Business Organizations

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the important factors to consider when choosing an entity type for a business. Specifically, this lesson will cover:

1. Purpose of Businesses

At its most fundamental level, a business exists to make a profit for its owners. In a capitalist market-driven economy, a business that fails to make a profit ultimately ceases to exist, overtaken by creditors and competitors. The need to make a profit is one truism that binds all businesses together, but beyond that, it's hard to draw generalizations about business operations.

The world of business is as varied as human experience itself, ranging from the neighborhood kids who shovel snow in the winter and sell lemonade in the summer, to the neighborhood pizza restaurant, to the small factory on the outskirts of town making machine tools, to the multinational **corporation** with hundreds of thousands of employees scattered throughout the globe.

Some businesses make things in factories (manufacturers), some businesses sell things that other businesses make (retailers or franchisees), and some businesses exist to help both the makers and sellers make and sell better (business consultants). Some businesses don't make things at all, and instead profit by selling their services (think of an accounting or law firm, a house painting company, or a hotel) or by lending money at a higher rate of interest than it can borrow.

TERM TO KNOW

Corporation
A business that is chartered by state law and requires a uniform structure such as shareholders who elect a board of directors who then elect officers. Regular meetings of record are required. The owners of a corporation (shareholders) are not liable for the business. Only the corporation itself is liable for the business's debts and judgments.

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2. Entity Choice

With this breadth and diversity, it's not surprising that there is no "one size fits all" approach to choosing a business organization.

When choosing which form of entity is best, business professionals must consider several factors:

1. They have to consider how much it costs to create the entity and how hard it is to create. Some entities are easy to create, while others are more complicated and have ongoing maintenance requirements that are important to consider.
2. They have to consider how easy it is for the business to continue if the founder dies, decides to retire, or decides to enter a new business altogether.
3. They have to consider how difficult it might be to raise money to grow or expand the business.
4. They have to consider what sort of managerial control they wish to keep on the business, and whether they are willing to cede control to outsiders.
5. They have to consider whether or not they wish to eventually expand ownership to members of the public.
6. They must give some thought to tax planning to minimize the taxes paid on earnings and income.
7. They have to consider whether or not they wish to protect their personal assets from claims against the business, a feature known as **limited liability**.

If you are ever in a position to start a new business venture, your focus is typically on growing revenue and cutting costs so that you can maximize profit. You may not be very concerned with entity choice at the outset, since so many other considerations are competing for your attention.
Once an entity choice is made, however, it is difficult (but not impossible) to change to another selection. Since entity choice can have a profound effect on these considerations, it is important to gain a basic understanding of the available choices so that you, the business professional, can focus on the business fundamentals rather than legal or accounting details.

TERM TO KNOW

Limited Liability
A limitation on a person's financial liability. In business, this refers to a corporation or a limited liability company (LLC). When one of these entities is sued, the owners of the corporation (shareholders) or of the LLC (members) are typically not liable at all for the acts of the company and only their investment in the company is at stake, not their personal wealth.

3. Types of Businesses

It's important to remember that choosing a business organization is different from what kind of business you run.

Some businesses are known as **franchises** because they operate under a license agreement (contract) whereby they agree to follow certain standards set by the **franchisor**, purchase their goods from the franchisor, and maybe share either a royalty fee or percentage of profits with the franchisor.

Franchises are a very common type of business (especially in the food and service industries), but there is no typical form of business for a franchise. Depending on the needs of the franchise owners, a franchise could be a **sole proprietorship**, a **partnership**, a **limited liability company (LLC)**, or a corporation.

Similarly, we sometimes refer to "nonprofit organizations," such as universities or charities, as separate legal entities. Although they are nonprofit, some of these enterprises can be very large, with complex operations that spread across borders (for example, The Red Cross or Doctors Without Borders).

For tax purposes, nonprofits do not have to pay any taxes if they meet strict qualifications under IRS guidelines to become a "501(c)(3)" organization (named for the section of the Internal Revenue Code that grants nonprofit status), but from a legal perspective, these entities can also take on any number of forms, from sole proprietorships to corporations.

TERMS TO KNOW

Franchise

The owner of intellectual property (patents, licenses, trademarks, etc.) who offers to franchisees (individuals or businesses) the use of its protected business ideas to operate a commercial enterprise under the name and mark of the owner.

Franchisor

A company (such as McDonald's) that enters into a contract with a franchisee (an individual or business) to use the franchisor's intellectual property (patents, licenses, trademarks, etc.) and operate a business as part of the franchise (such as an individual McDonald's restaurant).

Sole Proprietorship

A business that is owned by one individual alone. This business and the individual who owns the business are one and the same and there is no separation between them, and the owner is fully liable for the business.

Partnership

An unincorporated business formed by two or more individuals to make a profit.

Limited Liability Company (LLC)

A hybrid between a corporation and a partnership in that it is a separate entity but has fewer formalities than a corporation. It is a simpler form of entity than a corporation but also has limited liability of its owners like a corporation, and unlike a partnership. It can only be formed under state law.

SUMMARY

In this lesson, you learned that the basic **purpose of businesses** is to make a profit, but the organizational goals and output of businesses vary greatly. Therefore, **entity choice** should take into account such considerations as cost, ownership, managerial control, legal protection, and taxes. You also learned that the **type of business** is different from the entity or organization of the business. For example, a franchise could be classified as a sole proprietorship, a partnership, a limited liability company (LLC), or a corporation, depending on the specific business needs.

Best of luck in your learning!

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