CHAPTER 7: SECTION 1

About Business Firms
Why Do Business Firms Exist?

A business firm is an organization that uses resources to produce goods and services that are sold to consumers, other firms, or the government. Most businesses exist because a group of people working together can be more effective than a group of people working individually.
Three Types of Firms

- Sole Proprietorships
- Partnerships
- Corporations
SOLE PROPRIETORSHIPS

- A sole proprietorship is a business that is owned by one individual.
- This owner makes all the business decisions, receives all the profits or losses of the firm, and is legally responsible for the debts of the firm.
- About 18.3 million proprietorships operate in the United States.
SOLE PROPRIETORSHIPS

Advantages

- Easy to **form** and to **dissolve**
- All decision-making power resides with the sole proprietor
- The profits are **taxed** only once.

Disadvantages

- **Unlimited liability** – The sole proprietor’s personal assets may be used to pay off the debts of the firm
- There are challenges raising funds for **expansion**
- Usually ends with the **retirement** or **death** of the owner
PARTNERSHIPS

A **partnership** is a business that is owned by two or more **co-owners**, called partners.

The partners **share** profits and are legally responsible for debts.

About **2.3** million partnerships operate in the United States.
PARTNERSHIPS

Advantages

• **Specialization** – If one partner has a talent that goes well with the other partner’s talent, the partners can separate the responsibilities of the business.

• Taxes are assessed only at the *personal* level

Disadvantages

• Unlimited liability – If one partner incurs a substantial business-related debt, **all** partners are responsible for the debt.

  One exception is the **limited** partnership. Limited partners do not **participate** in the management of the firm or enter into contracts so they are only liable for the amount he or she **invested** in the firm.

• **Decision making** can be complicated in a partnership. Each partner may want to take different risks or operate the business in a different way.
The corporation is a business type familiar to most people. A corporation is a **legal entity** that can conduct business in its own name in the same way that an individual does.

- A corporation is owned by its **stockholders**. Stockholders are people who buy shares of stock in a corporation.

- A share of stock represents a claim on the **assets** of a corporation. Assets are anything of **value** to which the firm has a legal claim.

- All corporations have a **board of directors**. The board of directors decides corporate **policies and goals**, and much more.
CORPORATIONS

• All firms can raise money by borrowing from banks and other lending institutions. Corporations can also raise money from the sale of bonds, of statements of debt, and of stocks. If you buy a bond from a corporation, you are a lender. If you buy stock, you are an owner.

• About 5.1 million corporations operate in the United States and account for about 83% of all business receipts.
CORPORATIONS

Advantages

• **Limited liability** - An owner can lose only the amount that she or he has invested in the firm. Suppose a person spends $100 purchasing stock in a business firm. She is at risk of losing only her $100 investment, even if the firm performs poorly and accumulates millions in debt. Any **debts** accumulated by a corporation are the sole responsibility of the **corporation**.

• The corporation will continue to **exist** even if one or more owners sell their shares or die. A corporation is a legal entity, and its existence does not depend on the existence of its owners.

• Corporations are able to raise large amounts of **money** by selling more stock, providing **funding** for expansion.
CORPORATIONS

• *Disadvantages*

• **Double taxation** - First, the corporation is taxed on its *earnings*. Later, when the corporation distributes profits to stockholders in the form of *dividends*, the stockholders are taxed on their dividends.

• Corporations are more *complicated* to set up than proprietorships or partnerships.
Advantages and Disadvantages of Types of Business Firms

<table>
<thead>
<tr>
<th>Type of business firm</th>
<th>Examples</th>
<th>Advantages</th>
<th>Disadvantages</th>
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<tr>
<td>Sole proprietorship</td>
<td>Local barbershop, Many restaurants, Family farm, Carpet-cleaning service</td>
<td>Easy to form and to dissolve. All decision-making power resides with the sole proprietor. Profit is taxed only once.</td>
<td>Proprietor faces unlimited liability. Limited ability to raise funds for business expansion. Usually ends with retirement or death of proprietor.</td>
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<td>Partnership</td>
<td>Some medical offices, Some law offices, Some advertising agencies</td>
<td>Benefits of specialization can be realized. Profit is taxed only once.</td>
<td>Partners face unlimited liability (one partner can incur a debt and all partners are legally responsible for payment of the debt). Decision making can be complex and frustrating.</td>
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<tr>
<td>Corporation</td>
<td>Hewlett-Packard, Intel, Walt Disney</td>
<td>Owners (stockholders) have limited liability. Corporation continues if owners sell their shares of stock or die. Usually able to raise large sums of money.</td>
<td>Double taxation. Corporations are complicated to set up.</td>
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A Fourth Type of Business Firm: The FRANCHISE

- A franchise is a contract that lets a person or a group use a firm’s name and sell the firm’s goods in exchange for certain payments and requirements. A famous example is the franchises of the McDonald’s Corporation.

- The entity that offers the franchise is the franchiser. In this case, McDonald’s Corporation is the franchiser.

- The person or group that buys the franchise is the franchisee.

- A franchise begins when a franchisee pays an initial fee to use the name and sell the goods (in 2005, the initial fee for a McDonald’s franchise was $45,000). The franchisee will pay a royalty, or a percentage of profits to the franchiser (in 2005, the McDonald’s royalty rate was 12.5%), and follow guidelines established by the franchiser. In return, the franchisee receives help in training employees, advertising, and other benefits.
FRANCHISES

Advantages

• Use of national advertising helps all franchises.

• **Consistency** in the product (all Big Macs are made exactly the same).

• Less **risk** (the failure rate is about **12** times higher for independently owned businesses than for franchises)

Disadvantages

• Sometimes the financial and training support is not **effective** for success.

• The franchisee may not provide the **quality** of service and product that the franchiser expects.
What Is the Ethical and Social Responsibility of Business?

- Ralph Nader, a consumer advocate, thinks that businesses have **ethical** and **social** responsibilities. He also believes that businesses should treat their **employees** well. And he believes that businesses should **donate** funds to meet social needs in the community.

- Milton Friedman, winner of the 1976 Nobel Prize in Economics, believes that a business has only **one** social responsibility: to use its resources and increase its profits without **deception** or **fraud**. He believes that a business should earn as much as possible by selling the public something it wants to buy. Any other use of resources is outside the business’s social responsibility.