Unit 3

Types of Business Ownership

Objective: You should be able to compare and contrast sole proprietorships, partnerships and corporations. You should be able to explain the advantages and disadvantages of these three forms of business ownership. Why? Because you should know the advantages and disadvantages of each one before you choose one.

Ways to acquire a business:

- Take over a family business
- Buy an existing business
- Purchase a franchise (a legal agreement to begin a new business in the name of a recognized company)
- Start a business from scratch

Owning a business is a serious undertaking. It is highly recommended that you seek counsel from two important resources: Experienced Accountant & Attorney

Legal Forms of Business Ownership (3 major forms)

Sole Proprietorship: one person is responsible for the activities of the business. Approximately 75% of all US businesses

Partnership: two or more people own a business and share in the assets, liabilities, and profits – as well as in the business decisions and outcome. Specifics of a partnership are usually based on a written agreement – roles, responsibilities, distribution of profits, what happens if one partner dies or quits, etc. Two types are General Partners vs. Limited Partners.

Limited Partnership
Limited partner's liability is limited to their investment

General Partnership
General partners have unlimited personal liability and take full responsibility for the management and actions of the business and other partners. Law requires that all partnerships have at least one general partner.

Corporation: a business that is registered by a state and legally operates apart from its owner(s). There are different types of corporations. Corporations can either be privately held (Amanda's Piano Store, Inc.) or publicly traded (Disney Corp.) Corporations are required to have a board of directors. **A non-profit is also a type of corporation.**

LLC (Limited Liability Company) is a fourth form of business ownership. Has limited liability of a corporation. Its members are not liable for company debts. Tax advantages of a partnership. Shareholders are taxed once. Many law and medical firms form LLCs to protect their partners. Consult with an attorney.

Please note: There is no correlation between the number of employees of an organization and the type of business ownership. A sole proprietorship can have 100 employees and a corporation could have one employee.

Sole Proprietorship	Partnership	Corporation
Advantages ▪ Easiest and least expensive form of business to create (file DBA "Doing business as" and business license in town) ▪ Owner receives all profits ▪ Owner has 100% of control ▪ Owner can sell business at any time ▪ Taxes are paid at personal tax rate of owner (which is lower than business rate)	**Advantages** ▪ Inexpensive to create ▪ General partners have complete control ▪ Sharing of ideas ▪ Can secure investment capital more easily and in greater amounts) ▪ Control rests with general partners	**Advantages** ▪ A corporation can live on after the owners have sold their interests or died. ▪ Shareholders only liable to amount invested ▪ Control rests with shareholders who own majority of stock ▪ Profits to shareholders according to amount invested ▪ Shareholders free to sell stock at any time ▪ Easier to raise money (through selling of stock) ▪ Owners have limited liability ▪ Can create pension and retirement plans
Disadvantages ▪ Owner assumes all debt ▪ Owner is personally liable for all actions of business (personal assets are vulnerable) ▪ Business is dissolved upon death of owner ▪ May be difficult to raise capital (may not qualify for a loan) ▪ Business may be limited by skills and abilities of owner	**Disadvantages** ▪ Can get messy if there's a personality conflict or problem about authority, decision making, etc. (This happens when roles are not defined) ▪ It's difficult to dissolve one partner's interest in the business without dissolving the partnership. So if one partner wants to pull out or dies, that ends the business. Only if provisions have been placed in the partnership agreement is the business likely to survive. ▪ Personally liable for actions of other partners (general)	**Disadvantages** ▪ Most expensive to create. Includes attorney's fees and filing fees for incorporation documents through state. ▪ In Mass, about $1,000-$2,000 ▪ Min taxes $450/year ▪ $100 annual report ▪ Officers (stated in corporate documents) are liable for full amounts owed. ▪ More heavily taxed than SP or Partnership ▪ Double taxation ; corp pays taxes and shareholders pay taxes

Franchises

Franchisor: one that grants a franchise

Franchisee: one granted a franchise

Franchise:

- the right or license granted to an individual or group to market a company's goods or services in a particular territory
- the right of membership in a professional sports league

THE FRANCHISOR'S PERSPECTIVE

What motivates a business to offer a franchise? The answer to this question will help a potential franchisee become a more knowledgeable consumer. Understanding the franchisor's perspective can help the franchisee select a franchise and negotiate its purchase.

More rapid expansion. A primary reason for a business to become a franchisor is the capability to expand more rapidly. A lack of capital and a dearth of skilled employees can slow business expansion. The franchisee provides both when a new outlet is opened. A franchisor may assist a franchisee in obtaining financing for a new business, but the franchisee bears the liability for repayment of the funds. In addition, the franchise owner usually is selected because of his/her business experience and management skills. **Thus, a franchise operation is a mutually beneficial proposition for both the franchisor and the franchisee.**

Higher motivation. When a business franchises its operations, it acquires a motivated group of managers. Each manager is an owner and has a high level of motivation for success. A manager is also more accountable for actions because the manager as an owner is totally responsible for business outcomes. This means that a potential franchisee should ask why a franchisor wants the franchisee to purchase a franchise. If the only benefit a franchise brings is money, the franchisee should be cautious about why the franchisor wants to do business.

Capital. There is another advantage to franchising a business. It allows a company to raise money without selling an interest in the business

Image. The name and image of a company are at risk when it is sold to other individuals. Thus, a franchisor is often quite particular about quality and the standards that franchisees are expected to meet. Franchisors therefore usually designate very specific business practices that franchisees must follow. The concern over image also helps explain why many franchisors reserve the right to buy back a franchise operation. **Potential franchisees can take comfort in the**

fact that most franchisors want to see them succeed. This also motivates franchisors to provide the support necessary to help achieve success.

Potential competition. Franchising a business also has the liability of training competitors. Franchisees may learn how a business operates and then decide to replicate the operation under another name. This has happened to some franchisors, so it makes others cautious. A good franchisor will try to establish a positive relationship with franchisees to avoid this problem. The restrictions placed on franchisees are usually balanced by rewards in an attempt to retain their loyalty.

As you review a franchise agreement, keep in mind the franchisor's perspective. Look for an agreement that takes a balanced approach. **A good franchisor is one that desires to create a relationship where both parties are winners.**

THE FRANCHISEE'S PERSPECTIVE - BENEFITS

It is important to consider the benefits and costs from the franchisee's perspective before deciding to buy a franchise.

Benefits

The following benefits provide a good rationale for starting a business by purchasing a franchise. These must be balanced by the costs or disadvantages.

Lower Risks. Most business experts agree that a franchise operation has a lower risk of failure than an independent business. The statistics on this vary depending on the definition of failure. Whatever statistics are used, they consistently suggest that a franchise is more likely to succeed than are independent businesses.

Established product or service. A franchisor offers a product or service that has sold successfully. An independent business is based on both an untried idea and operation. Three factors will help you predict the potential success of a franchise. The first is the number of franchises that are in operation. The second predictor is how long the franchisor and its franchisees have been in operation. A third factor is the number of franchises that have failed, including those bought back by the franchisor.

Experience of franchisor. The experience of the franchisor's management team increases the potential for success. This experience is often conveyed through formal instruction and on-the-job training.

Group purchasing power. It is often possible to obtain lower-cost goods and supplies through the franchisor. Lower costs result from the group purchasing power of all franchises. To protect this benefit, most franchise agreements restrict the franchisee from purchasing goods and supplies through other sources.

Name recognition. Established franchisors can offer national or regional name recognition. This may not be true with a new franchisor. However, a benefit of starting with a new franchisor is the potential to grow as its business and name recognition grow.

Efficiency in operation. Franchisors discover operating and management efficiencies that benefit new franchisees. Operational standards set in place by the franchisor also control quality and uniformity among franchisees.

Management assistance. A franchisor provides management assistance to a franchisee. This includes accounting procedures, personnel management, facility management, etc. An individual with experience in these areas may not be familiar with how to apply them in a new business. The franchisor helps a franchisee overcome this lack of experience.

Business plan. Most franchisors help franchisees develop a business plan. Many elements of the plan are standard operating procedures established by the franchisor. Other parts of the plan are customized to the needs of the franchisee.

Start-up assistance. The most difficult aspect of a new business is its start-up. Few experienced managers know about how to set up a new business because they only do it a few times. However, a franchisor has a great deal of experience accumulated from helping its franchisees with start-up. This experience will help reduce mistakes that are costly in both money and time.

Marketing assistance. A franchisor typically offers several marketing advantages. The franchisor can prepare and pay for the development of professional advertising campaigns. Regional or national marketing done by the franchisor benefits all franchisees. In addition, the franchisor can provide advice about how to develop effective marketing programs for a local area. This benefit usually has a cost because many franchisors require franchisees to contribute a percentage of their gross income to a co-operative marketing fund.

Assistance in financing. It is possible to receive assistance in financing a new franchise through the franchisor. A franchisor will often make arrangements with a lending institution to lend money to a franchisee. Lending institutions find that such arrangements can be quite profitable and relatively safe because of the high success rate of franchise operations. The franchisee must still accept personal responsibility for the loan, but the franchisor's involvement usually increases the likelihood that a loan will be approved.

Proven system of operation. An attractive feature of most franchises is that they have a proven system of operation. This system has been developed and refined by the franchisor. A franchisor with many franchisees will typically have a highly refined system based on the entire experience of all these operations.

Common Mistakes of Prospective Franchisees

1. Not reading, understanding or asking questions about the disclosure document.
2. Not understanding or having an inaccurate or incomplete interpretation of the franchise agreement and other legal documents to be signed.
3. Not seeking sound legal advice.
4. Not verifying oral representations of the franchisor.
5. Not contacting enough current franchisees.
6. Not confirming the reasons for failed franchises.
7. Not analyzing your market in advance.