Chapter 5
Selecting a Form of Business Ownership

Learning Objectives
- Major forms of business ownership.
  - Sole Proprietorship
  - Partnership
  - Corporation
- Franchising
- Explain how business owners can measure their business performance.

Specific Business Ownership Impact

Forms of Business Ownership
- Sole Proprietorship
  - Owned by a single owner.
- Partnership
  - Co-owned by two or more people.
  - Co-owners must register with the state and may need an occupational license.
- Corporation
  - State chartered entity that pays taxes and is legally distinct from its owners.
  - http://www.dos.state.ny.us/corp/corpwww.html

Business Ownership Statistics

Sole Proprietorship
A business owned by a single owner.

Four Characteristics:
1. Single owner.
2. Bears all responsibility.
3. Represents 70% of all firms in U.S.
4. Generate less than 10 percent of all business revenue.

http://www.erie.gov/depts/government/clerk/applications_permits_dba.phtml
http://www.dos.state.ny.us/corp/corpwww.html
**Sole Proprietorship**

**Advantages**
- Retention of all profits.
- Ease of formation.
- Complete control.
- Lower taxes.

**Disadvantages**
- Incurs all losses
- Unlimited liability.
- Financing limitations.
- Limited skills.

**Types of Partnerships**

- **General Partnerships**
  - All partners have unlimited liability.

- **Limited Partnerships**
  - Some partners have personal liability that is limited to the cash or property they invested in the firm.
  - One or more general partners who actively manage the business, receive a salary, share in profits and losses, have unlimited liability.
  - Personal earnings received from the partnership are subject to personal income taxes.

**Partnerships**

**Advantages**
- Funding.
- Losses are shared.
- Specialization.

**Disadvantages**
- Control is shared.
- Unlimited liability.
- Shared profits.

**Corporations**

- Individual or group must adopt corporate charter and file it with the state
  - Describes name of the firm, stock issued, firm’s operations
  - Must also establish bylaws
  - Shareholders have limited liability
  - Shareholders elect members of board of directors

  [http://www.dos.state.ny.us/corp/corpwww.html](http://www.dos.state.ny.us/corp/corpwww.html)

**Stockholders/Shareholders/Owners**

- Elect members of board of directors who are responsible for establishing general policies of the firm
  - Elect president and other key officers who run the business
- Earn return on investment in two ways
  - May receive dividends
  - Stock may increase in value

**Private vs Publicly Held Corporations**

- **Privately Held**
  - Ownership is restricted to small group of investors.
  - Stock is not traded publicly.
  - Examples: L. L. Bean, Polo, Ralph Lauren.

- **Publicly Held**
  - Larger corporations.
  - Stock is traded publicly.
  - Act of initially issuing stock: “going public.”
Corporations
• State-chartered entity that pays taxes and is distinct from its owners.

Advantages
• Limited liability.
• Access to funds.
• Transfer of ownership.

Disadvantages
• May be costly to establish.
• Financial disclosure.
• Agency problems.
• Tax disadvantage.

Double Taxation in Corporations

Limited Liability Company
• A firm that has all the favorable features of a typical partnership while limiting the liability for their owners.

S - Corporations
• Special type of corporation with 75 or fewer owners.

Advantages
• Lower taxes.
• Limited liability.
• Transfer of ownership.

Disadvantages
• Regulations may vary from state to state which impact taxation and liability.

Limited Liability Company (LLC)

Advantages
☑ Corporate advantage of limited liability.
☑ Avoids the double taxation of corporations.
☑ Reduces the liability for the actions of the other owners.

Which form of ownership?
• Four physicians wish to start a practice together, and each wants to have limited liability.
• A friend wants to start her own convenience store.
• An entrepreneur wants to acquire a large U.S. business.
• Five friends want to build an apartment complex and are not concerned about limited liability.
Owning Existing Businesses

Methods:
- Assuming ownership of a family business
- Purchasing an existing business
- Franchising

Franchising

- Business owner (franchisor) allows another (the franchisee) to use its trademark, trade name, or copyright, under specified conditions.
- Each franchise operates as an independent business.
- Typically owned by a sole proprietor.

Well Known Franchises

- McDonald’s
- Thrifty Rent-a-Car System
- Mail Boxes Etc.
- Dairy Queen
- Super 8 Motels Inc.
- TGI Fridays
- Pearle Vision Inc.
- Baskin-Robbins

Three Types of Franchises

1. Distributorship
   - Dealer sells products produced by a manufacturer.
   - Example: Car dealers.

2. Chain-Style Business
   - Firm uses trade name of a company and follows guidelines.
   - Example: McDonald’s.

3. Manufacturing Arrangement
   - Firm manufactures a product using a formula from another company.
   - Example: Microsoft.

Franchising

Advantages
- Proven management style
- Name recognition.
- Financial support.
- Lower failure rate.

Disadvantages
- Sharing of profits.
- Less control.
- Start-up costs.
- Coattail effects.

Impact of Ownership on Return

- Return on Investment (ROI)
  - After-tax earnings represent the return in dollars to the business owners.

- Return on Equity (ROE)
  - Reflects earnings as a proportion of the firm’s equity
  - Equity is the total investment by the firm’s stockholders.
  - Return on Equity = \( \frac{\text{Earnings after tax}}{\text{Equity}} \)
Impact of Ownership on Risk

- Risk represents *uncertainty about the firm’s future earnings*
  - Depends on future revenues and expenses
- Sole proprietorships tend to be riskier than larger businesses, such as partnerships and corporations.
  - Limited funding restricts ability to diversify and spread business risk

Additional Resources

- Starting a business in NYS:
  - www.gorr.state.ny.us/Main_GORR_Pages/Permits/Startbus.html
- Growth company guide:
  - www.growco.com