Forms of business organization

Lecture of Corporate Finance

SILESIAN UNIVERSITY
SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

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Outline of the lecture

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- Type of business organization: privately held company
- The sole proprietorship
- Partnership
- Limited liability company
- Corporation
- Holding & subsidiary company
- Criteria for enterprises

TYPE OF BUSINESS ORGANIZATION: PRIVATELY HELD COMPANY

- company that is wholly owned by the company’s founders, management, or private investors
- Equity of the privately held company is not listed on the public stock exchange
- The shares of such companies are not open for sales and trading
- Financial and operational information remains confidential

TYPES:

- Sole proprietorship (not enterprise, but proprietor, entrepreneur)
- Partnership
- Private limited companies,
- Limited liability partnership,
- Non-profit corporations

TYPE OF BUSINESS ORGANISATION:
THE SOLE OR SINGLE PROPRIETORSHIP

- Business, owned by one person-proprietor, a single individual (founder), who generally (but not necessarily) manages and controls the business; owner may hire manager or other personal
- The owner (founder) is not separable from the business;
- The owner is not paid a salary by the business, but withdraws cash from it; such withdrawals are not costs
- Single proprietor pays individual income tax rate (not corporate profit tax)

Advantages:

- Independence; making the decisions without approval from a partner or the Board of Directors.
- Easy and cheap to establish; no special legal permission to set up business
- Simplicity; flexibility, and direct responsibility in management
- Easy records keeping, simplified (financial) reports
- Business confidentiality of the financial/economical results
- No asset bifurcation as to business or personal assets; both can be used one's business and are treated as owner's assets.
- After making proper arrangements with his creditors, the owner may dissolve his business any time.

Disadvantages:

- Unlimited liability of the owner for the debts; proprietor's personal holdings may be used to cover the claims of business creditors
- Limited possibility of raising financial resources (for example, limited by the property, which can be given as collateral to the bank)
- Limited ability for development, to attract specialized managerial talent
- High competition
- Owner's death = business death

TYPE OF BUSINESS ORGANISATION: PARTNERSHIP

- Business structure, wherein two or more persons, coming together as a partners, decide to share profits or losses in an agreed proportion, carrying an unlimited liability, managing their business by any one or all of them
- Two or more persons from different edges, having different capacities (managing or administering skills, money, labor, property, other capital or resources) and criteria come together with a motive to earn profits and carry on the lawful business together.
- Each partner reports the share of his profits as his personal income

TYPES OF PARTNERSHIP:

- GENERAL PARTNERSHIP: a mutual, formal or informal agreement between different persons. The partners have an equal share in the profits and debts, carrying an unlimited liability. They can equally participate in the management and control of the business. Each partner assumes his full responsibility towards the business and can act independently on behalf of the company without the other partner's consent
- LIMITED PARTNERSHIP: at least one person has to manage and take all the risks. He/she possesses an unlimited liability. Rest all other partners carry a limited liability and specific rights and responsibilities.
- LIMITED LIABILITY PARTNERSHIP: partners have a limited liability as to their share in the company. Also, they have a protection from the legal and financial faults and actions of the other partners. They are allowed to take part in the management and decision making.

TYPE OF BUSINESS ORGANISATION: PARTNERSHIP

Advantages:

- Combined capital, talents, skills, opinions
- Synergy
- Increasing borrowing capacity
- Low start-up costs and reporting requirements
- Distribution of the risks, sharing the responsibilities, mutual support
- Tax advantages – partners report the profits as their personal income for tax purposes
- Confidentiality of the reporting information

Disadvantages:

- Necessity of compromise, need to agree the decision with partners
- Slower decision-making process
- Mutual agency: responsible for other partner's deeds.
- Unlimited liabilities (except for the minor's)
- Restriction on transfer of share without the consent of the other partners.
- Possible disputes, conflict of interest among partners

TYPE OF BUSINESS ORGANISATION:
LIMITED LIABILITY COMPANY (LLC)

- The owners of the beneficial rights are called “members” rather in normal terms “shareholders”.
- The members of the corporate structure are not personally liable for the debts and obligations
- Combination of both the features of sole proprietorship or partnership and corporation
- From 1 to ∞ owners

Advantages:

- Owners are not responsible for the obligations of the corporation, their responsibility is limited by their contributions
- Comparatively less record keeping
- Even a single natural person can start an LLC
- Tax ease: an option to tax LLC either as a sole proprietorship, partnership or as corporation

Disadvantages:

- Difficult to raise capital
- Earnings of the business under this form do not necessarily have to be distributed equally or in the ratio of the partners’ capital contribution
- No perpetual existence: in case of member’s leaving, insolvency or death, the fully member’s decisions is needed, whether or not continue in the same company or create their new one

TYPE OF BUSINESS ORGANISATION: PUBLIC COMPANY (CORPORATION)

- Sells the shares to the public by IPO on stock exchange market.
- Shareholders are the owners of a corporation
- Board of Directors run the corporation
- Predominantly large companies

Advantages:

- The responsibility of the owners is limited by amount of their shares
- Access to the capital market
- Perpetual existence: continues to exist beyond the deaths of the Board of Directors, the executives, and the managers
- The shares (instruments of ownership) are freely transferable
- Corporation conveys the credibility of your business to suppliers, customers are other stakeholders of the business

Disadvantages:

- Very complex process of foundation
- Heavy paperwork , lots of permissions
- Double taxation: corporate profit tax and tax from received dividends
- Conflict of interests among management and shareholders
- Stringent regulation by Securities and Exchange Commission
- Full disclosure of information, necessity of activity's transparence

HOLDING (PARENT) COMPANY & SUBSIDIARY (DAUGHTER) COMPANY

- When the company holds less than 20% shares in any firm, these are financial investments for the company.
- When the company (investor) holds more than 20% but less than 50% shares in any firm (investee), investor has significant influence and uses equity method to evaluate investments.
- When the company holds less than 50% shares in any firm, it is called an affiliate firm.
- Parent company – company, that owns more than 50% of another firm (subsidiary company)

Holding (parent) company:

- Can be larger or smaller than the subsidiary
- Does not usually carry any traditional business activities, such as manufacturing or services
- Owns enough assets or equity of other companies to hold voting power or influence
- Distinct entity from the operating company, and thus, can't be legally held responsible for the losses and debts
- Can also be helpful in building economies of scale in operations
- Can have more than one subsidiary company
- Aggregates and consolidates subsidiary's transactions

Subsidiary (daughter) company:

- Partly owned subsidiary – when parent company owns 50% or more but less than 100% shares.
- Wholly owned subsidiary – when parent company owns 100% of shares (not a merger).
- Can have one and only one holding company
- Possible discounts and improved credit terms as the parent company buys in bulk.
- Possibility to get an edge over others in the industry with the help of parent company.
- Subsidiaries can be a tool for horizontal or vertical integration or monopolization.

CRITERIA FOR ENTERPRISES (EU recommendation 2003/361):

Enterprise category	Annual work unit, persons	Annual turnover		Annual balance sheet total
Micro	< 10	≤ EUR 2 million		≤ EUR 2 million
Small	< 50	≤ EUR 10 million	OR	≤ EUR 10 million
Medium-sized	< 250	≤ EUR 50 million		≤ EUR 43 million
Large	> 250	> EUR 50 million		> EUR 43 million

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Thank you for your attention!