Cambridge (CIE) IGCSE Business

Your notes

1.4 Types of Businesses

Contents

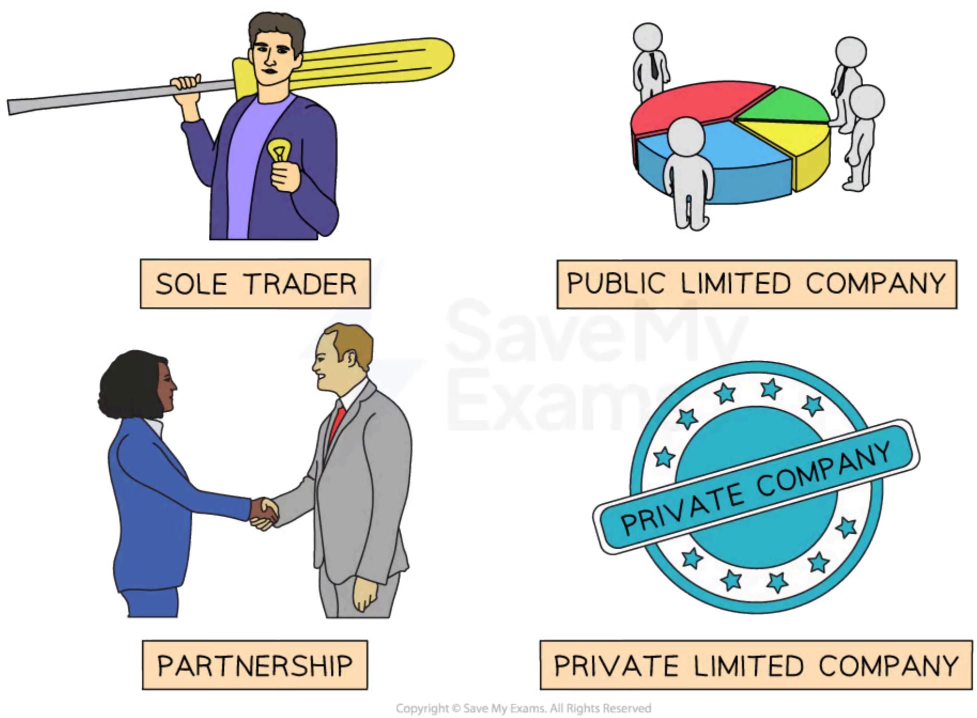
The Main Types of Ownership

Your notes

Risk, Ownership and Limited Liability

- When an entrepreneur starts a business, they need to consider **what kind of legal structure** they want for their business
- Their decision will depend upon a range of factors
  - The **level of personal risk** they are willing to take
  - The **advice** they receive
  - The **level of privacy** they would prefer in running the business

Diagram: types of business ownership



Businesses can operate as sole traders, partnerships or companies

- **Sole traders** and **partnerships** are **unlimited liability** businesses
  - They are **easy to set up** and start trading

Your notes

- Information about their financial performance **does not need to be shared outside of the business**
- **Private limited companies** and **public limited companies** offer the protection of **limited liability** to their owners (**shareholders**
  - Setting up a company is a **legal process** that takes time to arrange
  - Information about financial performance **needs to be shared with Companies House** and is available for scrutiny by any interested third party

Comparison of Unlimited & Limited Liability

Liability	Description	Implications
Unlimited liability	▪ The owners are fully **responsible for all debts** owed by the business ▪ Owners are also legally **responsible for any unlawful acts** committed by those connected to the business	▪ There is no legal distinction between the owners and the business ▪ As a result, these business owners may have to use their own **personal assets** to pay debts or legal fees ▪ E.g. a sole proprietor may need to sell their home to pay **creditors** if their business fails
Limited liability	▪ Owners (shareholders) of private limited companies and public limited companies can only **lose the original amount they invested** in the business if it fails ▪ Shareholders are not responsible for business debts ▪ In most cases, shareholders **cannot be held responsible** for unlawful acts committed by those connected with the business	▪ Companies are **incorporated** and owners are considered a separate legal entity to the business ▪ This means that if a company fails, the owners would **lose their investment** (shares) but would not have to use their assets to meet additional debts or legal fees ▪ E.g. In 2018 construction company Carillion entered **liquidation** and the shareholders lost their investments

Sole Traders, Partnerships and Limited Companies

Sole traders

- When an entrepreneur starts a business, they will often **start operating as a sole trader**
- This is a business that has a **single owner**, who may choose to hire employees or operate alone

Your notes

Evaluation of Sole Trader Businesses

Advantages	Disdadvantages
▪ Easy and inexpensive to set up ▪ The owner has **complete control** over the business ▪ All profits belong to the owner ▪ Simple tax arrangements	▪ Unlimited liability, meaning the owner is **personally responsible for any debts** the business incurs ▪ Limited access to finance and capital ▪ Limited skill set of the entrepreneur

- Over time - or if the business requires significant investment - they may change the legal structure of the business

Partnerships

- A sole trader may join with others to form a **partnership**
- A partnership is a formal arrangement by **two or more entrepreneurs** to manage and operate a business and share its profits
- Partnerships are often formed to **gain more funding**, **increase capacity** or **increase skills and experience in the business**
- Businesses commonly established as partnerships include **law firms, accountancy businesses** and **small-scale construction businesses**
- Partnerships can often be identified by suffixes such as '& Son' or 'and Partner'

Evaluation of Partnership Businesses

Advantages	Disadvantages
▪ Partnerships are easy and inexpensive to set up ▪ Partners share responsibilities, decision-making and liability for debts ▪ More skills and knowledge are available ▪ Increased access to finance and capital	▪ Partners have unlimited liability ▪ Potential for disputes between partners ▪ Profits are often shared equally, regardless of the contribution ▪ It is often difficult to transfer ownership to new owners

Private limited companies

Your notes

- An entrepreneur may choose to form a **private limited company** to **provide more financial security**, as they will benefit from **limited liability**
- The ownership of the private limited company is broken down into a **specified number of shares**
- These shares can be held in their entirety by the entrepreneur, sold to friends and family or to **venture capitalists**
- Decision-making often rests with the person appointed to run the company, often called the **Managing Director or CEO**

Evaluation of Private Limited Companies

Advantages	Disadvantages
▪ Limited liability means owners are not personally responsible for the company's debts ▪ Access to greater finance and capital ▪ Easier to transfer ownership to new shareholders ▪ Can provide a professional image and reputation	▪ They are expensive and time-consuming to set up ▪ More complex legal requirements and regulations than sole traders ▪ Annual financial reporting and auditing are required ▪ Shareholders have little control over the company as the founder usually imposes their agenda

Public limited companies

- When a business is growing rapidly, it may **require a significant amount of capital** to fund its expansion
- To secure this funding, it may choose to transition from a **private limited company (LTD) to a public limited company (PLC)**
- This is a complex legal process which involves undergoing a **stock market flotation**
- Public limited companies sell their shares to the public on the stock exchange, meaning they can have a large number of owners
- Public limited companies must publish their annual reports and hold an AGM each year
  - A **board of directors**, whose members are elected by shareholders at the AGM, acts as the governing body of a company,
  - The board of directors appoints a **CEO** to lead the company

Evaluation of Public Limited Companies

Advantages	Disadvantages
▪ Significant amounts of capital can be **raised very quickly** ▪ The risks associated with ownership are spread among a larger group of shareholders ▪ Becoming a PLC raises a company's profile and increases its visibility with customers, suppliers, and potential investors	▪ The business is required to adhere to a range of **legal and financial regulations**, which can be costly and time consuming to comply with ▪ Selling shares to the public creates many **shareholders**, **who have a say** in how the company is run ▪ PLCs are expected to deliver **consistent growth** and **profits** to their shareholders

Franchises & Joint Ventures

Franchising

- Franchising involves a business **(franchisee)** buying the rights to operate an existing successful business model **(franchisor)**
  - This right includes the use of its **branding** and **software tools** as well as business support**,** in exchange for an initial lump sum plus ongoing **royalties**

Your notes

Your notes

Some of the many food franchises available in the US

- The franchisee operates the business under the **franchisor's established system** and receives training, marketing support, and ongoing assistance
- Franchisors usually require the franchisee to operate as a private limited company

Evaluation of Owning a Franchise

Advantages	Disadvantages
▪ A ready-made, **recognised brand name** which is promoted centrally by the franchisor ▪ The franchisor **provides training,** such as how to make pizzas properly, so as to ensure quality and brand consistency ▪ Equipment and consistent supplies are provided through the franchisor ▪ The franchisor guarantees an exclusive geographical area or market to the franchisee so **competition is limited** ▪ **Advice, training** and the **use of software systems** are ongoing ▪ The franchisor may also provide loans, insurance and recruitment support	▪ The **cost of purchasing** a well-known franchise is likely to be high, compared to starting a business from scratch ▪ Core decisions are made by the the franchisor, reducing the autonomy of **business owners** ▪ **Royalties linked to the level of sales** must be paid regularly, regardless of profit ▪ Required materials, supplies or equipment sold by the franchisor may be sold to the franchisee at **inflated prices** ▪ If the franchisee does not **follow strict franchise rules** or fails to meet quality expectations, their franchise rights can be removed

Examiner Tips and Tricks

A franchise is not a form of business ownership - it is an alternative to starting up a brand new business from scratch. In most cases franchisors require businesses to operate as private limited companies as this ownership type is considered to have more stability than sole traders or partnerships

Joint ventures

- A joint venture is a medium- to long-term agreement for **two or more separate businesses** to join together to **achieve a defined business outcome,** such as entry into a new market
  - A new **combined business entity** is formed
  - Risks and returns are **shared by the parties involved** in the joint venture
  - Businesses in a joint venture are usually looking to **benefit from complementary strengths and resources** brought to the venture
- Many **European companies have set up joint ventures with businesses in China**

Your notes

- Chinese managers and employees understand market needs and consumer tastes, which gives the venture a greater chance of success
- The Chinese government encourages joint ventures rather than **foreign direct investment (FDI)**
- German car manufacturer BMW and Chinese rival Brilliance Auto Group formed a joint venture called BMW Brilliance in 2003 to produce and sell BMW cars in China

Evaluation of Joint Ventures

Advantages	Disadvantages
▪ Each partner in the joint venture benefits from **sharing expertise and resources,** such as distribution channels and R&D expertise ▪ Joint ventures are **less risky than 'going it alone'** if entering a new market or diversification ▪ **Local knowledge** can be accessed when one of the joint venture partner companies is already based in the country ▪ **Costs are shared** between joint venture companies, which is very important for expensive projects such as new aircraft	▪ If the joint venture is successful, profits have to be shared between the partner businesses ▪ **Disagreements may occur** regarding important decisions due to the input of managers in both businesses ▪ The objectives of each business may change over time, leading to a **conflict of objectives** between joint venture partners ▪ If the joint venture fails, it may need to be **dismantled, reorganised** or **sold,** which is likely to take significant time and resources

Deciding on the Business Ownership Model

Your notes

Unincorporated Businesses and Limited Companies

- A business may be **unincorporated** or **incorporated**. These terms are closely linked to the concepts of **limited liability** and **unlimited liability**
  - An **unincorporated business** does not have a separate legal identity from its owner(s)
    - If the business is sued the owner is responsible and may need to cover legal costs with their own money
    - Unincorporated business types include **sole traders** and **partnerships**
  - An **incorporated business** is called a company and has a separate legal identity from its owner(s)
    - If the business goes bankrupt its owners (**shareholders**) cannot be held responsible for debts and only lose the money they initially invested
    - Unincorporated businesses include private limited companies (Ltd) and public limited companies (PLC)

A Comparison of Unincorporated Businesses and Incorporated Companies

Unincorporated Businesses	Incorporated Companies
▪ The owner has **no legal separation** from the business	▪ A unique **legal entity** that is **separate from business owners** (shareholders)
▪ The owner(s) carry **full liability** (unlimited liability) for the business and it's activities	▪ **Reduced risk and liability** of the business to the owners (limited liability)
▪ Can be started with **little or no money**	▪ Can be **expensive to incorporate**

Recommending a form of Business Ownership

- An entrepreneur must choose the ownership structure **that suits the business needs, particular circumstances** and the **level of personal liability involved**
- Deciding on the best form of legal ownership requires the owners to consider **many different factors**

Type of ownership

- Is **unlimited** or **limited liability** most appropriate?

- Is the business **based on an original idea or a franchise**?

Desire for control and privacy

- How much **direct control over decisions** does the owner(s) want?
- Does the owner(s) want to **share the workload**?
- Does the owner mind if the financial accounts are made **publicly available**?

Financial considerations

- How much **start-up finance** is required?
- How might the choice of finance affect the **break even point**/profits?
- How is finance to be **managed**?

The aims and stage of business growth

- Is the business **new or established**?
- Does the owner want it to **grow**?

Examples of Business Ownership Recommendations

Business Description	Key Considerations	Recommendations
▪ Sarah wants to set up a new **pizza business**. She has 3 different options ▪ buy a franchise like Dominoes ▪ Start small as a sole trader ▪ Start small but register as a private limited company	▪ Sarah does not have much money ▪ **Banks are often willing to lend to franchisees** due to relatively low risk, but this money has to be repaid ▪ With a private limited company, **the owner is not liable for outstanding expenses if business failure occurs**	▪ A **private limited company** may be a better option as it is relatively inexpensive to setup and provides Sarah with legal protection ▪ The Franchise option is attractive but may be best bought into after some time, once Sarah knows she actually likes running a pizza business! ▪ Sarah lacks finance so starting small and growing **organically** may be the best way forward
▪ AMF is a large, fast-growing private limited company (Ltd) that specialises in	▪ If AMF sells shares, they lose some **control of the company** but do gain	▪ **Going public** would provide very quickly access to large sums of money and AMF finds this attractive

Your notes

Your notes

commercial cleaning and maintenance services
▪ AMF is seeking to to raise finance to continue their expansion. They can either
  ▪ Become a Public Limited Company and sell shares
  ▪ Take out a large bank loan
	access to a large pool of money
	  ▪ This money does not need to be repaid
	  ▪ New shareholders would have high expectations
	▪ Bank loans have to be repaid with **interest**, but AMF would keep control of their business
		▪ AMF could investigate the cost and likelihood of getting a bank loan before they make a final decision
		▪ Their final decision may depend on **how much money they need to raise.** If it is significant, going Public would be the best way forward

Examiner Tips and Tricks

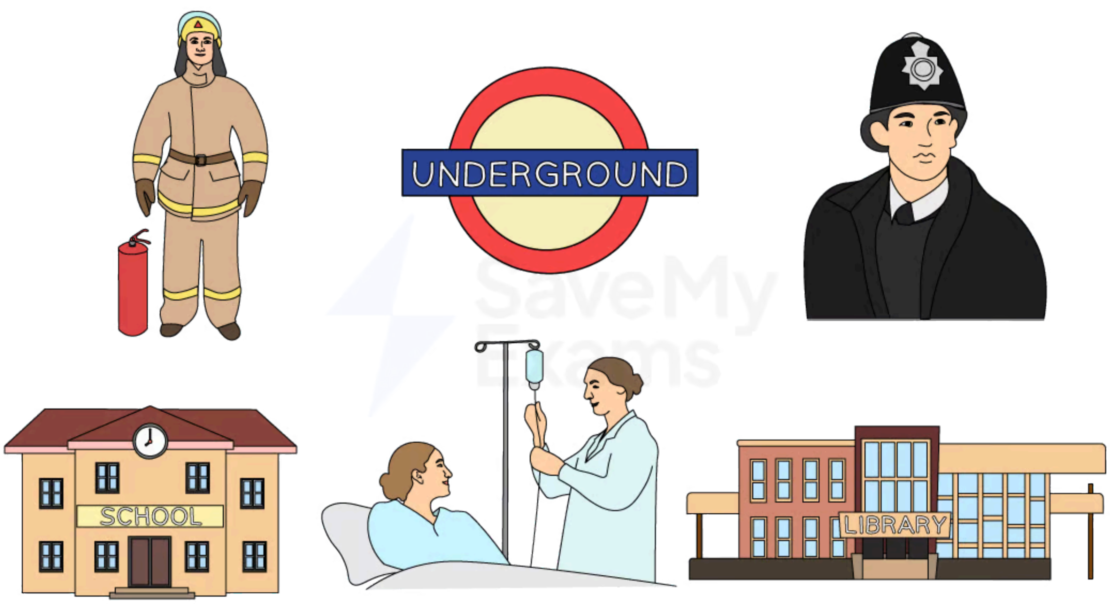
When assessing the best form of business to be used in a particular situation (or if a business should change its form), the decision needs to consider any evidence provided about the business owner, the product, the nature and size of the market, the funds required, and the level of profitability. For example, a business which generates sales of £30k a year is unlikely to be ready to become a public limited company, but it may well benefit from transitioning from a sole trader to a private limited company

Public Sector Businesses

Your notes

The Public Sector

- The public sector is a key element of **mixed economies**
- Public sector firms are **owned and controlled by the government** and are usually **funded through taxation**
- Their **main goal** is to **provide services** such as education, healthcare or emergency services that may not be provided by profit-focused businesses



Hospitals, schools and emergency services are often partly or fully provided by the public sector

- Public sector firms operate on a **local, regional** or **national government level**
  - **Transport for London** provides local transport in the London region
  - **Caribbean Airlines** operates across several countries in the Caribbean, with ownership shared by the governments of Trinidad and Tobago, Jamaica and Guyana
  - **Comboios de Portugal** provides train services across the country and in to Spain
- Governments are likely to retain ownership of organisations in the public sector for several reasons
  - They are **strategically important** to the country, such as the defence or justice systems

Your notes

- They provide **essential** services such as water, electricity supply or emergency services
- They are **merit goods** that may not be provided in sufficient quantities by private businesses, such as education or health services

Public Corporations

- Public corporations are **owned by the government**
  - They are usually businesses which were once owned by private individuals and have been **nationalised**
    - In 2022, the German government nationalised **Uniper**, the country's largest importer of gas, to improve energy security as a result of the conflict between Russia and Ukraine
    - In 2008, the UK government nationalised **Northern Rock**, a bank which was on the verge of collapse as a result of the global financial crisis
- Government ministers **appoint a Board of Directors,** which manages the corporation
  - They are expected to run the corporation according to objectives set by the government
  - Although they **may be profitable**, the aim of corporations is to provide a public service
  - Governments **should not interfere** with day-to-day operations and decisions of the corporation

Evaluation of Public Corporations

Advantages	Disadvantages
▪ Government ownership is **essential for some crucial or sensitive industries** ▪ Examples include water, power and communications	▪ Due to a **lack of competition,** public corporations may become **inefficient** or have **no incentive to improve,** affecting consumer choice
▪ **Important public services,** such as TV and radio broadcasting, are often in the public sector ▪ Non-profitable but important programming can be made available to the public	▪ Corporations may become **complacent or have an unfair advantage over private sector rivals** as they can access government subsidies to help them if they are struggling
▪ The government can choose to **nationalise industries** that may be in financial trouble	▪ **Funding can be cut** as a result of political decisions and **changes of governments** can cause significant disruption to corporation missions and operations

▪ **Jobs** can be secured and consumers will still have **access to the important goods or services** the business provides	

Your notes

Other Public Sector Enterprises

- In some cases, **profit-making companies are partly owned or controlled by the government**
    - They sell shares on the publicly listed **stock exchanges** so they are a mix of the private and public sector
        - In the US, **Amtrak** (passenger trains) is a state-owned for-profit enterprise whose shares are majority owned by the federal government
- Other businesses are funded by central and local government
    - They may still **levy charges for some services**
        - The **NHS** is free at the point of use for British citizens, but they must pay for medical prescriptions, some procedures and parking on hospital premises
        - The French state funds leisure facilities such as **swimming pools** and **public sports venues** but usually charges users a small fee for their use
        - Due to the **constraints of government spending** in many countries, many services are now being **privatised** or suffer from **insufficient funding**