About Business Firms

Why Do Business Firms Exist?

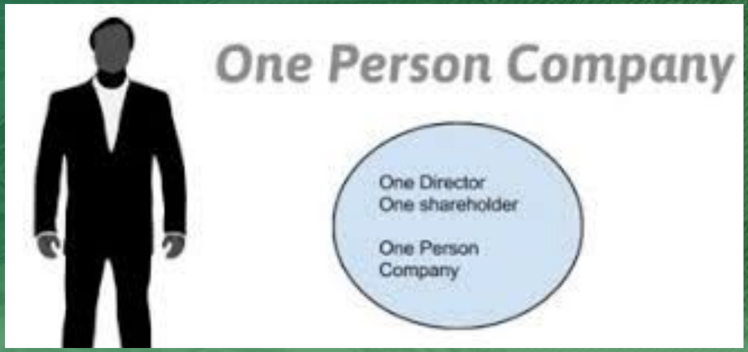
- A **business firm** is an organization that uses resources to produce goods and services that are sold to consumers, other firms, or the government. Most businesses exist because a group of people working together can be more effective than a group of people working individually.

Why Are Bosses Necessary?

- Business firms need bosses and employees: people who give the orders and people who carry out the orders.
- When a worker puts forth less effort than he or she has agreed to put forth, the worker is **shirking**.
- A boss must have the ability to hire and fire people. The threat of dismissal by the boss reduces shirking in a firm.

Three Types of Firms

- Firms are grouped into three types: sole proprietorships, partnerships, and corporations. (See Transparency 7-1; you might add your own or students’ examples to the chart.)
- 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.



- There are several advantages to organizing a business as a sole proprietorship. Sole proprietorships are easy to form and to dissolve, all decision-making power resides with the sole proprietor, and the profits are taxed only once.

- 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.
  - A partnership has the ability to take advantage of 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. And, as with a sole proprietorship, taxes are assessed only at the personal level.

- Partnerships do have the disadvantages of unlimited liability. If one partner incurs a substantial business-related debt, all partners are responsible for the debt. One exception is the limited partnership.
- 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.

- A major advantage of forming a corporation is that the stockholders have limited liability. **Limited liability** means that 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.
- Another advantage of the corporation is that it 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.

- A third advantage is that corporations are able to raise large amounts of money by selling more stock, providing funding for expansion.
- One disadvantage of a corporation is 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.
- Another disadvantage is that corporations are more complicated to set up than proprietorships or partnerships.

Corporation Structure

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

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. The franchisee will pay a percentage of profits to the franchiser, and follow guidelines established by the franchiser. In return, the franchisee receives help in training employees, advertising, and other benefits.

What Is the Ethical and Social Responsibility of Business?

- Ralph Nader 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 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.

Where Will Firms Locate?

- Similar firms have an incentive to locate near each other as they compete for customers. Have you ever noticed multiple gas stations at an intersection? several car dealerships located next to each other?

TRANSPARENCY 7-1: Advantages and Disadvantages of Types of Business Firms

Type of business firm	Examples	Advantages	Disadvantages
Sole proprietorship	• Local barbershop • Many restaurants • Family farm • Carpet-cleaning service	• Easy to form and to dissolve. • All decision-making power resides with the sole proprietor. • Profit is taxed only once.	• Proprietor faces unlimited liability. • Limited ability to raise funds for business expansion. • Usually ends with retirement or death of proprietor.
Partnership	• Some medical offices • Some law offices • Some advertising agencies	• Benefits of specialization can be realized. • Profit is taxed only once.	• 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.
Corporation	• Hewlett-Packard • Intel • Walt Disney	• Owners (stockholders) have limited liability. • Corporation continues if owners sell their shares of stock or die. • Usually able to raise large sums of money.	• Double taxation. • Corporations are complicated to set up.

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Wrap It Up!