Chapter 5

Selecting a Form of Business Ownership

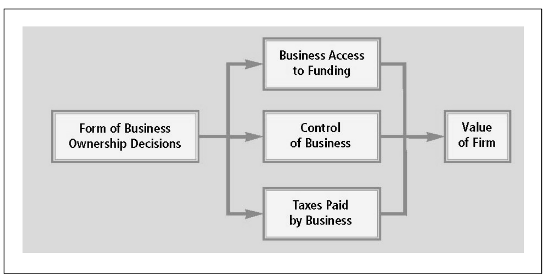
Learning Objectives

❶ Major forms of business ownership.
- Sole Proprietorship
- Partnership
- Corporation

❷ Franchising

❸ Explain how business owners can measure their business performance.

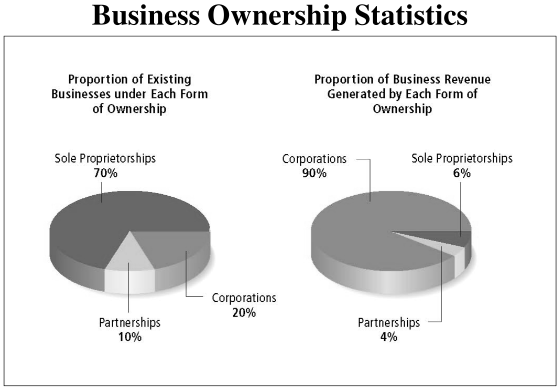
Specific Business Ownership Impact



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

Sole Proprietorship

Advantages	Disadvantages
• Retention of all profits.	• Incurs all losses
• Ease of formation.	• Unlimited liability.
• Complete control.	• Financing limitations.
• Lower taxes.	• 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	Disadvantages
• Funding.	• Control is shared.
• Losses are shared.	• Unlimited liability.
• Specialization.	• 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

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.

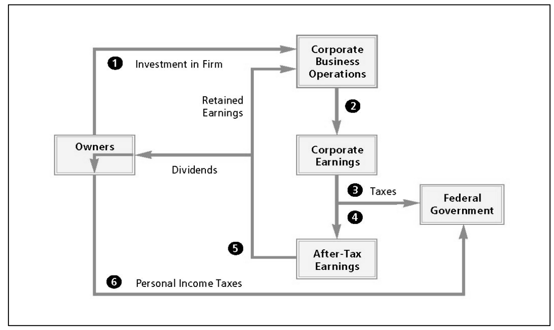
Advantages

• 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.

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.

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.

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: McDonalds.

③ Manufacturing Arrangement

Firm manufactures a product using a formula from another company. Example: Microsoft.

Franchising

Advantages	Disadvantages
✓ Proven management style	☒ Sharing of profits.
✓ Name recognition.	☒ Less control.
✓ Financial support.	☒ Start-up costs.
✓ Lower failure rate.	☒ 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