INTRODUCTION TO BUSINESS

Lecture 3

Outline

- How are businesses organised and structured?
- Major aims of business
- How to achieve these aims?
- Legal forms of business
- Business ethics

How it is organised?

- Micro approach ‘black box’: production function: inputs in, output out.
- Firm: An economic organisation that co-ordinates the process of production and distribution.
- But products require a complex production process – two major factor organising these: market (prices signals), firm (hierarchy of managerial authority).
- Within the firm transaction costs are lowered.

Firm

- Transaction costs: those incurred when making economic contracts in the marketplace
- Reasons for transaction costs:
  - Uncertainty of contracts
  - Complexity of contracts
  - Monitoring contracts
  - Enforcing contracts

Therefore, for most goods, firm represents a superior way to organise production!

Goals of the firm

- Traditional assumption: firms want to maximise profits.
- Owners clearly interested in profits maximisation.
- However maximisation is a process of undertaking decisions on how much to produce, at what price etc.
- In many cases it is not up to owners to undertake these decisions – rather to managers.
- Ownership ≠ control. In most cases modern company is legally separated from its owners.

Principal-agent relationship

- Objectives of managers: profits or other aims?
- Principal-agent problem: One where people (principals), as a result of lack of knowledge (information), cannot ensure that their best interests are served by their agents.
- Asymmetric information: A situation in which one party has superior position with respect to the information (knows more than another).
- Possible ways of solving: monitoring or incentives

Principal-agent

- Principal-agent problem in practice. Solutions:
  - Reasonable compensation package
  - Direct intervention of shareholders
  - Threat of takeover
- All this leads to increased stress on business ethics!
- Business ethics: A company attitude and conduct toward its employees, customers, community and stock-holders.

Business ethics

- How to measure commitment to business ethics?
    - » compliance to law
    - » product safety
    - » Fair employment practices
    - » Fair marketing and selling practices
    - » Lack of use of confidential info for personal profits
    - » Community involvement
    - » Lack of corruption
- How to obey: code of ethical behaviour, various trainings

Business ethics

- But in many cases right choice is unclear….
- Consequences: bankruptcy, lack of trust, individual tragedies.
- Are companies unethical or just some of their employees? In most cases individuals are blamed, however in Arthur Andersen case otherwise.

Right legal structure

- This decision is in most cases one of the earliest decisions to make. It affects:
  - Taxation/social insurance the business pays
  - The record and accounts that have to be kept
  - The liability faced by the owner if the business fails
  - The sources avaiable to the business
  - The way decisions are made

Types of business organization

- **Prioprietorship** (UK: *sole trader*) – a person is in business on his/her own behalf. Usually small business, but may employ other people.
- (+) inexpensive, easy formation; less regulated, usually easier tax regime, business affairs are private, close relationship with customers, workload individualy tailored
- (-) unlimited personal liability; difficulties in funding on larger scale, owner inability to handle all aspects of company activities, life of business limited to the life of individual who created it☹

Partnership

- Two or more people own the business (incl. sleeping partners). Advantages similar to priopriεtorship plus more capital available (each partner bring some money), but each partner liable for business debt (from 2001 in UK limited liability partnerships allowed).
- Case: Arthur Andersen – each partner suffered from those who worked with Enron, WorldCom.

More on partnership

- Very often partners draw up a Deed of Partnership which specifies key features like:
  - How much of the finance each contributed
  - How the profits will be shared
  - How much control each partner has
  - How the partnership can be resolved

Incorporated vs unincorporated

- Sole traders and partnerships are unincorporated
- Incorporation means that new legal entity is created, something that exists as the law is concerned.
- With incorporated business <u>the business itself exists</u>, whereas with an unincorporated business <u>the owner (or owners in case of partnership) is the business.</u>

Corporation

- A legal entity registered by a state, separate and distinct from its owners and managers, having unlimited life, easy transferability of ownership and limited liability.
- (-) taxation – in most cases double: first on corporate level (corporate tax – Poland: CIT) next on personal level when paid out as dividend, more complicated start, lenders may view limited liability as a risk.
- (+) Limited liability reduces investors' risk – lower risk=higher value; growth opportunities due to easier access to capital; better liquidity due to facilitation of ownership transfer.

Private limited companies

- Limited liability (ltd) – a feature of incorporated business which means that owners’ liability is limited to the amount that have invested in the business.
- Popular form for family business and for relatively small and well established businesses
- Generally shares can be sold privately and with the consent of the shareholders.

Public limited companies

- Shares are bought and sold publicly (plc)
- So, there is a market value
- Initial sale of shares called flotation or IPO
- Larger scale, usually requirements regarding minimum value of share capital
- Separation of ownership and control
- Regular detailed financial information have to be provided
- Case: **rising share price means that plc gets more money?**

Specific forms

- Co-operatives – three types: consumer co-operatives (in many countries Co-ops, Poland Społem(?); producer (or service) co-operatives., workers co-operatives.
- Not-for –profit business – social enterprises
- Public corporations – state owned enterprises in various forms. Legal identity separate from government. UK: BBC, Bank of England. Poland: numerous state-owned enterprises, NBP(?).
- Franchises: A business which has bought the right to trade under an established name. Legal form may vary.