BUSINESS STRUCTURE (1.2)

(Chapter 2 - AS level 1.2)

Economic sectors

We generally divide business activity into 3 sectors - **primary**, **secondary** and **tertiary**. Typically speaking, high income countries are more involved in the tertiary sectors, middle income emerging countries (such as China) are more involved in secondary sectors, and low income countries tend to be more primary sector focused.

This explains the average income wages, as jobs done by the primary sector are generally lower paid than those done in the tertiary sector.

Primary sector

Businesses engaged in farming, fishing, oil extraction and all other industries that extract natural resources so that they can be used and processed by other firms in the secondary/tertiary sectors

Secondary sector

Businesses that manufacture and process products from natural resources obtained from the primary sector - including computers, brewing, baking, clothes-making and construction

Tertiary sector

Businesses that provide services to consumers and other businesses, such as - retailing, transport, insurance, banking, hotels, tourism and telecommunications

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Up until the mid 18th century, the primary sector was the largest sector in the world, as agriculture was the main profession. After the industrial revolution, more countries began to become more industrialised and urban, leading to a rapid increase in the manufacturing sector (**industrialization**).

Nowadays, as countries are becoming more developed, the importance of the tertiary sector is increasing, while the primary sector is diminishing. The secondary sector is also slightly reducing in size (**deindustrialization**) compared to the growth of the tertiary sector . This is due to the growing incomes of consumers which raises their demand for more services like travel, hotels etc.

The public and private sector

Another way to divide business activity is by the **private** or **public sector** and or by the type of *legal organisation* it is.

Public sector businesses are run by the government, and tend to not have profit as their main aim - rather focusing more on social objectives that contribute to its community. Of course they will still need to be somewhat profit focused as they'll require money to reinvest to keep the business going, but the need to profit is secondary to providing a service to the people.

Private sector businesses are where private individuals own and run business ventures. Their aim is to make a profit, and all costs and risks of the business are undertaken by the individual. Examples : Nike, McDonald's, Virgin Airlines etc.

The majority of economies are what we call a **mixed economy**, where there is a somewhat even amount of both private and public sector businesses.

Although this isn't the case in all countries. Countries with a **free-market economy** system have very few public sector businesses. Countries with a **command economy system** will have very few businesses in the private sector.

Free-market economy is where economic resources are owned largely by the private sector with very little state intervention.

Command economy is where economic resources are owned, planned and controlled by the state.

The legal structure of business organisations (all in the private sector)

The 7 kinds of legal types for business organisations are as follows :

- Sole trader
- Partnership
- Private limited company
- Public limited company (nothing to do with government - not the same as public sector)
- Cooperatives
- Franchise
- Joint venture

Sole trader

A business in which one person provides the permanent finance and, in return, has full control of the business and is able to keep all of the profits. This is the most common form of business organisation, where there is a single owner who may choose to employ others, but will most likely remain a small business, not looking to expand.

Benefits of being a sole trader :

✔ **Owner keeps all profits**

✔ **Owner makes all decisions -** doesn't need to consult with others

✔ Able to be **flexible** as they are a small business

✔ **Easy to set up -** no legal documents required

✔ Able to create personal, **good relationships with customers** (encouraging them to buy again)

Limitations of being a sole trader :

✖ **Unlimited liability -** the owner does not have **separate legal identity** from their business so if the business fails their personal assets are at risk of being taken, or they can be taken to court for the business's wrong doings

✖ Owner alone may **not have the management skills** necessary to run business

✖ **Lack of finance -** owners own savings will be invested, but will it be enough? Banks are hesitant to loan to new sole traders (or any new businesses really)

✖ **Hard to compete** with existing firms that have more people/more experience

✖ **Lack of continuity** – as the business does not have separate legal status, when the owner dies the business ends too

Partnership

Is a business formed by two or more people to carry on a business together, with shared capital investment and, usually, shared responsibilities. Partnerships are formed to help overcome some of the limitations of being a sole trader. More people means more finance that can be invested, more skills and experience added and sharing the workload. It requires a *partnership agreement* to set up. It has unlimited liability shared between both partners.

Benefits of being a partnership :

✔ **More money to be invested as opposed to a sole trader** - 2 or more rather than just 1

✔ **A sharing of responsibility and workload**

✔ Partners are able to **contribute different skills and work experience**

✔ **Business losses are shared between partners**

✔ **Are more flexible -** Compared to larger corporations, and require fewer legal formalities than most companies (just the partnership agreement)

Limitations of being a partnership :

✖ **Profit must be shared**

✖ **No continuity** - if one partner dies the partnership must be reformed or else the business ceases to exist

✖ **Partners are bound by the decisions of the others** - i.e a more competent, hard working partner may be held back by their incompetent partner (choose your partner carefully!)

✖ **Unlimited liability** - both partners personal assets at risk if business fails

✖ **Can be difficult to get loans from banks** - seen as a risk to invest money in

✖ **Lack of independence** - must consult the other partner before making decisions

✖ **Don't have separate legal identity** - they can be taken to court over business's issues

Private limited company

Is a small to medium-sized business that is owned by shareholders who are often members of the same family; this company cannot sell shares to the general public. The word limited refers to the fact that the liability of these such companies are limited. This means the owners (the shareholders) personal assets are not at risk if the business fails. They only lose the amount of capital they have invested into the business.

New issues of shares cannot be sold on the open market and existing shareholders may sell their shares only with the agreement of the other shareholders.

Benefits of being a private limited company :

✔ **Shareholders have limited liability** - they only lose the amount they invest

✔ **Separate legal personality** - shareholders can't be taken to court over business misconduct

✔ **There is continuity** - the death of a shareholder doesn't mean the death of the business

✔ **Not at risk of business being bought out and changing of ownership** - the selling of shares must be permitted by current shareholders

✔ **Able to raise capital by selling shares** - to friends, family and employees

✔ **Greater status** than unincorporated businesses (A business that does not possess a separate legal identity from its owner - so sole traders and partnerships)

Limitations of being a private limited company :

✖ **Legal formalities** involved in establishing the business

✖ **Cannot sell shares to the general public** - limited finance (unlike public limited companies)

✖ **end-of-year accounts must disclosed** – available for public inspection there (less secrecy over financial affairs than sole trader or partnership)

Share: a certificate confirming part ownership of a company and entitling the shareholder owner to dividends and certain shareholder rights.

Shareholder: a person or institution owning shares in a limited company (public or private)

Public limited companies

Is a limited company, often a large business, with the legal right to sell shares to the general public – share prices are sold on the national stock exchange. It is the most common form of legal organisation for larger businesses - this being because they are able to raise a lot of money for expansion.

A public limited company has all of the benefits of a private limited company + can advertise their shares and sell them to whomever without requiring permission of existing shareholders. The consequence to this is that because it's so easy to purchase the shares, the original creators of the business may be unable to keep their ownership as they can't control who buys the majority of the business's shares. (owning 51% of the shares for example means you call most of the shots, and are considered to be the owner.)

Shareholders own the company, but they appoint, at the **annual general meeting**, a board of directors who control the management and decision making of the business. There can be a '*divorce between ownership and control*' referring to disputes over differences of objectives between those who own the business (shareholders) and those who control the business (directors).

For example, a shareholder may prefer decisions that lead to short-term profit to benefit themselves - whereas the directors may decide to aim for long-term growth of the business to further their own status. It is often said that the major investors in a plc are only interested in short-term gains. '**Short-termism**' can be damaging to a business long-term.

Benefits of being a public limited company :

✔ **Limited liability** - shareholders only risk what they invest
✔ **Continuity -** if a shareholder passes business carries on
✔ **Easy buying and selling of shares for shareholders** – this encourages investment
✔ **Access to substantial finance sources -** due to the ability to being able to sell and advertise shares on the stock market
✔ **Easier to expand -** due to large amount of capital that can be made
✔ **Separate legal identity** - shareholders can't be taken to court over business malpractices, as the owners and the business are seen as separate entities (unlike sole trader + partnership.)

Limitations of being a public limited company :

✖ **Potential loss of control experienced by owners** - anyone can purchase shares on the stock exchange or otherwise this can lead to a takeover
✖ **Divorce between ownership and control** - caused by differing objectives
✖ **Are legally required to disclose all accounts/documents -** unlike PLC which is just some
✖ **Share prices subject to fluctuation** – sometimes for reasons beyond business control, for example state of the economy (a recession = having to lower share prices)
✖ **Directors may be influenced** by short-term objectives of major investors

Cooperatives

A company where all members/owners can contribute to the running of the organisation and profits are shared between them. This can create incentive to operate the business as efficiently as possible as all will benefit from higher profits. Common in agriculture and retailing.

Benefits of cooperatives :

✔ **All members can contribute** to the running of the business, sharing the workload, responsibilities and decision-making etc.

✔ Are **able to buy in bulk**

✔ Good **motivation** for all members to work hard as they will benefit from equally shared profits

Limitations of cooperatives :

✖ **Poor management skills**, unless professional managers are employed

✖ **Capital shortages** because no sale of shares to the non-member general public is allowed

✖ **Slow decision-making** if all members are to be consulted on important issues

Franchises

Is a business that uses the name, logo and trading systems of an existing successful business. A franchise is not strictly a form of legal structure for a business, but it is a legal contract between two firms. This contract allows one of them (the franchisee) to use the name, logo and marketing methods of the other (the franchiser). The franchisee can then, separately, decide which form of legal structure to adopt. McDonald's and Ben and Jerry's being just two examples of well known franchises.

Benefits to the franchisee :

✔ An **established brand and trademark**, so the chance of business failing is low (but not 0)

✔ Franchisor will **give technical and managerial support/advice**

✔ Franchisor will **supply the raw materials/products**

✔ **National advertising** paid for by franchisor

✔ Franchiser agrees not to open another branch in the local area - so **less competition**

✔ **Banks/investors more willing to lend loans** if they're investing in a well known business

Limitations to the franchisee :

✖ Must pay for the **cost of setting up business**

✖ **No full control** over business- need to strictly follow franchisor's standards and rules as franchisors seek to maintain a certain image and franchisees must adhere to this

✖ **Profits have to be shared** with franchisor

✖ Need to **pay franchisor** franchise fees and royalties

✖ ***Local* promotions** may still have to be paid for by franchisee

✖ Initial franchise licence fee can be **expensive**

Benefits to franchisor :
✔ Is a rapid, **low cost method of business expansion**
✔ Gets and income from franchisee in the form of franchise fees and royalties
✔ **Franchisee will better understand the local tastes**
✔ Can **access ideas** and **suggestions** from franchisee
✔ **Franchisee will run** the operations

Limitations to franchisor :
✖ **Profits** from the franchise needs to be **shared with the franchisee**
✖ **Loss of control** over running of business
✖ If one franchise fails, it can **affect the reputation** of the entire brand
✖ **Franchisee may not be as skilled**
✖ Need to **supply raw material/product** and provide **support and training**

Joint ventures

When two or more businesses agree to work closely together on a particular project and create a separate business division to do so. This allows risk and costs to be shared although it may lead to disputes over decisions + leadership. Like a collab between nike/adidas.

Benefits of joint ventures :
✔ **Costs and risks** of a new business venture are shared
✔ Different companies can **share different ideas and abilities**
✔ They might have their major markets in different countries and they could exploit these with the new product more effectively than if they both decided to 'go it alone.'

Limitations of joint ventures :
✖ Styles of management and culture might be so different that they **do not blend well together**
✖ **Errors and mistakes** might lead to one blaming the other for mistakes
✖ The **business failure** of one of the partners would put the whole project at risk - the failure of the business venture will negatively affect each of their reputations

(Bonus business type)

Holding companies

Is a business organisation that owns and controls a number of separate businesses, but does not unite them into one unified company. Holding companies are not a different legal form of business organisation, but they are an increasingly common way for businesses to be owned. Often, the separate businesses are in completely different markets, this allows them to diversify their activities and spread risk over multiple markets.

Appropriateness of legal structure (What kind of business legal structure is appropriate for who)

- **Sole trader** - Appropriate for a one person business owned by an entrepreneur wanting to keep control and not expand the business
- **Partnership** - Appropriate for when a sole trader wants to expand business by taking on a partner to generate extra capital, plus able to share responsibilities and workload
- **Private limited company** - Appropriate for business owners who want the security of limited liability and retaining ownership, but also want to raise funds by sale of shares
- **Public limited company** - Appropriate for owners who want to raise large sums of capital for substantial business growth and expansion, who are also prepared to risk some loss of control
- **Franchises** - Appropriate for a business that is looking for a quick, low cost form of expansion - Appropriate for an entrepreneur who is looking for a low risk business expensure
- **Co-operatives** - Appropriate for multiple people who want to share risks and responsibilities, benefit from bulk buying and splitting the profit made
- **Joint ventures** - Appropriate for two or more business that want to share risks and costs to come together to work on a project that may lead to diversifying their business into different markets

Concept of limited liability and its importance

Limited liability in business refers to the only liability (loss) that a shareholder has if the company fails - the amount invested in the company, not the total wealth of the shareholder.

Limited liability has two important effects :

- People are more prepared to provide finance to enable companies to expand - as their own personal wealth and assets won't be at risk
- The greater risk of the company failing to pay its debts is now transferred from investors to creditors (those suppliers/lenders who have not been paid). Creditors, as a result, are very interested in both checking whether the word 'limited' appears in the business name and scrutinising the company's accounts for signs of potential future weakness

Legal formalities in setting up a company

When a **Memorandum of Association** (which states the info of a company like its name and objectives etc.) and a **Articles of Association** (which covers the internal working of the business) document have been completed satisfactorily, the registrar of companies will issue a **certificate of incorporation**. A company legally comes into existence or becomes a separate legal entity on the date stated in its certificate of incorporation.

Public-sector enterprises (public corporations)

Is a business enterprise owned and controlled by the state, funded through taxation, that focuses on improving the wellbeing of its citizens. Public-sector organisations do not often have profit as a major objective. For example - State-owned airlines have safety as a priority, rather than making profit.

Not to be confused with *public limited companies* - that are owned by shareholders and therefore are in the private sector. However, in every country there will be some enterprises that are owned by the state – usually the central or local government. These organisations are therefore in the public sector.

There are issues that come with selling off public corporations to the private sector. (**privatisation**) as the objectives will change from being focused on providing a service for citizens to making as much profit as possible.

Benefits of public sector businesses :
✔ **Managed with social objectives** rather than solely with profit objectives
✔ Loss-making services might still be kept operating if the social benefit is great enough
✔ Finance raised mainly from the government

Limitations of public sector businesses :
✖ Subsidies from government can make them **inefficient** - encourages that you don't need to work hard to receive money
✖ Government may **interfere in business decisions for political reasons** - for example by opening a new branch in a certain area to gain popularity

Potential problems resulting from changing one legal structure to another

1. **Cost -** It can be expensive to create a limited company or to arrange the public sale of shares to convert a private company into a public limited company
2. **Loss of control** - Taking on a partner/selling shares to new shareholders/converting a private limited company into a public limited company all involve some loss of control over business decision making
3. **Sharing of profits** - by taking on additional owners, profits must be shared between more people

(Chapter 6 - A level 1.2)

Local, national and multinational businesses

Local businesses have operations in just one location or region - They do not have expansion as an objective and make no attempt to expand to obtain customers across the whole country. *Examples include : hairdressers, carpentry firms and child-minding services*

National businesses have operations in several locations or regions of a country but do not operate in other countries - They make no attempt to establish operations in other countries. *Examples include : retail shops with many branches and national banking firms*

Multinational businesses operate in more than one country and these are termed 'multinationals"

International trading links

Trading links between countries are increasing quickly and this is mainly due to **globalisation**. The main reasons for this growth are :

- **Cheaper transport** - especially when huge container ships are used
- **Fewer trade restrictions** - free trade agreements have reduced the number of *tariffs* and *quotas* and other restrictions on trades in goods and services
- **Internet** - has increased the quantity of information about goods and services available in other countries

Globalisation : The increasing freedom of movement of goods, capital and people all around the world

What is the impact of international trading links?

✔ **More opportunities for businesses to sell abroad** and expand into other countries
✔ **More choice for consumers** - particularly when online shopping
✔ Consumers often benefit from **lower prices** as a result of competition

✖ There may be **loss of jobs from local firms** that cannot compete with imported goods
✖ Newly established businesses may find it impossible to survive against competition
✖ Some importers lower the price of their goods to eliminate competition from domestic firms (**price undercutting**)

✖ If the value of imports exceeds the value of exports (products sold abroad) for several years, then this could lead to a **loss of foreign exchange** **(currency is worth less compared to other countries)**

Free trade and globalisation

Free trade refers to when there are no restrictions or trade barriers that limit trade between countries. The most common forms of trade barriers are **tariffs**, **quotas** and **voluntary export restraints**. When any of these are used, this is called **protectionism.**

Tariffs are taxes imposed on imported goods to make them more expensive than they would otherwise be.

Quotas are limits on the physical quantity or value of certain goods that may be imported.

Voluntary export limits is when an exporting country agrees to limit the quantity of certain goods sold to one country (possibly to discourage the setting of tariffs/quotas).

Protectionism is the act of using barriers to free trade to protect a country's own domestic industries.

Benefits of free trade :

✔ **Wider choice for customers** from a variety of sources

✔ Importing products creates **additional competition for domestic industries** and this should encourage them to keep costs and prices down and keep quality high

✔ The **living standards of all consumers trading together should increase** - as there is more choice, cheaper products and a better economy

Limitations of free trade

✖ May **reduce opportunities for growth in less-developed economies** and threaten jobs in developed economies.

✖ **Potential exploitation of workers and the environment** as free trade has allowed firms to relocate to countries with lower costs (usually lower wages), where workers and the environment can be exploited (as health, safety and environmental laws in such countries are likely to be relaxed).

✖ Small businesses in developing countries may not be able to compete with larger foreign firms, which can lead to **loss of jobs**

Multinationals (MNCs)

A multinational company is a business organisation that has its headquarters in one country, but with operating branches, factories and assembly plants in other countries. Commonly known as MNCs.

The recent growth of multinational companies are due to the many benefits that come with being one. The potential reasons why more businesses are becoming multinationals are :

- Increased free trade and reduction in trade barriers makes it **easier for businesses to expand operations** in other countries (globalisation)
- **Potential cost savings** made by operating in a low cost country - lower minimum wages + cheaper rent and site costs
- Foreign operations might be closer to important markets - therefore **lower transport costs** for the finished goods
- May **have access to local resources** that might not be available in 'home' country
- **Access to government grants and tax incentives** designed to encourage the industrialisation of such countries
- **Avoid import restrictions** – by producing in the local country there will be no import duties to pay and no other import restrictions

Potential issues multinationals face :

- **Poor communication** between headquarters - poor communication can lead to business failure
- **Language, legal and culture differences** with local workers and government officials could lead to misunderstandings
- It is likely that the skill levels of the local employees will be low and this may require having to spend a lot for **training programmes**

Benefits of multinationals to the 'host' country

✔ **Local jobs will be provided**

✔ **Training programmes** provided by the multinational business will improve the quality and efficiency of local workers

✔ Local firms will be forced to bring their **quality and productivity up** to international standards either to compete/supply to them

✔ **Tax revenues** to the government will be boosted from any profits made by the multinational

✔ The total output of the economy will be increased and this will raise gross domestic product - **increased GDP** will lead to a **increased standard of living**

Disadvantages of multinationals to the 'host' country

✖ **Exploitation of the local workforce** might take place - due to the absence of strict labour and health and safety rules in some countries

✖ **High income jobs may go to foreign workers** rather than local ones

✖ **Profits will be sent back to home country** - so local profit tax will be avoided

✖ **Large scale production could damaged local environmen**t - pollution from plants might be at higher levels than allowed in other countries. Either this could be because of slack rules or because the host government is afraid of driving the multinational away if it insists on environmentally acceptable practices - this is an example of the kind of influence a multinational can have over a host country's government

✖ **Local competing firms may be squeezed out of business** - due to inferior equipment and much smaller resources than the large multinational

✖ **A reduction in cultural identity** - some large Western-based businesses have been accused of imposing Western culture on other societies by the power of advertising and promotion

Possible relationships between multinationals and the state

The relationship between multinationals and the government of the countries they work in can be close - with the company helping the government meet their economic objectives. Additionally, governments often provide financial incentives to the company to set up operations in their country.

Although there are some downsides. As multinationals are large, **they can influence the government and economy**. They could threaten the government that they will close down and make workers unemployed if they are not given financial grants, or allowed to pollute / use up resources from the environment. Privatisation may also be something that occurs.

Privatisation

Privatisation refers to the selling of state owned organisations to investors in the private sector. The main aspect of privatisation is the transfer of ownership of nationalised (state-owned) industries into the private sector by creating public limited companies.

The main argument used by supporters of privatisation is that business enterprises will use resources much more efficiently in the private sector, as they will be driven by the profit motive.

Those against the policy argue that the state can pursue other objectives apart from just making a profit through public-sector enterprises and that privatisation nearly always leads to job losses in order to cut costs

Advantages of privatisation

✔ **Raises finance for the government** by selling - which can be spent on other state projects

✔ Businesses can now **operate without political control/motives**

✔ Private owners will expect profits from their investment so the **business will have to be operated efficiently** - more so than when a business is supported and subsidised by the state

✔ It could lead to **increased competition** as other businesses enter the industry - forcing existing businesses to increase efficiency and possibly reduce prices for customers

✔ Without government financial support the business will be **forced to produce what customers will pay for** in order to be successful (can't rely on gov. funds - must make own money)

✔ **faster decision making** - as decision making in state run businesses can be very slow and bureaucratic

Disadvantages of privatisation

✖ **Some important public services may be cut back** if they are not profitable - these public services should be run based on the needs of society rather than the wants of shareholders

✖ **Jobs losses** can be a result when private owners attempt to improve efficiency to maximise profit

✖ If a state controlled business is replaced by a privately owned business then **customers may be exploited with higher prices**

✖ **Some industries are too important to be operated by private investors**

✖ Through state ownership, an **industry can be made accountable** to the country