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Shaping Reality

Structuring a Business Firm
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Introduction

Our previous note on Value-focused Growth introduced a framework for discerning a firm's value drivers through abstraction. A structure is required to bring a firm into existence, organize its drivers to create value, enter into transactions, and account for its financial results. This note shares how we view a business firm's structure. It is not intended to provide technical details but a general approach to structuring a firm.

The Structure of a Firm

Broadly speaking, a firm's structure has several aspects: its legal form, governance, organizational arrangement, mode of operation, and transactional formats.

Legal Form – The Foundation

A business is a value-creating system, converting inputs into outputs, generating revenue and profits. The business firm must exist in a form that allows it to deal with people and enter into contracts. This decision regarding legal form impacts everything from tax obligations to liability exposure, and even the ability to raise capital.

Proprietorship and Partnership (unincorporated entity). The most basic forms of existence are proprietorship (sole-owner) and partnership (multiple-owners). These firms are separate accounting entities but not legally distinguishable from their owners, who are therefore subject to unlimited liabilities arising from the business. This means the owner's personal assets are at risk if the business incurs debt or faces lawsuits. The simplicity of these forms often makes them attractive to start-ups, but the unlimited liability poses a significant risk as the business grows.

Limited Liability Company or corporation. Business owners may legally limit their liabilities by establishing firms as limited liability companies, which are separate legal persons distinct from their owners. Such companies are afforded the privilege of limited liability, such that their owners' liabilities are limited to their respective capital contributions. This separation protects the personal assets of the owners from business debts and lawsuits. The choice between a corporation and an unincorporated entity often depends on tax considerations, the desire for attracting investors (corporations are generally preferred), and the complexity of the operational structure.

Business Groups and MNE. As businesses grow, complexities set in, and companies usually evolve to become business groups defined in terms of sphere of influence and control. When a business group operates across national boundaries, it becomes a multinational enterprise (MNE), which can be a combination of legal and non-legal entities in different forms – subsidiaries, associates, ventures, branches, offices, or establishments, depending on the degree of presence in the territories concerned.

MNEs face additional complexities including differing regulatory environments, currency risks, and the need to manage operations across diverse cultures. Structuring an MNE requires careful consideration of transfer pricing for intragroup dealings, tax optimization, and compliance with local laws in each jurisdiction.

Establishment. It should be noted that in most jurisdictions, the absence of a physical presence can still give rise to legal presence or establishment, such that the fiscal authority can tax activities pertaining to the establishment. This is particularly relevant where businesses can generate revenue in a country without having a physical office there.

Governance – The System of Control and Risk Management

One must bear in mind that the limited liability privilege is only available to those who conduct their business in a responsible manner, and most legal systems have sufficient avenues to deal with the deceitful and irresponsible. Those relying on this limited liability privilege must therefore be prepared to prove that they operate their companies responsibly with good accounting and proper books and records to provide audit trails to establish accountability.

Accountability and hence credibility is the crux of the matter in modern business. When one embarks on a risky venture in the form of a limited liability company, the fiscal protection he enjoys is provided at the expense of the larger community (consumers, suppliers, taxpayers, and more). Hence, companies are subject to regulations administered by different government agencies or public bodies, in addition to the contractual obligations they incur in doing business. These regulations can include environmental protection, labor laws, data privacy, and consumer protection. Compliance is not only a legal requirement but also crucial for maintaining the company's reputation and avoiding penalties.

To establish accountability, good accounting is the cornerstone of corporate governance, which is, however, a broader system of risk management and internal control. This system encompasses measures designed to prevent fraud, ensure the accuracy of financial reporting, and safeguard company assets.

Governance is derived from the notion that a company is distinct from those who contribute capital and funds to bring it into existence. Those entrusted with the company are therefore expected to create and oversee the system of governance to ensure the company’s mission is appropriately strategized, performance delivered, and risk managed. Those in charge of governance are usually the board of directors and, where complexities require, functional committees to provide specialized oversight and expertise in critical areas of governance (e.g. risk and audit).

Organization – Arrangement to Organize and Manage Value Drivers

Organization refers to arrangements designed to organize and manage value drivers, personnel, equipment, systems, processes, and cycles that form an organization’s entire value chain.

Determining the appropriate organizational structure depends on several factors, including the size and complexity of the business, the industry in which it operates, and its strategic goals. Typically, it is an organizational matrix with multi-dimensions – member (people of different roles at different levels), function (e.g., marketing and sales, procurement, R&D, production), business unit of a particular focus (e.g., product lines, duty portfolios), territory (home and host countries, region), legal (form of presence or existence, level and relation in the group), compliance and accountability (reporting lines).

The main consideration is how each element and member fits in with and contributes to the overall organizational goals, strategies, performance coordination, and motivation schemes. This is highly complex and should not be driven by personal preference or management style. The organization should be a logical arrangement that yields the best synergies and valued outcomes. Deployment of technology solution is a must to achieve this end.

Mode of Operation – Actions and Events to Bring About Results, Rules to Win

Mode of operation refers to how resources flow, functional units interact, and individual members communicate, and how they are positioned and mobilized to optimize outcomes and achieve objectives. This entails operational details including defining standard operating procedures, establishing communication protocols, and implementing performance management systems. The efficiency and effectiveness of the mode of operation directly impact the company's profitability and competitiveness. By persistently streamlining processes, reducing waste, and enhancing quality, companies can improve their operational efficiency and customer satisfaction over time.

Team competition is basically a coordination game. On a level playing field, the best-coordinated team wins. Rules to move and win can therefore be induced from an organization’s modus operandi or sequence of events and actions.

Transactional Format – Realizing Values and Fair Accounting

A firm must deal with counterparties, whether related or unrelated, to realize values created, giving rise to rights and obligations. An exchange can take different forms even if the substance of the exchange is the same. One may provide services as an independent contractor or as an employee. A good may be sold separately or as part and parcel of a composite transaction. Associated rights and obligations thus arising are noticeably different as the characters of the transactions are different.

Characterization of a transaction is therefore important in determining how its consequences should be understood and accounted for. Its importance cannot be overstated in resolving potential disputes, in ascertaining the extent of tax liabilities, and more.

Conclusion

In conclusion, business is in itself an abstract entity, but the effects it brings are hard practical matters – profits or losses, assets or liabilities, rises or falls, wealth or poverty. It is abstraction that shapes these realities.