Reading 18

Entrepreneurs Choose Different Types of Business Organization

In this lesson you will learn about the different ways entrepreneurs can choose to start a business. When entrepreneurs start businesses, they must consider several types of business organizations. These include sole proprietorships, partnerships, and corporations. Entrepreneurs must also decide whether to start a new firm, purchase an existing firm, or buy a franchise. Each of these alternatives offers advantages and disadvantages that entrepreneurs must evaluate in the light of their own needs and objectives.

When you were a young child, you may have run a lemonade stand in front of your home on hot summer days. Maybe you charged 10 or 15 cents a glass. People stopped to buy a drink and praised you for doing a good job. If you had earned a dollar or two by the end of the day, you were pleased. You probably did not need the permission of anyone other than your parents to sell your lemonade. Certainly the government was not interested in your business. However, if you decide to open a restaurant today or in the future, you need to meet government requirements. The nature of these requirements will vary depending on the type of business you want to start and where your business is located.

Most businesses in the United States are **sole proprietorships** in which a single owner takes full responsibilities for the business. One person owns the business and is responsible for its activities. Sole proprietorships are easy to start because only one person makes all the decisions about how the firm is to be run. These businesses may be started by filling out a few simple forms provided through an office of the county or state government. People who do not like sharing responsibility with others might choose to operate a sole proprietorship.

Despite the advantages, there are also problems associated with the sole proprietorship form of business organization. The amount of money you can raise for a new business venture is about the same amount you can raise to buy a house. Banks do not lend more money just because you want to open a business. In general, they will not lend amounts of money greater than the value of assets the borrower can pledge as **collateral** for the loan. If a borrower fails to make timely payments, the lender takes the collateral to satisfy the debt. If you have $20,000 in a savings account and $30,000 invested in your home, you will be able to borrow only up to the $50,000 value of your assets. You can understand why most sole proprietors start small businesses. They are limited by the value of the things they already own.

A second disadvantage is that sole proprietors are personally responsible for their firm's debts. If the business failed, the courts could take most of the owner's personal property to satisfy the business debts. This is called **unlimited liability**. Another disadvantage of sole proprietorships is that they must be reorganized if the owner dies. This process takes time and may leave the firm without leadership while it is being reorganized. Finally, many sole proprietors spend most of their time running their business because they feel they must make all the decisions. They may take few vacations and have little time left over for other activities.

The least common form of business organization is the partnership. A **partnership** is a form of business organization in which two or more people share the responsibility and liability for the operation of a business. The papers necessary to form a partnership are available through either county or state offices.

A partnership offers several advantages. For one thing, it has a greater ability to raise money than a sole proprietorship. The resources of two or more owners are likely to be greater than those of only one proprietor. Partners may also share their time and skills in running the firm.

The greatest disadvantage of a partnership is its unlimited liability. Each partner is responsible for the debts of any other partner. Entrepreneurs must be vary careful when they choose a partner. Finally, partnerships, like sole proprietorships, must also be reorganized when any partner dies.

A third type of business organization is the corporation, A **corporation** is a form of business organization with a legal identity that is separate from the identities of its owners. A corporation is formed when a state government grants a charter to sell stock and start a business. The charter specifies the type of business to be formed, where the business will operate, how many shares of stock will be sold and at what price. A share of **stock** is a unit of ownership in a corporation. Charters provide other types of information depending on the state in which the corporation is organized. After the stock is sold, the stockholders elect a board of directors. The board of directors either runs the firm or hires managers to do this for them.

Corporations are able to raise large amounts of money because they can sell stock to many people. Although entrepreneurs who start corporations have the use of the money raised by selling stock, the other owners or stockholders share some control of the business and its profits. In the United States, corporations make more than 80 percent of all the sales of goods and services . Although there are more sole proprietorships, on average, they are much smaller than the average corporation.

The owners of corporations have another advantage. They have limited liability. **Limited liability** provides a limitation on the legal responsibility of owners of a corporation to the money invested in a firm. If a corporation fails, the most a stockholder can lose is the value of the money used to buy the stock. The law recognizes corporations as legal individuals. The courts can take all the assets of the firm to satisfy a corporation's debts, but the courts cannot take the personal property of the stockholders.

Corporations also have unlimited life. This means they continue to function even when an owner dies. Control over the firm is determined by a majority of the voted stock. If an owner is not able to vote stock, it does not affect the firm's ability to operate.

Deciding what form of business organization is most appropriate is not the only important choice new entrepreneurs must make. They must decide if they should start a new business or buy an existing business.

Many successful entrepreneurs got started when they purchased a business from people who wanted to sell their firm. There are, of course, both advantages and dangers in purchasing an existing firm. For example, if you bought an established restaurant, it would probably already have customers who would continue to eat there. However, it is possible that the former owner is selling out because there is a problem with the business that is difficult or impossible to overcome. New entrepreneurs who buy existing businesses need to conduct research on the firms before purchase.

Another way to start a business is to purchase a franchise. New entrepreneurs who lack much training or experience often do this. A **franchise** is a form of business in which a parent firm that is experienced sells the right to copy its trademark and method of doing business and has the ability to train people to operate units of the business. The people who buy the franchise pay a fee and a percentage of their sales to the parent firm. In exchange, they receive help and direction in running their businesses. In some instances the parent firm also supplies the merchandise. Thousands of new entrepreneurs have become successful through buying and operating fast-food franchises. The actual form of business organization that is used to start a franchise may be a sole proprietorship, partnership, or corporation.

In order to make the best choice possible, people who are thinking about starting a business need to identify their abilities, needs, and objectives. They should then evaluate each possible form of business organization in terms of these factors.

CHECK YOUR UNDERSTANDING

Consider each of the following questions. If you are not sure of an answer, review the reading to find the information you need before moving on to the next question.

1. Why are sole proprietorships the most common form of business organization?
2. Why are most sole proprietorships relatively small?
3. What is unlimited liability?
4. Why should entrepreneurs be very careful when they form partnerships?
5. What is a share of stock?
6. Why are almost all large businesses corporations?
7. How is a corporation's board of directors chosen?
8. Explain the limited liability of owners of corporations.
9. Describe the possible advantages and disadvantages that an entrepreneur might encounter when buying an existing firm.
10. What is a franchise?