

Learning Module 1: Organization Forms, Corporate Issuer Features and Ownership

LOS 1a: compare the organizational forms of business

Generally, there are three major organizations in market economies, each with specific reasons, stakeholders, and a governing legal framework. They include:

- i. For-profit organizations (businesses or companies)
- ii. Not-for-profit, non-governmental organizations (non-profits)
- iii. Governments.

Under for-profits or simply businesses, there are three business structures:

- i. Sole trader or sole proprietorship.
- ii. Partnership.
- iii. Limited company.

We concentrate on the for-profits in the subsequent discussions.

Organizational Forms of Business

A business structure describes how a business is organized, influencing day-to-day operations.

Five factors determine a business structure:

- i. **Legal Identity:** Describes the legal relationship between the owner(s) and the business.
- ii. **Owner Liability:** Indicates the level of liability an individual assumes due to a business' actions or debts. The levels of liability can be described as **limited** or **unlimited**.
- iii. **Owner-manager Relationship:** Describes the relationship between a business's owner(s) and the management.
- iv. **Taxation:** Describes the tax regime applicable to a business structure.
- v. **Access to financing:** A firm's ability to raise capital and distribute risk.

Types of Business Structures

Considering the above factors, we now discuss the following business structures:

1. Sole Proprietorship (or Sole Trader)

In a proprietorship, the owner raises the business capital and fully controls business operations. Moreover, the owner benefits fully from financial returns and assumes all the business risks. In most jurisdictions, sole proprietorship does not require formal legal registration. The sole trader is dissolved when the owner stops business operations. A good example would be a plumber.

General Features of Sole Trader

- The owner operates it.
- The business is not a legal identity. Hence it is considered as an extension of the owner.
- The owner keeps all the financial returns and bears all risks.
- Profits generated by the business are taxed as personal income.
- It is simple and flexible to operate.
- Financing is solely from the owner.
- Business growth depends on the financial ability and risk appetite of the owner.

2. Partnerships

In partnership business structures, multiple owners contribute resources and share business risk and return. There are two types of partnerships: General partnerships and limited partnerships.

i. General Partnership

In the general partnership business structure, at least two owners (partners)

whose roles and responsibilities are stated in the **partnership agreement**. However, partnerships can also be initiated verbally or incidentally. Unlike a sole proprietorship, there are multiple sources of funds, and the returns and risks are shared.

Good examples are professional service businesses such as law and accounting firms.

General Features of General Partnership

- Partners operate the business.
- It has no legal identity since ownership is set in the partnership agreement.
- The partners share all business risks and business liabilities.
- The partners share business returns, and profits are taxed like personal income.
- Capital and expertise are provided to the partners.
- Business growth depends on the ability of the partners to finance and the level of their risk appetite.

ii. Limited Partnership

In a limited partnership, partners are divided into two:

1. At least one **general partner (GP)** has **unlimited liability** and is responsible for managing the business.
2. **Limited partners (LPs)** have, as the name suggests, limited liability. This means their losses are capped at their investment amounts in the limited partnership.

The limited partners earn a share profit that is usually lower than that of the general partners. General partners earn more, given their managerial position in

the business.

Limited partnerships include private equity funds, real estate, and hedge funds.

General Features of Limited Partnerships

- The partners provide capital contributions and expertise.
- The general partner manages the business and has unlimited liability.
- Limited partners do not have business control and have limited liability.
- All partners are entitled to a share in returns, where profits are taxed as personal income.
- Business growth depends on the financial capabilities of the GPs and LPs, risk appetite, and the competence and integrity of the GP(s).

A **limited liability partnership (LLP)** is a unique form of limited partnership existing in certain jurisdictions. An LLP does not have a general partner; it consists of only limited partners. All partners bear limited liability and share management responsibilities.

Commonly, one or more partners are voted in as managing partners. For example, in the USA, LLPs include service firms such as law and accounting firms.

Limited Companies

A limited company is similar to a limited partnership, except that a limited company incorporates more features that facilitate more access to capital and skills that promote growth.

Limited companies are categorized into:

- i. Private limited company
- ii. Public limited company

Private Limited Company

A private limited company is like a limited partnership. However, in a limited company, all owners bear limited liability, ownership can be easily transferred using shares, and owners and managers are separated.

The owners called the shareholders, elect the board of directors to oversee the company and approve the distribution of profits to the owners. On the other hand, the board of directors appoints various managers.

A private limited company goes by different names depending on the jurisdiction within which it operates. For instance, it is referred to as a limited company in the UK and a limited liability company (LLC) in the US. In the US, LLCs are legally restricted to a certain number of shareholders, and taxation is applied at the shareholder level only.

Public Limited Companies (Corporations)

A public limited company (corporation) is similar to a private limited company, except that in many jurisdictions, there is no legal restriction on the number of owners or transfer of ownership.

General Features of a Corporation

- A corporation is a separate legal entity.
- Dividends (distributions) paid to the owners are taxed as personal income.
- Corporations have unlimited opportunities to access capital, hence unlimited capital potential.
- Owner-operator separation allows for higher and more diverse resourcing with significant risk control.
- In some countries, corporations are **tax disadvantaged** due to double taxation of corporate profits.

- Business liability is shared among multiple owners with limited liability.

Given the features of a corporation, it is the most appropriate form of company that wishes to go public and have a substantial global organizational form in terms of revenues and asset values.

Question

Which of the following statements is *most likely* correct regarding business structures?

- A. Sole trader and general partnerships business structures both have a legal identity.
- B. The taxation regimes for sole traders and partnerships are different.
- C. Corporate bondholders and shareholders have different claims on a corporation in exchange for the capital they provide.

Solution

The correct answer is C.

Corporate bondholders and shareholders are the capital providers of a corporation. Corporate bondholders provide debt capital, while the shareholders provide equity capital. The bondholders provide debt capital in exchange for issued debt securities with no ownership entitlement. On the other hand, aside from returns, shareholders are entitled to the company's ownership.

A is incorrect. Sole traders (sole proprietorships) and general partnerships do not have a legal identity. The business structures are considered an extension of the owner (sole proprietorship) or partnership agreement (general partnerships).

B is incorrect. The tax structures in both sole trader and partnerships are comparable because, in both business structures, profits are taxed as personal income.

LOS 1b: describe key features of corporate issuers

In this section, we shall delve more into corporations. Corporate issuers are corporations that raise their capital in financial markets. It is essential for financial analysts to understand corporate issuers because they can raise more capital from investors than governments worldwide.

Key features include:

Legal Identity

When a corporation is formed, articles of incorporation to a regulatory authority are filled. As such, a corporation is considered a legal entity that is unique and separate from its owners. Being a legal entity implies that a corporation has the rights and responsibilities of an individual. As such, it can participate in activities such as signing contracts, hiring employees, suing, being sued, borrowing, lending money, paying taxes, and initiating investments.

Established corporations are subject to regulatory jurisdictions in which they conduct business, list their securities, and are incorporated.

Depending on where the company is incorporated, where business is conducted, and where the company seeks financing, notable activities that regulatory bodies mainly concentrate on include:

- Registration of corporations.
- Financial and non-financial reporting and disclosure.
- Corporation's capital market activities.

Owner-Manager Separation

A notable corporation feature is owner-operator separation; the business owners and managers

are independent. In other words, the business owners are excluded from the company's day-to-day operations.

The owners elect a board of directors to run the business. The board then hires the CEO and other senior managers to oversee the corporation's day-to-day operations. The board of directors must conduct business that aligns with the owner's interest; otherwise, the owners may enact change through voting rights linked to their share.

In addition to adhering to the owner's interests, the board is expected to consider the interests of other stakeholders such as employees, creditors, customers, suppliers, regulators, and members of the society where the corporations operate.

The Owner-Manager separation of a corporation allows corporations to access capital financing easily. This is because capital is the only requirement to become one of the owners. As such, the owners can leverage greater resources to run the business.

Owner/Shareholder Liability

The risks in a corporation are shared among all owners. However, owners have limited liability. This implies that the maximum loss owners can incur is the amount of their investment in the business. Moreover, returns are shared by the owners through equity claims proportional to their respective shares.

There is no contractual obligation for the repayment of the ownership claim. Nevertheless, the owners have a residual claim on the corporation's cash flows and assets after liabilities have been settled.

External Financing

Corporations access capital financing through capital providers. These individuals and entities are willing to finance a company in return for the company's issued securities. The issued securities raise two types of capital:

- **Ownership capital (equity):** This is the money invested by a corporation's owners in

return for the company's ownership (they become shareholders), hence entitled to receive profit distributions in terms of dividends.

- **Borrowed capital (debt):** Money borrowed from lenders (bondholders). The bondholders exchange their capital for issued debt securities with no ownership entitlement.

Capital providers include corporations, family offices, governments, and individuals.

Taxation

Corporations are subject to the tax authority and tax codes outlining the issuer's tax reporting, payment, and status. Tax regimes on corporations vary from country to country.

In most countries, corporations are taxed directly on their profits. Moreover, shareholders may be taxed on dividends (double taxation of corporate profits). However, in some countries, shareholders are not taxed if the corporations had initially paid taxes on the dividends distributed.

Question

Double taxation will matter the *most* for:

- A. A company that reinvests its after-tax profits each year into business expansion.
- B. Shareholders who live in a country with high tax rates on dividend income.
- C. A company in a tax jurisdiction that pays no tax at all.

Solution

B is correct. High tax rates on shareholder dividends will cause companies to retain profits, change the organizational form of business or find an alternative way of distributing profits.

A is incorrect. No double taxation occurs because the company reinvests its profits; thus, no dividends are paid to shareholders.

C is incorrect. Double taxation will not be an issue if the company is not entitled to pay tax.

LOS 1c: compare publicly and privately owned corporate issuers;

A corporation can either be regarded as private or public. The following factors determine this classification:

- Issuance of shares.
- Exchange listing and share transfer.
- Registration and disclosure requirements.

1. Issuance of SharesPublic Companies

Public companies may issue additional shares in the capital markets to raise vast amounts of capital from investors. The investors can then trade among themselves in the secondary market.

Private Companies

In contrast, private companies invite investors to purchase their shares through a private placement memorandum (PPM) (also called an offering memorandum). This document describes a business, the terms of the offering, and the risks involved in investing in the company.

Private securities are typically unregulated. As such, only accredited investors may be invited to purchase the shares. **Accredited investors** are sophisticated investors whose high-risk appetite is so high that regulatory oversight and protection are unnecessary. An accredited investor should have a particular level of income (i.e., in the US, \$200,000 in income over the past two years or \$1 million in the capital) or a certain level of professional experience, such as holding in good standing a Series 7, 65, or 82 licenses.

2. Exchange Listing and Share Ownership TransferPublic Companies

Typically, the shares of a public company are listed and traded on an exchange. This allows the owners of a company to be easily transferred since buyers and sellers transact directly with one another in the secondary market.

Each transaction between a buyer and seller causes a change in share price. Such transactions, therefore, can show the changes in the value of companies over time. Moreover, the effect of significant news about a company or the overall economy can affect the value of the shares.

A listed public company's equity (market capitalization) can easily be calculated by multiplying the most recent stock price by the number outstanding.

Market capitalization is the theoretical amount an investor would pay to own an entire company. However, the investor must add a premium over market capitalization to woo the shareholders into acquisition.

Investors are also interested in the enterprise value of a public company. Enterprise value represents the market value of a company, i.e., the net cash held by the company. It is calculated as:

$$\text{Enterprise value} = \text{Market value of shares} + \text{Market value of Debt} - \text{Cash}$$

Enterprise value gives a better value than the cost of owning a company that is free and clear of all debt.

Private Companies

In private companies, shares are not listed on an exchange. For this reason, there is no noticeable valuation or price transparency, making it difficult to buy and sell shares. However, if the private company owner wants to sell shares, they will have to find a willing buyer and then agree on the price.

For private company shareholders, their investment is locked up either until another company buys the company or it goes public. However, the potential returns earned from private companies are generally higher than those earned from public companies.

3. **Registration and Disclosure Requirements****Public Companies**Public companies are obligated to register with a regulatory authority. This implies that they are subject to greater compliance and reporting requirements. For instance, the Securities and

Exchange Commission (SEC) regulates US public companies.

Additionally, public companies must disclose certain information, such as directors' stock transactions. The disclosed documents are publicized. It is, therefore, easier for investors and analysts to gauge the risks that might affect a company's business strategy and profit generation or those that might impede the fulfillment of its financial obligations.

Private Companies

Private companies are not subject to the same level of regulatory authority as public companies. Despite that, some pertinent rules, such as filing tax returns and prohibitions against fraud, are still applicable. It is worth appreciating that, unlike their public counterparts, private companies have no obligation to disclose certain information to the public.

Private companies can willingly disclose important information directly to their investors. This mainly happens when there is an objective to raise capital in the future. They are not required to file documents to a regulatory body.

Going from Private Company to Public Company

A private company can go public in three ways: **Initial public offering (IPO)**, **direct listing**, and **acquisition**.

Initial Public Offering (IPO)

In this method, a private company that meets specific listing requirements outlined by the exchange completes an IPO. An IPO involves an investment bank that underwrites the sale of new or existing shares. If it goes through, the company is public, and thus its shares are traded on an exchange.

The proceeds from an IPO go to the issuing company, which can then use to capitalize on other investments.

Direct Listing (DL)

Unlike an IPO, the direct listing does not involve an underwriter, and no new capital is raised. In a direct listing, the company is listed on an exchange where the existing shareholders sell the shares. A direct listing is beneficial in that it is fast and cost-effective.

Acquisition

A private company may go public when acquired by a large public company. Another way is through a unique purpose acquisition company (SPAC). A SPAC is a public company specializing in acquiring an unspecified company in the future; thus, it is mainly called a “blank check” company.

How do SPACs operate?

SPACs raise capital through an IPO, where proceeds are put in a trust account. The money in the trust account can only be distributed to complete the acquisition or can be returned to the investors after a finite time has elapsed.

Investors in SPACs do not know what the SPAC will buy, but they can speculate from the backgrounds of the SPAC's executives or comments on social media. When the SPAC finalizes the purchase of the private company, the company goes public.

Going from Public Company to Private Company

A company can go from public to private when investors (or groups of investors) purchase all the company shares and then delist them from the exchange. This can happen through a **leveraged buyout (LBO)** or **managed buyout (MBO)**.

Both LBOs and MBOs involve borrowing capital to finance the acquisition. The difference between LBOs and MBOs comes with the relationship between the investors buying a company and the acquired company. In an LBO, the investors are not affiliated with the company, while in an MBO, the buying investors are part of the acquired company's management.

LBOs and MBOs typically occur when investors feel a company's shares are undervalued in the public market. Further, they can happen when investors are persuaded that the financing costs of the acquisition are significantly low and attractive.

Trends in Public and Private Companies

In emerging economies, the number of public companies is increasing. This is because there are higher growth rates. Besides, this trend is attributable to the transition from closed to open market structures. The opposite is true for developed economies.

In developed economies, the number of private companies is increasing (an intuitively decreasing public companies) due to the following reasons:

- Mergers and acquisitions.
- Many private companies prefer to be private for easy accessibility of capital from the private market. This is because they can dodge regulatory hampers and associated costs.
- Companies prefer to remain private to discourage the short-term focus most investors in public companies have. Privatization offers flexibility and fruitful decision-making to business leadership.

Question

Which of the following statements is *most likely* true regarding a corporation at the maturity stage?

- A. Revenue and cash flows are positive and predictable.
- B. Revenues are positive and predictable, but cashflows are harmful and unpredictable.
- C. Low potential to source external financing.

Solution

The correct answer is A.

At the maturity stage, a corporation has positive cash flows and revenues. As such, the corporation has a high potential to outsource external financing at reasonable terms because its cash flows are more predictable with business-as-usual operations.