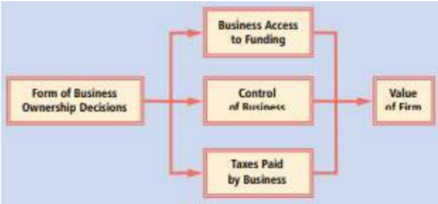
E. Selecting a Form of Business Ownership



1. Sole Proprietorship
   A business owned by a single owner is referred to as a **sole proprietorship**. The owner of a sole proprietorship is called a sole proprietor. A **sole proprietor** may obtain loans from creditors to help finance the firm's operations, but these loans do not represent ownership. The sole proprietor is obligated to cover any payments resulting from the loans but does not need to share the business profits with creditors.

   - Characteristics of Successful Sole Proprietors
     Sole proprietors must be willing to accept full responsibility for the firm's performance. The pressure of this responsibility can be much greater than any employee's responsibility. Sole proprietors must also be willing to work flexible hours. They are on call at all times and may even have to substitute for a sick employee. Their responsibility for the success of the business encourages them to continually monitor business operations. They must exhibit strong leadership skills, be well organized, and communicate well with employees.

   - Advantages of a Sole Proprietorship
     - All Earnings Go to the Sole Proprietor
     - Easy Organization
     - Complete Control
     - Lower Taxes

   - Disadvantages of a Sole Proprietorship
     - The Sole Proprietor Incurs All Losses
     - Unlimited Liability
     - Limited Funds
     - Limited Skills

2. Partnership
   A business that is co-owned by two or more people is referred to as a **partnership**. The co-owners of the business are called **partners**.
   In a **general partnership**, all partners have unlimited liability. That is, the partners are personally liable for all obligations of the firm. Conversely, in a

limited partnership, the firm has some **limited partners**, or partners whose liability is limited to the cash or property they contributed to the partnership.

A limited partnership has one or more **general partners**, or partners who manage the business, receive a salary, share the profits or losses of the business, and have unlimited liability.

General partnership is a partnership in which all partners have unlimited liability. **Limited partnership** is a firm that has some limited partners. **Limited partners** are partners whose liability is limited to the cash or property they contributed to the partnership. **General partners** are partners who manage the business, receive a salary, share the profits or losses of the business, and have unlimited liability.

- Advantages of a Partnership
  - Additional Funding
  - Losses Are Shared
  - More Specialization

- Disadvantages of a Partnership
  - Control Is Shared
  - Unlimited Liability
  - Profits Are Shared

- S-Corporations

  A firm that has 100 or fewer owners and satisfies other criteria may choose to be a so-called **S-corporation**. The owners of an S-corporation have limited liability (like owners of corporations), but they are taxed as if the firm were a partnership. Thus, the earnings are distributed to the owners and taxed at the respective personal income tax rate of each owner.

- Limited Liability Company (LLC)

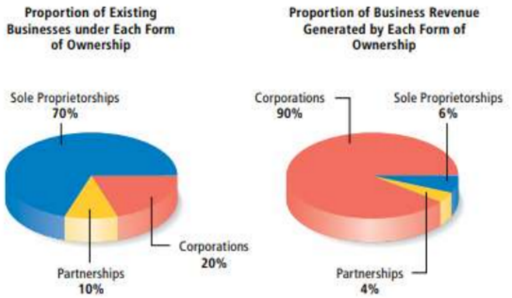
  A type of general partnership called a limited liability company (LLC) has become popular in recent years. An LLC has all the favorable features of a typical general partnership but also offers limited liability for the partners. **Limited liability company (LLC)** is a firm that has all the favorable features of a typical general partnership but also offers limited liability for the partners.

3. Corporation

   A third form of business is a **corporation**, which is a state-chartered entity that pays taxes and is legally distinct from its owners. To form a corporation, an individual or group must adopt a corporate **charter**, or a document used to incorporate a business, and file it with the state government. The people who organize the corporation must also establish **bylaws**, which are general guidelines for managing the firm.

Exhibit 5.1

Relative Contributions to Business Revenue of Sole Proprietorships, Partnerships, and Corporations



- How Stockholders Earn a Return
  Stockholders can earn a return on their investment in a firm in two different ways. First, they may receive dividends from the firm, which are a portion of the firm's recent earnings over the last three months that are distributed to stockholders. Second, the stock they hold may increase in value.

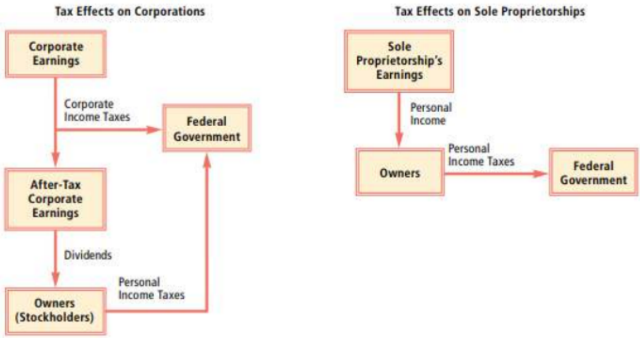
- Private versus Public Corporations
  People become owners of a corporation by purchasing shares of stock. Many small corporations are **privately held**, meaning that ownership is restricted to a small group of investors. Most large corporations are **publicly held**, meaning that shares can be easily purchased or sold by investors. The act of initially issuing stock to the public is called **going public**.

- Advantages of a Corporation
  - Limited Liability
  - Access to Funds
  - Transfer of Ownership

- Disadvantages of a Corporation
  - High Organizational Expense
  - Financial Disclosure
  - Agency Problems
  - High Taxes

Exhibit 5.3

Comparison of Tax Effects on Corporations and Sole Proprietorships



- Comparing Forms of Business Ownership
  - Using the Internet to Compare Forms of Business Ownership

    In addition to government agencies, many private organizations provide information and services to small businesses that are just being formed. Many of these organizations, such as The Company Corporation, allow corporations and other forms of businesses to be set up entirely over the Internet. A particularly attractive feature of these services is their low cost. Nevertheless, some entrepreneurs may still prefer to hire an attorney to form the business, especially if their ownership situation is complicated.

4. How Ownership Can Affect Return and Risk
   - Impact of Ownership on the Return on Investment

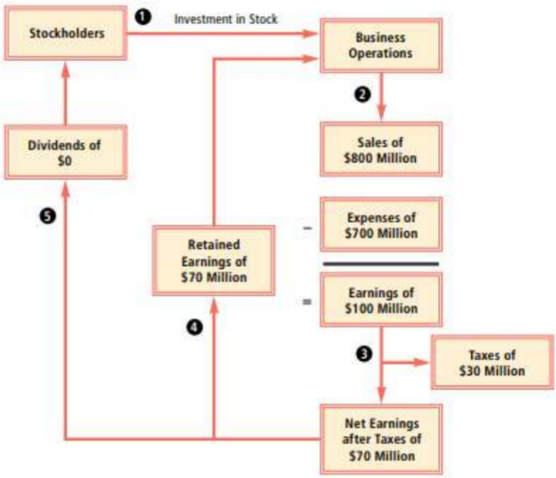
     The dollar value of a firm's after-tax earnings is not necessarily a useful measure of the firm's performance unless it is adjusted for the amount of the firm's equity, which is the total investment by the firm's stockholders. For this reason, business owners prefer to measure a firm's profitability by computing its return on equity (ROE), which is the earnings as a proportion of the equity:

$$\text{ROE} = \frac{\text{Earnings after Tax}}{\text{Equity}}$$

For example, if the stockholders invested \$1 million in a firm and its after-tax earnings last year were \$150,000, its return on equity last year was:

$$\text{ROE} = \frac{\$150{,}000}{\$1{,}000{,}000}$$
$$= .15, \text{ or } 15\%$$

Exhibit 5.4
Return on Equity for Zemax Company



- Impact of Ownership on Risk
  The **risk** of a firm represents the degree of uncertainty about the firm's future earnings, which reflects an uncertain return to the owners.

5. Obtaining Ownership of an Existing Business
   Some people become the sole owners without starting the business. The following are common methods by which people become owners of existing businesses:
   - Assuming ownership of a family business
     Many people work in a family business and after a period of time assume the ownership of it. This can be an ideal way to own a business because its performance may be somewhat predictable as long as the key employees continue to work there. Major decisions regarding the production process and other operations of the firm have been predetermined. If the business has historically been successful, a new owner's main function may be to ensure that the existing operations continue to run efficiently. Alternatively, if the business is experiencing poor performance, the new owner may have to revise management, marketing, and financing policies.

   - Purchasing an existing business
     Businesses are for sale on any given day in any city. They are often advertised in the classified ads section of local newspapers. Businesses are sold for various reasons, including financial difficulties and the death or retirement of an owner.

   - Franchising
     A **franchise** is an arrangement whereby a business owner (called a **franchisor**) allows another (the **franchisee**) to use its trademark, trade name,

or copyright, under specified conditions. Each individual franchise operates as an independent business and is typically owned by a sole proprietor.

- Types of Franchises

  Most franchises can be classified as a distributorship, a chain-style business, or a manufacturing arrangement.

  In a **distributorship**, a dealer is allowed to sell a product produced by a manufacturer. In a **chain-style business**, a firm is allowed to use the trade name of a company and follows guidelines related to the pricing and sale of the product. In a **manufacturing arrangement**, a firm is allowed to manufacture a product using the formula provided by another company.

- Advantages of a Franchise
  - Proven Management Style
  - Name Recognition
  - Financial Support

- Disadvantages of a Franchise
  - Sharing Profits
  - Less Control

- The Popularity of Business-to-Business Franchises

  Franchises that serve other businesses (called business-to-business or B2B franchises) have grown substantially in the last few years. In particular, many franchises focus on providing hiring services, consulting services, and training services for firms. These types of franchises are popular because they normally require a smaller initial investment than many other franchises such as hotels and restaurants.