Cambridge

AS - Level

Business studies

CODE: (9609)

Unit 01- Chapter 02

Business structure

Introduction

The chapter highlights the significance of business activity in an economy, the role of entrepreneurs, and successful entrepreneurship characteristics. It also discusses various business structures, legal structures, and the diminishing role of public-sector enterprises due to privatization.

KEY TERMS

Primary sector business activity: firms 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.

Secondary sector business activity: firms that manufacture and process products from natural resources, including computers, brewing, baking, clothes-making and construction.

Tertiary sector business activity: firms that provide services to consumers and other businesses, such as retailing, transport, insurance, banking, hotels, tourism and telecommunications.

Classification of business activity

Firms produce a vast range of different goods and services, but it is possible to classify these into three broad types of business activity. The stages are the **primary**, **secondary** and **tertiary** sectors of industry.

Country	Primary	Secondary	Tertiary
United Kingdom	2	19	79
China	42	26	32
Ghana	54	20	26

Table 2.1 Employment data 2013 – as percentage of total employment

Primary production – dairy farm in France

Secondary production – clothing factory in China

Tertiary sector – the breath-taking Burj Al Arab hotel in Dubai

Changes in business activity

It is very important to recognise two features of this classification of business activity:

1. The importance of each sect or in an economy changes over time. Industrialisation is the term used to describe the growing importance of the secondary-sector manufacturing industries in developing countries.

Benefits

■ Total national output (gross domestic product and this raises average standards of living.) increases

■ Increasing output of goods can result in lower imports and higher exports of such products.

■ Expanding manufacturing businesses will result in more jobs being created.

■ Expanding and profitable firms will pay more tax to the government.

■ Value is added to the countries' output of raw materials, rather than just exporting these as basic, unprocessed products.

Problems

■ The chance of work in manufacturing can encourage a huge movement of people from the countryside to the towns, which leads to housing and social problems.

■ Imports of raw materials and components are often needed, which can increase the country's import costs.

■ Much of the growth of manufacturing industry is due to the expansion of multinational companies. The consequences of this are covered later in this chapter.

2. In developed economies, the situation is reversed. There is a decline in the importance of secondary-sector activity and an increase in the tertiary sector.

■ Rising incomes associated with higher living standards have led consumers to spend much of their extra income on services rather than more goods.

■ As the rest of the world industrialises, so manufacturing businesses in developed countries face much more competition and these rivals tend to be more efficient and use cheaper labour.

3. The importance of each sector varies significantly between different economies. Table 2.1 gives details of the differences that exist between three different countries' economies and the share of total employment accounted for by each sector of industry

Public and private sectors

Industry may also be classified in other ways, for example by public or private sector and by type of legal organisation.

KEY TERMS

Public sector: comprises organisations accountable to and controlled by central or local government (the state).

Private sector: comprises businesses owned and controlled by individuals or groups of individuals.

In nearly every country with a **mixed economy**, most business activity is in the private sector.

Those economies that are closest to a **free-market** system have very small public sectors.

KEY TERMS

Mixed economy: economic resources are owned and controlled by both private and public sectors.

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

Those countries with central planning **command economies** will have very few businesses in the private sector.

KEY TERM

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

The legal structure of business organisations – the private sector

Figure 2.1 on the next page shows the main types of private sector business.

Sole trader This is the most common form of business organisation. Although there is a single owner in this business organisation, it is common for **sole traders** to employ others, but the fi rm is likely to remain very small.

KEY TERM

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.

Partnership

The partnership agreement does not create a separate legal unit; a partnership is just a grouping of individuals.

KEY TERM

Partnership: a business formed by two or more people to carry on a business together, with shared capital investment and, usually, shared responsibilities.

Partnerships are the most common form of business organisation in some professions, such as law and accountancy.

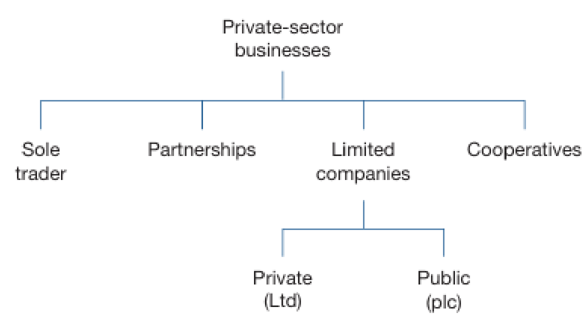

Figure 2.1 The private sector – legal structure

Advantages	Disadvantages
■ easy to set up – no legal formalities ■ owner has complete control – not answerable to anybody else ■ owner keeps all profits ■ able to choose times and patterns of working ■ able to establish close personal relationships with staff (if any are employed) and customers ■ business can be based on the interests or skills of the owner – rather than working as an employee for a larger firm	■ unlimited liability – all of owner's assets are potentially at risk ■ often faces intense competition from bigger firms, for example in food retailing ■ owner is unable to specialise in areas of the business that are most interesting – is responsible for all aspects of management ■ difficult to raise additional capital ■ long hours often necessary to make business pay ■ lack of continuity – as the business does not have separate legal status, when the owner dies the business ends too

Table 2.2 Advantages and disadvantages of sole-trader organisations

Advantages	Disadvantages
■ partners may specialise in different areas of business management ■ shared decision-making ■ additional capital injected by each partner ■ business losses shared between the partners ■ greater privacy and fewer legal formalities than corporate organisations (companies)	■ unlimited liability for all partners (with some exceptions) ■ profits are shared ■ as with sole traders, no continuity and the partnership will have to be reformed in the event of the death of one of the partners ■ all partners bound by the decisions of any one of them ■ not possible to raise capital from selling shares ■ a sole trader, taking on partners, will lose independence of decision-making

Table 2.3 Advantages and disadvantages of partnerships

Limited companies

There are three distinct and important differences between companies and the two forms of 'unincorporated' business organisation that we have just studied. These are:

1. Limited liability

Individuals with large blocks of shares often become directors of the business. All shareholders benefit from the advantage of **limited liability.**

KEY TERM

Limited liability: the only liability – or potential loss – a shareholder has if the company fails is the amount invested in the company, not the total wealth of the shareholder.

Nobody can make any further claim against shareholders, should the company fail. This has two important effects:

■ People are prepared to provide finance to enable companies to expand.
■ 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).

2. Legal personality

A company is recognised in law as having a legal identity separate from that of its owners. This means, for example, that if the foods sold by a company are found to be dangerous or contaminated, the company itself can be taken to court – not the owners, as would be the case with either a sole trader or a partnership.

3. Continuity

In a company, the death of an owner or director does not lead to its break-up or dissolution. All that happens is that ownership continues through the inheritance of the shares, and there is no break in ownership at all.

Private limited companies

KEY TERM

Private limited company: 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 protection that comes from forming a company is, therefore, substantial. Small fi rms can gain this protection when the owner(s) create a **private limited company.**

Advantages	Disadvantages
■ shareholders have limited liability ■ separate legal personality ■ continuity in the event of the death of a shareholder ■ original owner is still often able to retain control ■ able to raise capital from sale of shares to family, friends and employees ■ greater status than an unincorporated business	■ legal formalities involved in establishing the business ■ capital cannot be raised by sale of shares to the general public ■ quite difficult for shareholders to sell shares ■ end-of-year accounts must be sent to Companies House – available for public inspection there (less secrecy over financial affairs than sole trader or partnership)

Table 2.4 Advantages and disadvantages of private limited companies

KEY TERMS

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.

The word 'Limited' or 'Ltd' ('Pte' in some countries) tells us that the business has this legal form. Usually the **shares** will be owned by the original sole trader, relatives, friends and employees.

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**.

KEY TERM

Public limited company: a limited company, often a large business, with the legal right to sell shares to the general public – share prices are quoted on the national stock exchange.

Public limited companies

A **public limited company** (plc) has all the advantages of private-company status, plus the right to advertise their shares for sale and have them quoted on the stock exchange.

Limited companies can raise large sums from public shares, but existing shareholders can sell their shares if they wish. This flexibility encourages the public to purchase shares and invest in the business. The main difference between private and public companies is the 'divorce between ownership and control'. The original owners retain a majority of shares and management control when a company converts to private company status. However, public limited companies have a larger number of investors and shareholders, leading to conflicts over objectives and direction. Many private limited companies convert to plc status to overcome this divide and take a long-term planning view.

Legal formalities in setting up a company

All governments insist that certain legal stages are completed before a company may be established, in order to protect investors and creditors. In the UK, the following steps must be taken:

1. A **Memorandum of Association** must be completed. Being aware of the company's aims means that shareholders can avoid businesses that may operate in markets and products – such as weapons – that they may not want to be associated with

KEY TERM

Memorandum of Association: this states the name of the company, the address of the head office through which it can be contacted, the maximum share capital for which the company seeks authorisation and the declared aims of the business.

Advantages	Disadvantages
■ limited liability ■ separate legal identity ■ continuity ■ ease of buying and selling of shares for shareholders – this encourages investment in plcs ■ access to substantial capital sources due to the ability to issue a prospectus to the public and to offer shares for sale (called a flotation)	■ legal formalities in formation ■ cost of business consultants and financial advisers when creating such a company ■ share prices subject to fluctuation – sometimes for reasons beyond business control, for example state of the economy ■ legal requirements concerning disclosure of information to shareholders and the public, for example annual publication of detailed report and accounts ■ risk of takeover due to the availability of the shares on the stock exchange ■ directors influenced by short-term objectives of major investors

Table 2.5 Advantages and disadvantages of public limited companies

2. The other main document is called the **Articles of Association**. When these documents have been completed satisfactorily, the registrar of companies will issue a certificate of incorporation. Private limited companies may now begin trading.

KEY TERM

Articles of Association: this document covers the internal workings and control of the business – for example, the names of directors and the procedures to be followed at meetings will be detailed.

Other forms of business

organisation Cooperatives

Certain features are common to all cooperatives:

■ All members can contribute to the running of the business, sharing the workload, responsibilities and decision-making, although in larger cooperatives some delegation to professional managers takes place.

■ All members have one vote at important meetings.

■ Profits are shared equally among members.

Th e cooperative often buys the produce of the members and then sells it collectively in order to obtain a better price. The advantages of such business units are:

■ Buying in bulk

■ Working together to solve problems and take decisions

■ Good motivation for all members to work hard as they will benefit from shared profits.

The potential drawbacks can include:

■ 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

A **franchise** is not strictly a form of legal structure for a business, but it is a legal contract between two firms.

KEY TERM

Franchise: a business that uses the name, logo and trading systems of an existing successful business.

This contract allows one of them, the franchisee, to use the name, logo and marketing methods of the other, the franchiser. Th e franchisee can then, separately, decide which form of legal structure to adopt.

Benefits of opening a franchised business	Possible limitations
■ fewer chances of new business failing as an established brand and product are being used ■ advice and training offered by the franchiser ■ national advertising paid for by franchiser ■ supplies obtained from established and quality-checked suppliers ■ franchiser agrees not to open another branch in the local area	■ share of profits or revenue has to be paid to franchiser each year ■ initial franchise licence fee can be expensive ■ local promotions may still have to be paid for by franchisee ■ no choice of supplies or suppliers to be used ■ strict rules over pricing and layout of the outlet reduce owner's control over their own business

Table 2.6 Advantages and disadvantages of franchises

Joint ventures

These are not the same as a merger, but they can lead to mergers of the businesses if their joint interests coincide and if the joint venture is successful. The reasons for **joint ventures** are:

■ Costs and risks of a new business venture are shared – this is a major consideration when the cost of developing new products is rising rapidly.

■ Different companies might have different strengths and experiences, and they therefore fit well together.

■ 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'.

KEY TERM

Joint venture: two or more businesses agree to work closely together on a particular project and create a separate business division to do so.

Such agreements are not without their risks:
■ Styles of management and culture might be so different that the two teams 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.

KEY TERM

Holding company: a business organisation that owns and controls a number of separate businesses, but does not unite them into one unified company.

KEY TERM

Public corporation: a business enterprise owned and controlled by the state – also known as nationalised industry.

Holding companies

Holding companies are not a different legal form of business organisation, but they are an increasingly common way for businesses to be owned.

Public-sector enterprises – public corporations

However, in every country there will be some enterprises that are owned by the state – usually central or local government. These organisations are therefore in the public sector and they are referred to as public corporations.

Advantages	Disadvantages
■ 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	■ tendency towards inefficiency due to lack of strict profit targets ■ subsidies from government can also encourage inefficiencies ■ government may interfere in business decisions for political reasons, for example by opening a new branch in a certain area to gain popularity

Table 2.7 Advantages and disadvantages of public corporations

Revision questions

Q1. 9707/12/O/N/2009/Q1 (a)
State two advantages of being a soldier. [4]

Q2. 9707/11/M/J/2011/Q1 (b)
State to objectives of a private business sector. [2]

Q3.9606/13/M/J/2017/Q4 (a)
Define the term “share capital “. [2]

Q4.9707/11/O/N/2015/Q4 (b)
Briefly explain two external sources of finance that could be used to fund the capital expenditure of a partnership. [3]

Q5.9707/11/O/N/2010/Q4
(a) Define the term ‘private limited company’. [2]
(b) Explain two possible disadvantages to sole trader of changing to a private limited company. [3]

Q6.9707/13/O/N/2011/Q1
(a)Define the term ‘partnership’. [2]
(b)Outline two advantages that a partnership might have over a sole trader. [3]

Q7.9707/12/O/N/2012/Q4
(a) Define the term ‘public limited company’. [2]
(b) Briefly explain two advantages a public limited company has compared to a private limited company. [3]

Q8.9707/13/O/N/2012/Q1
(a) Define the term ‘private limited company’. [2]
(b) Briefly explain two advantages to a sole trader of changing to a private limited Company. [3]

Q9.9707/13/M/J/2013/Q4
(a) State two features of ‘public limited company’. [2]
(b) Briefly explain two advantages to a sole trader of changing to a partnership. [3]

Q10.9707/12/O/N/2013/Q2
(a) Define the term ‘private sector’. [2]
(b) Briefly explain two characteristics of public sector enterprises (for example public corporations or nationalized industries). [3]

Q11.9707/11/M/J/2015/Q4
(a) Define the term ‘franchise’. [2]
(b) Briefly explain two benefits for an entrepreneur of becoming a franchisee. [3]

Q12.9609/12/F/M/2016/Q1

(a) Distinguish between the 'private sector' and the 'public sector'. [2]

(b) Briefly explain two advantages of public sector business. [3]

Q13.9609/12/O/N/2016/Q1

(a) Define the term 'joint venture'. [2]

(b) Briefly explain two advantages of joint venture to the business involved. [3]

Q14.9707/11/O/N/2011/Q1

(a) Define the term 'sole trader'. [2]

(b) State three problems of operating as a sole trader. [3]

Q15.9609/13/O/N/2018/Q1

(a) Define the term 'private limited company'. [2]

(b) Briefly explain one advantage and one disadvantage at o business of operating as a Public limited company, rather than as a private limited company. [3]

Q16.9707/11/O/N/2010/Q3

Explain how a public limited company might finance large capital investment project. [5]

Q17.9707/13/O/N/2011/Q3

Explain why service differentiation is important for business in the tertiary sector. [5]

Q18.9707/11/O/N/2015/Q3

Explain why many tertiary businesses sector differentiate their service. [5]

Q19.9707/11/M/J/2012/Q5 (a)

Explain the advantage for a franchisee of a 'franchise' as form of business. [8]

Q20.9707/12/M/J/2012/Q5 (a)

Explain the advantage of a 'co-operative' as form of business. [8]

Q21.9707/13/M/J/2014/Q7 (a)

Explain how the main difference between the legal structures of sole traders and public limited companies affect the way such businesses are financed. [8]

Q22.9707/13/O/N/2014/Q7 (a)

Explain the strength and weaknesses of 'co-operative' legal structures for business. [8]

Q23.9609/13/O/N/2018/Q5 (a)

Analyze the advantages of a partnership as legal structure for the owners of small business. [8]

Q24.9707/12/O/N/2015/Q7 (b)

Discuss why an entrepreneur might choose to become a franchisee rather then start an independent restaurant business.

Q25.9609/13/M/J/2016/Q5

(a) Analyze the advantages of a co-operative as legal form of business. [8]

(b) Discuss the factors that could influence the success of a small business manufacturing fashion clothing for children. [12]