1.2 Types of business entities

For-profit commercial enterprises

The images below show two famous entrepreneurs. Do you recognise them? Jeff Bezos is the founder of Amazon, an online retailer. Cher Wang, an entrepreneur and philanthropist, is the co-founder and chairperson of HTC Corporation and integrated chipset maker, VIA Technologies. An innovator in touch and wireless hand-held devices, she is considered one of the most successful women in computer technology.

Figure 1. Jeff Bezos, the founder of Amazon, a global online retailer.

Source: (https://www.flickr.com/photos/seattlecitycouncil/39074799225/)Seattle City Council (https://www.flickr.com/photos/seattlecitycouncil/39074799225/), CC BY 2.0 (https://creativecommons.org/licenses/by/2.0/), via Flickr

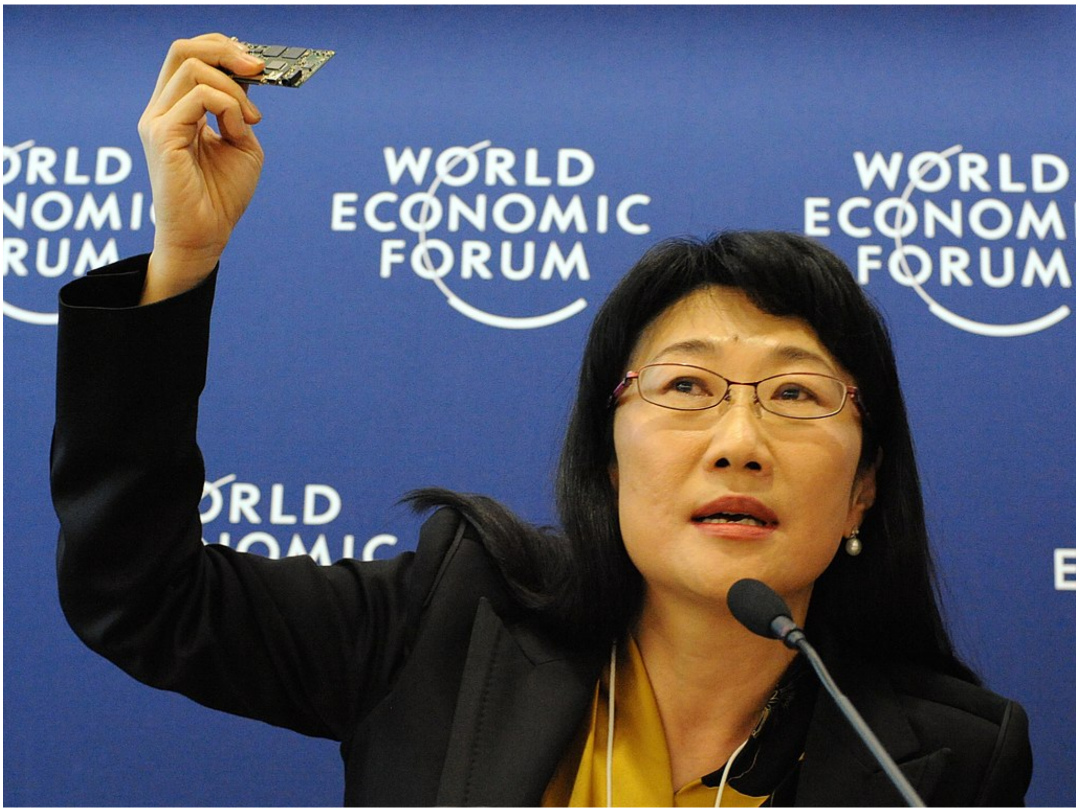


Figure 2. Cher Wang, entrepreneur and philanthropist.

Source: (https://commons.wikimedia.org/wiki/File:Cher_Wang_in_WEF.jpg)Robert Scoble from Half Moon Bay, USA (https://commons.wikimedia.org/wiki/File:Cher_Wang_in_WEF.jpg), (https://creativecommons.org/licenses/by/2.0) CC BY 2.0 (https://creativecommons.org/licenses/by/2.0), via Wikimedia Commons

As you learned in Subtopic 1.1 (/study/app/y12-business-management-a-sl-may-2024/sid-352-cid-174703/book/the-big-picture-id-36828), starting a business and becoming an entrepreneur is not an easy process. There are financial and external risks and constraints. Many entrepreneurs who start businesses want to earn profits in return for their risks and efforts. Thus, many business owners choose to operate as a for-profit commercial enterprise. These businesses earn profits and distribute them to the owners of the business, which may be one person or thousands of people, depending on the ownership structure. In this subtopic, you will learn about the four main types of ownership structure in the context of for-profit commercial activity:

- sole traders
- partnerships
- for-profit privately held companies
- for-profit publicly held companies

Sole traders

A sole trader is an individual who owns and runs a business alone. There is little legal distinction between the individual and their business, and this form of organisation is fairly easy to set up. Another advantage of this type of ownership is that sole traders are able to run the business as they see fit and keep all the profits. They can choose whether to reinvest profits in the business, or use them to meet their own financial needs.

Figure 3. A small business.

Credit: Howard Pugh (Marais), Getty Images

Examples of sole trader businesses include people who are self-employed, restaurant owners, freelance workers, fashion designers, tailors and interior decorators. Sole traders can work alone or can employ people to work for them. Often, these are small family businesses started with little capital investment. Personal savings are often used to start this type of business.

In a sole trader business, the success or failure of the business is the responsibility of the sole trader. They are responsible for debts they take on and any losses they suffer. If the business is unable to pay its debts, creditors (such as suppliers and banks, for example) can seize the owner's personal possessions, including their home. Sole traders may hire employees to help them, but these employees have no ownership interest in the business.

Another potential disadvantage of operating as a sole trader is the lack of distinction between the owner and the business. If the owner dies or is unable to work, for example, the future of the business itself may be uncertain. The business of a sole trader, in this case, may end operations, since the business does not have a separate legal identity from the owner. Sole trader businesses cannot be inherited and continued. They need to be unregistered in the event of the owner's death.

Some well-known companies operating currently were started as sole trader businesses. The luxury fashion house Chanel was started by Coco Chanel in 1910 and has become one of the most famous global brands today.

Figure 4. Coco Chanel, the founder of Chanel.

Source: (https://en.wikipedia.org/wiki/File:Coco_Chanel,_1920.jpg)in the public domain (https://en.wikipedia.org/wiki/File:Coco_Chanel,_1920.jpg), via Wikipedia

Table 1. Advantages and disadvantages of a sole trader.

Advantages	Disadvantages

Advantages	Disadvantages
Easy to set up. There are few legal formalities, regulations and paperwork.	**Unlimited liability.** The sole trader is legally responsible for the debts of the business. They may have to give up personal assets such as their own property to settle debts.
Profits. All profits go to the sole trader as the owner of the business.	**Difficult to finance.** Many sole traders have to use personal savings to finance the business. Expansion and growth of the business might be slower.
Fast decision-making. Sole traders do not need to consult with other owners.	**High risk of failure.** The business may face strong competition from larger, better funded businesses.
Personal service. The small size of the business can help the sole trader to cater to individual customer needs.	**High workload.** The sole trader must manage their own accounts, human resources and marketing.
Financial records remain private.	**Lack of continuity.** If the sole trader dies, the business is likely to cease trading.
	Possible higher taxes. The owner may have to pay income tax, often higher rates, instead of corporate tax.

Partnerships

A partnership involves the creation of a business by two or more individuals, or partners. Partnerships are governed by partnership agreements, which define the ownership interests of the different partners, as well as how major decisions will be made by the partnership. Two partners may set up a business where ownership and control are split equally between the partners, or they may determine another arrangement that suits the purposes of the business. Some common examples of partnership are medical practices and law firms.

A partnership agreement will likely include the following:

- the amount of money put in by each partner
- the sharing of profits and losses by each partner
- the roles and responsibilities of each partner
- the rules around accepting new partners or withdrawal of existing partners
- the procedures for ending the partnership

Figure 5. Medical practices may be set up as partnerships.

Credit: Cecilie_Arcurs, Getty Images

Table 2. Advantages and disadvantages of partnerships.

Advantages	Disadvantages

Advantages	Disadvantages
Easy to set up. There are few legal formalities or regulations to set up a partnership of two or more partners.	**Unlimited liability.** Partners are legally responsible for all debts if the business fails. They may have to give up their own personal property to settle debts.
Greater access to finance. There is more than one person (partner) to invest in the business.	**Lengthier decision-making and potential for disagreement.** Partners have to consult each other, so decision-making about the business may take time, and partners may disagree.
Greater efficiency and productivity. As partners specialise in different skills, **productivity** increases and helps reduce costs.	**Legal and financial responsibility.** Mistakes made by one partner can reduce profits for all partners.
Financial records remain private.	**Lack of continuity.** If one partner dies, the deed of partnership (legal agreement) becomes invalid and will have to be made again (depending on laws of the country).

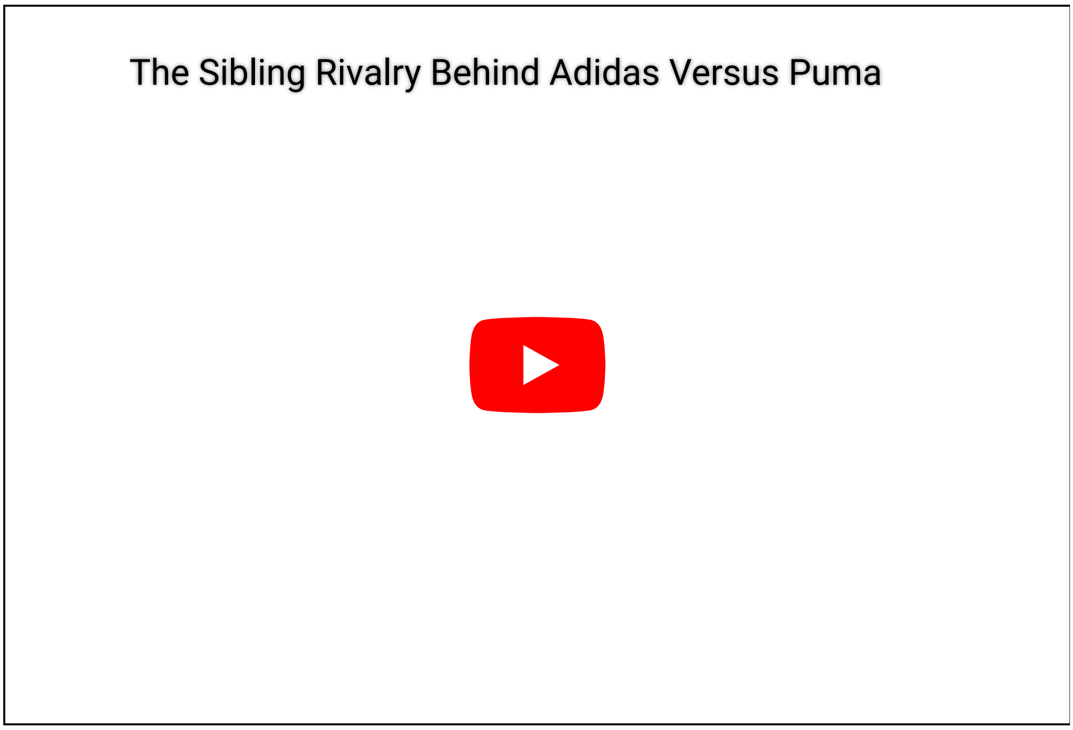
Activity

Learner profile: Thinkers
Approaches to learning: Thinking skills (transfer)

Did you know that the founders of footwear companies Puma and Adidas were siblings?

Puma and Adidas are two of the best-known shoe brands globally. The siblings (brothers Adi and Rudi Dassler) were originally partners in a shoe company "Gebrüder Dassler Schuhfabrik" (English: Dassler Brothers Shoe Factory). The company was started by Adi Dassler, and his brother Rudi joined in 1924. However, after a disagreement following World War II, the brothers went their separate ways and started their own companies in 1948. The following video explains what happened.

What does this story tell you about the potential disadvantages of partnerships?



Video 1. The story of the Dassler brothers and how the Puma and Adidas brands were founded.

Companies (corporations)

A company (corporation) is generally a larger organisation than either a sole trader business or a partnership and is usually 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)

When businesses are incorporated, they become legal entities separate from their shareholders. These shareholders enjoy 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.

Limited liability is a powerful tool that allows companies to access finances more easily than is possible for sole traders and partnerships. Investors can buy shares of the company in the hope of making a good return on their investment without exposing themselves to undue risk. The death of a shareholder has no impact on the continued functioning of the company. Shareholders are, in most cases, also free to sell their shares in the company, and this sale will generally have a limited impact on the company.

Companies whose shares are traded on the stock exchange (where shares may be bought and sold) have to follow complicated regulations. Regulations protect investors who buy shares in a company, but who do not run or control its operations. A board of directors is elected to run the company on behalf of the shareholders. The board of directors represents the shareholders and provides broad oversight of the company's operations.

There are two types of limited liability companies (corporations):

- privately held companies
- publicly held companies

International Mindedness

Here there is a difference between British and US terminology, with the IB Business Management guide reflecting British usage. In British terminology, 'company' and 'corporation' can be used interchangeably, with both words used only for organisations with shareholders who benefit from limited liability. In the US, however, 'company' is a generic word for a business, and includes sole traders and partnerships as well as corporations.

Privately held companies

A privately held company is privately owned and often has family or friends as the shareholders. The shares are not sold to the wider public and are not traded on a stock exchange. Financial capital is raised from family and friends who then own a share of the company. Shares generally cannot be sold to anyone else outside, without prior approval from all shareholders. This is so that the shareholders retain the ability to make decisions about 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).

Figure 6. IKEA is an example of a privately held company.

Source: (https://commons.wikimedia.org/wiki/File:Kuopio_Ikea.jpg)Tiia Monto (https://commons.wikimedia.org/wiki/File:Kuopio_Ikea.jpg), (https://creativecommons.org/licenses/by-sa/3.0)CC BY-SA 3.0 (https://creativecommons.org/licenses/by-sa/3.0), via Wikimedia Commons

Two documents are required before privately held companies can start operating. These documents are:

- the Memorandum of Association, which states the details of the company

- the Articles of Association, which states the internal roles and responsibilities of the board of directors and shareholders

Below are some well-known privately held companies.

- Koch Industries (consumer goods, USA)
- Deloitte (accounting, UK)
- Visy Industries (packaging, Australia)
- Vodacom Group Ltd (communications, South Africa)
- KPMG (accounting, UK/Netherlands)
- IKEA (furniture, Netherlands/formerly Sweden)
- LEGO (toys, Denmark)
- Huawei (telecommunications, China)
- Tata Group (automobiles, India)
- Lifestyle International (consumer goods, UAE)

Table 3. Advantages and disadvantages of privately held companies.

Advantages	Disadvantages
Control and ownership. Control and ownership is shared between a small group of people, usually family and friends.	**Profits.** Profits are shared between several shareholders.
Greater access to finances. Multiple people can invest in the business. There may be better access to external sources of finance.	**Lengthier decision-making.** All shareholders need to discuss and agree on decisions.
Limited liability. The personal assets of shareholders are not at risk if the business fails.	**Shares cannot be traded publicly to raise finances.**

Advantages	Disadvantages
Financial records. These are private and are not made public, enabling the company to take a longer-term view on the development of the company.	**Privacy.** The business may not be examined by external experts.
	Expensive. It is more costly and time-consuming to set up a privately held company.

Publicly held companies

Privately held companies that wish to access large amounts of financial capital in order to grow may decide to 'go public' in an initial public offering (IPO). This is where the company sells all or part of the business to external shareholders for the first time. The initial public offering results in the company becoming a publicly held company (public limited company). As owners of the business, shareholders usually receive a portion of the profits earned, or a dividend. With a larger number of shareholders, it means that profits of publicly held companies are spread among many more people than is typically the case with privately held companies.

One consequence of becoming a publicly held company is that a business must publish its financial accounts to the public, including its competitors. Another consequence is that it can be taken over by other companies who purchase large quantities of shares.

A publicly held company has a separate legal identity, so it has limited liability for shareholders. The death of one shareholder does not affect the working of the company. Rules and regulations are set up for its formation, working and management. There is no limit on the number of shareholders a publicly held company can have. And there is no legal obligation to inform or obtain consent from shareholders if members want to sell or transfer their shares.

Figure 7. Apple is one of the largest publicly held companies.

Source: (http://www.arne-mueseler.com/)Arne Müsele (http://www.arne-mueseler.com/)r, (https://creativecommons.org/licenses/by-sa/3.0/de/deed.en)CC BY-SA 3.0 (https://creativecommons.org/licenses/by-sa/3.0/de/deed.en), (https://commons.wikimedia.org/wiki/File:Apple_park_cupertino_2019.jpg)via Wikimedia Commons (https://commons.wikimedia.org/wiki/File:Apple_park_cupertino_2019.jpg)

Before a publicly held company can start operating, the following two documents need to be in place:

- a **memorandum of association**, which states the details of the company
- **articles of association**, outlining the internal roles and responsibilities of the board of directors and shareholders

Once the above documents are ready and an application fee is paid, a 'certificate of incorporation' is issued to the company. This is a licence recognising the company as a separate legal entity and allowing it to trade.

Shareholders of publicly held companies meet yearly at an Annual General Meeting to vote for or elect the board of directors and learn about the performance of the business from the chief operating officer. The financial accounts are also presented at the meeting to evaluate the performance of the financial year.

Below are some well-known publicly held companies.

- ICBC (banking, China)
- Apple (computer software and hardware, USA)
- AstraZeneca (pharmaceuticals, UK)
- Airbus (aerospace and defence, Netherlands)
- Saudi Aramco (oil, Saudi Arabia)
- Natura & Co. (personal care and cosmetics, Brazil)
- Adaro Energy (coal mining, Indonesia)
- Reliance Industries (conglomerate, India)
- Sonic Healthcare (health care, Australia)
- Samsung (electronics, South Korea)

Table 4. Advantages and disadvantages of publicly held companies.

Advantages	Disadvantages
Finances. Money (capital) can be raised through selling of shares to the public.	**Shared profits.** Profits are shared between many shareholders.
Risks. The risks are shared among a large number of shareholders.	**High costs.** It is expensive and a time-consuming process to set up a publicly held company.
Separate legal identity. If one shareholder dies, the business continues to operate.	**Loss of control.** Outsiders can get control of the business by becoming the largest shareholder.
Limited liability. If the business fails or suffers losses, the personal assets of shareholders are not at risk.	**Accounts are publicly available to be viewed.**

Case study

Mars Inc. is a privately held company in the United States, producing pet food, pet care and food products such as M&Ms, the Dolmio brand and more. With close to 40 billion USD in annual sales, it is one of the largest privately held companies in the world, owned entirely by the Mars family.

Mars is committed to being a privately held company and has no plans to become a publicly held company. The company is famous for its secrecy. Its former chairman, Steven Badger, says that remaining a privately held company allows Mars more freedom to pursue its business activities in the way it wants, enabling it to take a long-term perspective.

Thinking and acting for the long-term health of a business is often not possible in publicly held businesses that have to report earnings to shareholders every quarter. Mars has the advantage of being able to see the actions and earnings of their publicly held competitors, without revealing their own information to the public. This can give the company a strategic advantage. It may also be possible for Mars to reach decisions more quickly than would be the case if there were more shareholders.

Questions

1. Define the term privately held company. [2 marks]
2. Explain one advantage and one disadvantage for Mars Inc. as a privately held company, instead of a publicly held company. [4 marks]