Types of Business Organizations

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WHAT'S COVERED

In this lesson, you will learn about the advantages and disadvantages of different types of business structures. Specifically, this lesson will cover:

1. Types of Organizational Structure

Business organizations can be structured in various ways, depending on their standing as legal entities, internal structure, and management processes.

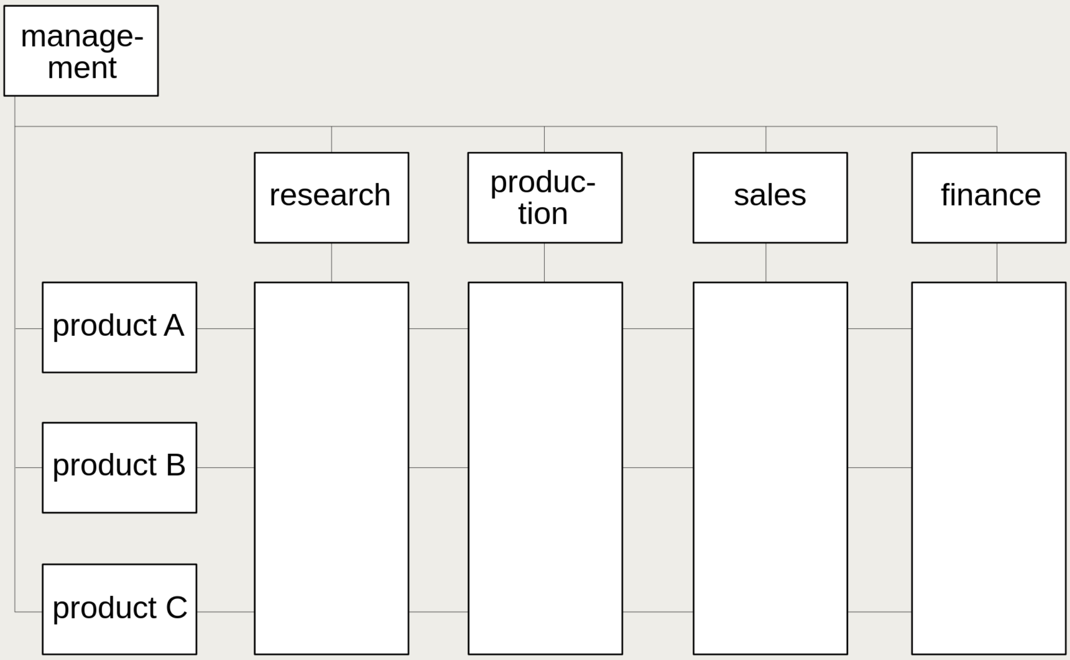
The following table describes different organizational structures.

Organizational Structure	Description
Pre-bureaucratic	These structures lack standardization of tasks. This structure is most common in smaller organizations and is best used to solve simple tasks. The structure is totally centralized and appears like a hierarchy. The strategic leader makes all key decisions and most communication is done by one-on-one conversations. It is particularly useful for a new (entrepreneurial) business as it enables the founder to control growth and development.
Bureaucratic	Bureaucratic structures have a certain degree of standardization. They are better suited for more complex or larger scale organizations, usually adopting a tall structure. The tension between bureaucratic structures and non-bureaucratic is echoed in Burns and Stalker's distinction between mechanistic and organic structures.
Functional	Employees within the functional divisions of an organization tend to perform a specialized set of tasks; for instance, the engineering department is staffed only with software engineers. This leads to operational efficiencies within that group. However, it could also lead to a lack of communication between the functional groups within an organization, making the organization slow and inflexible. As a whole, a functional organization is best suited as a producer of standardized goods and services at large volume and low cost.
Divisional	Also called a "product structure," the divisional structure groups each organizational function into a division. Each division within a divisional structure contains all the necessary resources and functions within it. Divisions can be categorized by different points of view. One might make distinctions on a geographical basis (a US division and an EU division, for

	example) or on a product/service basis (different products for different customers, households, or companies). In another example, an automobile company with a divisional structure might have one division for SUVs, another division for subcompact cars, and another for sedans.
Matrix	The matrix structure groups employees by both function and product. This structure can combine the best of both separate structures. A matrix organization frequently uses teams of employees to accomplish work, in order to take advantage of strengths and make up for weaknesses of functional and decentralized forms. Matrix structure is amongst the purest of organizational structures – a simple lattice emulating order and regularity demonstrated in nature.

IN CONTEXT

Suppose a company produces three products: Product A, Product B, and Product C. Using the matrix structure, this company would organize functions within the company by product and function, as shown below.



1a. Legal Considerations

In the US and elsewhere, many business structures require a form of incorporation to register the business as a legal entity. The owner files articles of incorporation with the secretary of state's office for the particular jurisdiction. The organization may also hold meetings, select a board of directors, adopt bylaws, and report on a regular basis.

The business entity's type, its geographic span of operations, risk profile, and other factors are issues to consider when choosing what entity type to use, in what jurisdiction to **incorporate**, how the articles should be drafted, and if a stock form should be used.

TERM TO KNOW

Incorporate

To form into a legal company.

1b. Business Perspective

There are various forms of organizational structures from a business perspective, including:

- Sole proprietorships
- Cooperatives
- Partnerships
- Limited liability companies
- Corporations

All of these structures are for-profit, but there are also non-profit corporations and other structures. The differences in structures can depend on the number of entrepreneurs or owners involved, and the different tax treatments.

One of the issues dividing forms is that of**liability**. With sole proprietorships and some forms of partnership, owners can be personally liable for business losses, meaning their personal assets are not protected against the claims of creditors. These organizational structures are also not separate entities from the owners/entrepreneurs, unlike a corporation.

TERM TO KNOW

Liability

An obligation, debt or responsibility owed to someone.

1c. Organizational Behavior

Internally, organizations can also be structured differently, in terms of the groupings of organizational relationships and the characteristics of management. Some common structures are the functional, divisional, matrix, team, network, and modular structures.

Independent from their legal and internal structures, organizations can also behave differently. For example, hybrid organizations, which may fall under various legal categories, can mix elements, value systems, and logics of action from the private, public, and voluntary sectors.

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2. Sole Proprietorship

The sole proprietorship is one type of business structure from a legal status perspective. It is a structure open to businesses run and owned by one **entrepreneur**, also known as a **proprietor**.

There are both advantages and disadvantages when it comes to using a sole proprietorship as a business structure.

Advantages:

- There is an ease of filing incorporation and tax documents.
- It has uninterrupted control of the business.
- It does not require formal incorporation, meaning that sole proprietors do not need to formally file articles of incorporation, hold regular meetings, or elect an advising or directing board.

- Simplicity is also reflected in tax treatment, as a sole proprietor files taxes as personal income.
- Sole proprietors also have control over the aspects of their business without the involvement of elected board members.

Disadvantages:

- There is no separation between the entrepreneur and the business. With sole proprietorships, like some forms of partnership, owners can be personally liable for business losses, meaning their personal assets are not protected against the claims of creditors.
- It is not a separate entity from the owner/entrepreneur, unlike a corporation. As a result, if the proprietor dies, the business ceases to exist.
- Because the enterprise rests exclusively on one person, it often has difficulty raising long-term capital.

BIG IDEA

The sole proprietorship structure has the benefit of simplicity and control but the drawback of unlimited liability.

TERMS TO KNOW

Entrepreneur
A person who organizes and operates a business venture and assumes much of the associated risk.

Proprietor
An owner.

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3. Partnership

The **partnership** is the next simplest business structure after the sole proprietorship. Because sole proprietors can only have one owner, the partnership is the simplest structure open to collaborative ownership.

There are both advantages and disadvantages when it comes to using a partnership as a business structure.

Advantages:

- There is an ease in filing and tax treatment.
- With a general partnership, two or more people can start a business as co-owners with no special formalities, directly controlling the partnership and making binding decisions with a simple majority vote.
- Partners are taxed individually on their share of the partnership's profits.
- By default, profits are shared equally among the partners. However, a partnership agreement will almost invariably expressly provide for the manner in which profits and losses are to be shared.

Disadvantages:

- Owners can be personally liable for business losses in some forms of partnership, meaning their personal assets are not protected against the claims of creditors.
- The partnership is not a separate entity from the owners/entrepreneurs, unlike a corporation. This means that the partnership structure is only as good as the partnership at the relational level. If the mutual

consent to form a partnership breaks down, the partnership breaks down as well; partnerships are considered to be an aggregate of their partners rather than a separate entity.

There has been debate in most states as to whether a partnership should remain aggregate or be allowed to become a business entity with a separate continuing legal personality. Types of partnership beyond the general partnership have developed to mitigate some of the disadvantages of the structure. Limited partnerships allow limited liability for some partners who have no management authority, and in some cases (depending on the jurisdiction) limited liability partnerships provide for limited liability for all partners.

BIG IDEA

The partnership structure has the benefit of simplicity and control but the drawback of personal liability for the partnership's activities.

TERM TO KNOW

Partnership

An association of two or more people to conduct a business.

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4. Corporation

The corporation is another type of business structure. There are also both advantages and disadvantages when it comes to using a corporation as a business structure.

Advantages:

- It has the protection of personal assets. Stockholders, directors, and officers of a corporation are typically not liable for the company's debts and obligations. They are limited in liability to the amount they have invested in the corporation, which makes financing more attractive from a risk perspective.
- Because the corporation is an entity separate from its owners, ownership is easily transferable.
- It does not cease to exist with the death of shareholders, directors, or officers of the corporation.
- In the United States, corporations are generally taxed at a lower rate than are individuals.

Disadvantages:

- Compared to other business structures, it is less simple to found and maintain.
- The incorporator must file articles of incorporation with the secretary of state's office in the state in which it will be incorporated, as well as hold an organizational meeting to elect a board of directors.
- It generally requires the maintenance of at least annual reporting. In many jurisdictions, corporations whose shareholders benefit from limited liability are required to publish annual financial statements and other data, so that creditors who do business with the corporation are able to assess the creditworthiness of the corporation and cannot enforce claims against shareholders. Shareholders, therefore, experience some loss of privacy in return for limited liability.
- There is the issue of double taxation, wherein the corporation is taxed on its profits and shareholders are also taxed on their earnings.

BIG IDEA

The corporate structure is less simple to found and maintain but has the advantages of limited liability and perpetual life.

4a. S Corporation

A S corporation is the best of both worlds. S corporations are merely corporations that elect to pass corporate income, losses, deductions, and credit through to their shareholders for federal tax purposes. S status combines the legal environment of standard corporations with US federal income taxation similar to that of partnerships.

As with partnerships, the income, deductions, and tax credits of an S corporation flow through to shareholders annually, regardless of whether distributions are made. Thus, income is taxed at the shareholder level and not at the corporate level.

Payments to S shareholders by the corporation are distributed tax-free to the extent that the distributed earnings were previously taxed. Also, certain corporate penalty taxes (e.g., accumulated earnings tax, personal holding company tax) and the alternative minimum tax do not apply to an S corporation.

SUMMARY

In this lesson, you learned about the **types of organizational structure** that businesses can utilize, including pre-bureaucratic, bureaucratic, functional, divisional, and matrix. When choosing what type of business entity to form, **legal considerations**, the **business perspective**, and **organizational behavior** must be considered. Business structures include**sole proprietorships, partnerships, corporations, and S corporations**, among others. Each type of entity carries different implications for ownership, liability, and taxation.

Best of luck in your learning!

TERMS TO KNOW

Entrepreneur
A person who organizes and operates a business venture and assumes much of the associated risk.

Incorporate
To form into a legal company.

Liability
An obligation, debt or responsibility owed to someone.

Partnership
An association of two or more people to conduct a business.

Proprietor
An owner.