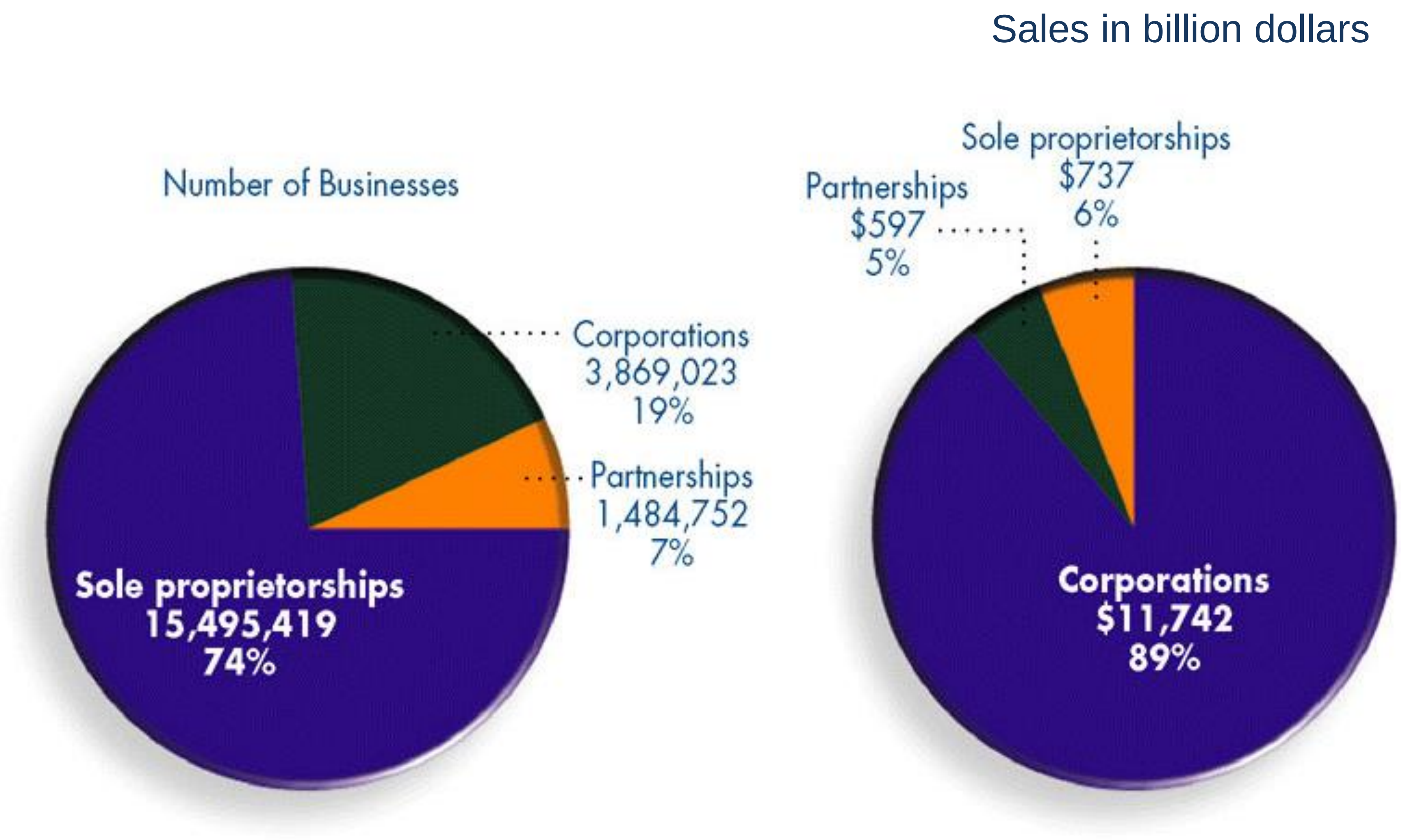
LIMITED COMPANY

<u>Public</u> companies are those whose shares can be publicly traded, often (although not always) on a regulated stock exchange. Therefore, there are not restrictions on transfer of shares.

<u>Private</u> companies do not have publicly traded shares and often contain restrictions on transfers of shares.

Country	Can go public	Cannot go public
Spain	Sociedad Anónima (S.A.)	Sociedad Limitada (S.L.)
UK	Public Limited Company (plc)	Private Limited Company (Ltd.)
USA	Corporation (Corp., Inc.) C-Corporation	Limited Liability Company (LLC) S-Corporation

Forms of Business Ownership (US)



LIMITED COMPANY

PROS

Shareholders only risk their initial investments and earnings that have being generated thanks to limited liability

LIMITED RISK

FINANCING

SPECIALIZATION

Shareholders specialize in risk taking and managers specialize in managing thanks to limited liability that reduces risk taking.

Great ability to raise funds thanks to limited liability that reduces risk taking.

PROS

FINANCING

- Great ability to raise funds.
- May have as many investors (shareholders) as needed. Investors can contribute with very small amounts but the sum can be huge.

SPECIALIZATION

- Professional managers can develop managerial skills efficiently.
- Shareholders specialize in risk bearing. By diversifying their investment portfolios, they can reduce the risk each of them bears individually.

LIMITED COMPANY

CONS

HIGH INFORMATION REQUIREMENTS (PUBLIC DISCLOSURE)

EXPENSIVE TO FORM AND OPERATE

Separation of ownership and management leads to a fundamental conflict of interest.

CONFLICT OF GOALS

Owner / Shareholder ≠ Manager / Officers

Profit maximization

Value creation for the owner

Compensation (salary, benefits, incentives)

Prestige, power, image

Growth (empire building)

Golden parachutes

LIMITED COMPANY

SOLVING THE CONFLICT: CONTROL MECHANISMS

INTERNAL CONTROL

- Board of Directors
- Incentive plans

LIMITED COMPANY

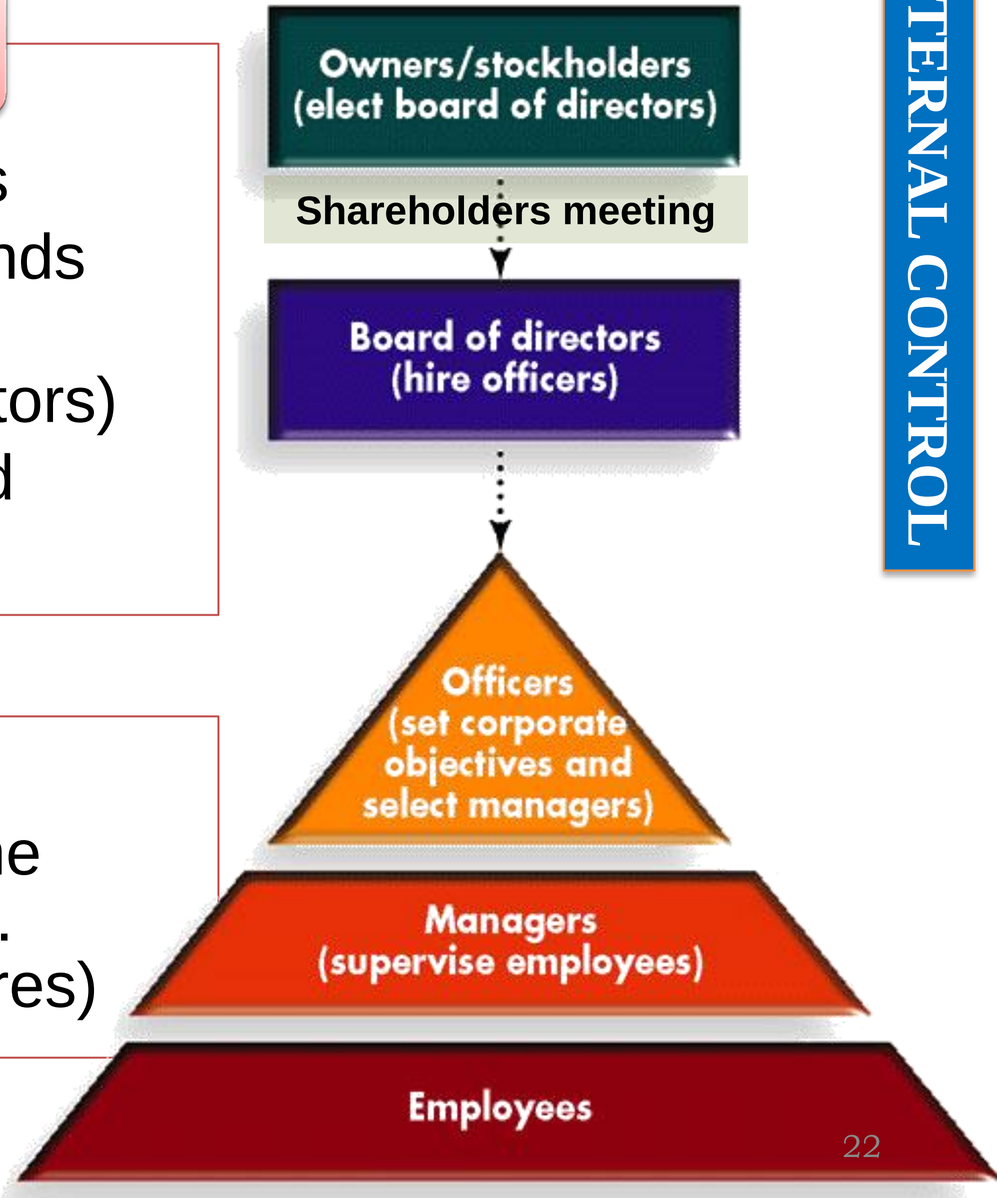
SOLVING THE CONFLICT: CONTROL MECHANISMS

BOARD OF DIRECTORS

- Delegates of shareholders
- Effective monitoring depends on board composition:
  - Internal (executive directors)
  - External (proprietary and independent directors)

INCENTIVE PLANS

- Compensation tied to some predefined objectives (e.g. market value of stock shares)



INTERNAL CONTROL

CO-OPERATIVE

SPAIN: cooperativa

They are autonomous **association of people who voluntarily cooperate for their mutual social, economic, and cultural benefit** through a jointly-owned and **democratically-controlled** enterprise.

Voluntary and open membership

- Non discrimination principle (race, gender, etc..)

Democratic member control

- Equal voting rights (one member, one vote).

Member economic participation

- Surplus is allocated to: development of the co-operative, setting up reserves and benefiting members in proportion to their transactions with the co-operative.

Limited interest on capital

- Capital is a necessary production factor and must be compensated with a fixed interest rate.

Limited liability

- Members financial liability is limited to their capital contribution to the co-op.

Shares cannot be publicly traded

- It would generate problems (interfere with human resources management, twist the co-op idea).

CO-OPERATIVE TYPES

Worker Co-ops

- Owned and self-managed by workers. Real co-ops are hybrid forms that allow outside owners (capitalist investors) and hired labor (not owners).

Production Co-ops

- Created by other firms (usually farmers) to obtain services for their productive activities in favorable conditions (usually to gain scale economies, to reduce costs).

Consumer Co-ops

- Owned by its customers (supermarkets, housing, insurance, etc.).

CO-OPERATIVE

PROS

Motivation

- Oriented towards serving the needs of members instead of having the goal of rewarding capital.
- Workers control the business in which they work.

Concern for community

- Sustainable development of the community is a traditional goal stated in co-operative principles .

Tax incentives

- Co-operatives are protected by law and enjoy important tax advantages over corporations.

CO-OPERATIVE

CONS

Limited time horizon of members

- Short term investments are preferred and long term projects are abandoned, since worker's claim on the residual terminates when she leaves the firm. Shares are not sold in the market.

Concern about incorporating new members

- New members enjoy the same benefits (which includes profit sharing) as old members.

Risk concentration

- Members concentrate much risk, specially in worker co-ops because they are both workers and capitalists.

Key concepts

SMEs and large firms.

Primary, secondary and tertiary sectors.

Local, regional, national and multinational firms.

Private, mixed and state ownership (Privatization and expropriation).

Private and public companies.

Sole proprietorships.

Limited company: limited liability, shareholders, SLs, SAs.

Limited company: conflict of interest and corporate governance.

Co-operative: worker, production and consumer co-ops.