3.1.1 Size and types of firms

a) Reasons why some firms tend to remain small and why others grow
b) Significance of the divorce of ownership from control: the principal-agent problem
c) Distinction between public and private sector organisations
d) Distinction between profit and not-for-profit organisations

- Firm: a production unit. Its function is to transform factors of production into goods and services
- Reasons why firms remain small:
    - Niche market: demand is specialised and limited
    - Lack of economies of scale, or to avoid diseconomies of scale: a minimum efficient scale is the smallest output a firm can operate at having exploited internal economies of scale
    - Need for a dynamic, responsive, service-led firm: firms in design are often small and quick to respond to the needs of larger firms
    - Simpler and less expensive legal requirements
    - They don't want extra work or risk
    - Firms may want to remain small to avoid being noticed and taken over by larger firms
    - Greater awareness and control of their environmental impact
    - Lack of finance as they're often seen as risky investment
    - Lack of skills and enterprise necessary to expand
    - Lack of resources to be able to cope with additional regulations and bureaucracy that larger firms have to deal with
- Reasons why firms want to grow:
    - Profit maximising: (economies of scale, increasing market share and expanding into new markets)
    - Sale or revenue maximising
    - Economies of scale: larger firms = lower unit costs per unit of output in the long-run
    - Increased market share: more market power= control prices/ retain consumer loyalty/ reduced threat of competitors
    - Economies of scope: larger firms are less exposed to the risk that firms might have if they are narrowly focused especially in times of recession
    - Psychological factors: managers gain more satisfaction
    - Reduce risk of failure or a takeover
    - Improve shareholders returns6
- The principal-agent problem:
    - Shareholders (principals) own businesses but directors and managers (agents) control the business for them
    - Shareholders want to maximise their dividend whereas managers might want to maximise sales and revenue at the expense of profits
    - Managers may pursue a personal gain such as a bonus
    - Their aims diverge and the policies that they choose conflict with the other's aim
- Ways to reduce the principal-agent problem:
    - Making managers and directors accountable
    - Shareholders can remove directors by vote if they're not happy with them, but they often lack information that might make them do this

    - Accountability means managers and directors have to justify what they've done in the past
    - Owners may offer incentives to directors
- Public sector: assets are owned by society as a whole and provided through the government and funded largely through taxation. Target social welfare not profit.
- Private sector: assets are owned by individuals or groups, not the government and it is funded by private payments from individuals or companies.
- Private sector firms have to make profit to survive, so this is generally their primary objective
- Public sector firms can survive without making a profit because the government can make up any shortfalls in revenue. Some may have other important aims such as quality of service. The lack of a profit motive can make them inefficient and loss-making
- Profit organisation: aims to maximise the financial benefit of its shareholders and owners (targets maximum profit)
- Non-profit organisations don't have profit as their main motive but do usually have to cover their costs. They count as part of the private sector. Goal is to maximise social welfare
- Ways of measuring the size of firms:
    - Sales revenue
    - Profits
    - Cash flows
    - Capital invested
    - Production output
    - Number of employees
    - Number of outlets or locations
    - Market capitalisation
    - Market share
- Types of firms:
    - Sole trader:
        - One owner- all control
        - 100% of profits
        - Unlimited liability
        - Easy to set up
    - Partnership:
        - 2 to 20 owners
        - Unlimited liability unless specified as limited
        - A lot of legal documents
        - Use their own money
    - Limited company (Ltd):
        - Ownership by shareholders, but not on the stock market
        - Greater access to finance
        - Limited liability
        - Lot of legal documents and costs to setting up
        - Generally family businesses
    - Public company (Plc):
        - Share float on the stockmarket- ownership depends on number of shares
        - Limited liability

    - Generate finance by issuing shares
- Franchise:
    - A business with a well-known brand allows others to use it in return for payments
    - Liability depends on how the business is establised
- Cooperative:
    - It exists for the benefits of its users
    - The members receive a share of the profits, based on how much they spend in the business
    - Owned by its members
    - Run by its members
- Non-profit:
    - Motivated by the desire to achieve social goals rather than maximise profit
    - Profit is reinvested
- State-owned:
    - Money raised through taxation
    - Not expected to be profitable although quality of service is important

	Advantages	Constraints on growth
Sole trader	• The business is un-incorporated; the owner and the business is separate • Fewer legal costs and requirements • The owner keeps all profits • Quick and easy decisions • Private finances	• Harder to gain finance- riskier • Large workload • Owner takes burden of debt • Owner may not have a wide variety of skills needed e.g. marketing • Larger firms may not deal with them- prefer large companies
Partnership	• Easy to establish • Greater access to capital • Workload shared and partners can specialise • Losses are shared • Private finances	• Slower decision making • Conflicting opinion • Restrictions on size limits capital • Less motivation- profits shares • Unlimited liability unless 'sleeping partners'

Private Limited Company (Ltd)	• Greater access to capital • Limited liability- encourages investors • Less risky • Continues after owner died	• Conflicts and different ideas • Expensive to set up • Families can fall out • Possibility of a takeover • More complicated organisation • More complicated management structures
Public Limited Company (Plc)		• Owners may lose control • Short-terms gains over long-term gains • Managers and owners are separate
Franchise	• Cheaper to expand • Franchisee has direct control • Advertising is paid for	• Franchiser lacks control over the product • Cost of a franchise • Conflict between franchiser and franchisee • Franchiser may charge higher prices which leads to lower profits
Cooperative	• Stakeholder conflict is minimised • Legally straightforward • Limited liability • Motivation by members to provide high quality service	• It is questionable whether an ethical company can survive • Limited capital • Weak management- slow decision making