

Entrepreneurship and Design Thinking  
Lecture 3: Forms of Business Ownership  
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**Introduction**

- In the last topic we looked at design thinking and innovation, where we noted that design thinking is a methodology to help an entrepreneur come up with an innovative new product, service or process.
- In this topic when the idea is ready the entrepreneur must ask; which is the best form of business should I use to release my product to the market?

**Learning Outcomes**

At the end of this chapter, you should be able to:

- Describe characteristics, advantages and disadvantages of sole proprietorship.
- Describe characteristics, advantages and disadvantages of partnership.
- Explain the characteristics, advantages and disadvantages of a company.

**Introduction**

- When entrepreneurs establish a business, they must decide on the form of business ownership.
- There is no single form that can be said to apply to all individuals, but the person venturing into business need to first consider the following factors:
  - Formation requirements
  - Ease of creation
  - Flexibility
  - Expenses to start and maintain
  - Legal requirements
  - Government control and regulation
  - Income taxes consequences

- Liability

## **Forms of Business Ownership**

### **1. Sole Proprietorship**

- The sole proprietorship is by far the simplest and easiest way for an entrepreneur to do business.
- A sole proprietorship is not even a legal entity at all.
- The term is used to imply an individual who is self-employed and operates a business alone.
- By far this is the most common form of business ownership in most of the developing countries due to its simplicity.

## **Advantages of the sole proprietorship**

- *Being their own boss*, the owner has full control, and this eliminates any chance of conflict or misunderstanding during decision-making.
- *Simplicity of creating and dissolving*. In most cases you only need an idea, money and a simple license to start. When dissolving you don't have to consult anyone. All you need to do is to simply put a sign on the door saying, "out of business."
- *Low cost of creating the business*. Sole proprietorship is usually one of the least costly forms of business to create. Because legal papers are not necessary, start-up legal expenses are minimal. And since the owner is the boss and probably the only one there will be few labor costs.
- *Total commands over decisions and profits*. Since the owner has full control over the business, he/she can make decisions without consulting others and withdraw the money from the business whenever necessary. And since all the profits go to the owner there is greater motivation to grow the business.
- *Uncomplicated tax basis*. A sole proprietorship is taxed as a person and not the business

## **Disadvantages of sole proprietorship**

- *Not easy to raise enough capital to start one's own business*. Where capital required is substantial.

- *Risk of financial loss*, the owner risks all the investment put in the business, plus all the debts from doing business given the unlimited nature of business
- *Lack of continuity*. Sole proprietorship is established by the initial owner, operated by the owner and tends to die with the owner.
- *Opportunities for raising further capital are limited*, this can severely restrict the growth of the business.
- *Unlimited liability*, there is no limit on the debts for which the owner is liable. When the business is sued the owner is liable for the debt.
- *Limited skills*, the individual may be limited in terms of skills that they possess, and for these reasons they may be unable to control all parts of the business.

## **2. Partnerships**

- In partnership the co-owners share the assets, liabilities and profits of the business. (E.g. Procter & Gamble, Johnson & Johnson were once a partnership).
- In business today most partnership occurs among doctors, lawyers, accountants and other professionals.
- A partnership is relatively simple to establish and does not require the same amount of record keeping as a corporation.
- Unless the partnership agreement provides otherwise, the law that governs entrepreneurs who do business as general partners spreads the ownership and management among the partners so that they share equally in the rights and responsibilities.
- This is why partners are encouraged to come up with a formal partnership agreement that would cater for their interest.
- Where there is no partnership agreement/deed or it is not clear, the law will take effect,
- The co-owners of the business prepare an agreement and states where the business life span is expected to be more than one year (the agreement must be in writing). This document is called partnership agreement. Below are some of the key elements that partnership agreement should contain;
  - The name of the partnership and those of each partner.

- A general description of the type of business that will be conducted and the purpose of the partnership.
- The power and duties of the partners, including any limitations or restrictions.
- The financial contribution each partner will make.
- How profits and losses are to be divided
- How partners can leave the business and new one added.
- What steps must be taken to dissolve the partnership.
- Methods that will be used to settle disputes.
- What procedure should be used in the event of a tie vote between partners on crucial partnership decisions.

### **Advantages of partnership**

- There is increased capital due to the partners contributions
  - Greater access to finance unlike the sole trader
  - Wide range of experience and expertise brought by different partners
  - Business is not taxed; rather it is the individuals who are taxed.
  - Losses are shared among the partners according to the agreed ratio.

### ***Disadvantages***

- Partners are personally liable in case the business incurs debts.
- Slow decision making due to consultation
- A decision by one partner can get others into trouble since they are jointly liable.
- Profit is shared
- More requirements when starting in comparison with sole trader.
- Lack of continuity due to death of one partner.

### **What leads to partnership dissolution?**

- An event, which makes it unlawful for the business or the partners to carry on the partnership, occurs.
- The partnership was entered into a fixed period and the fixed period has come to an end.

- If the partnership was entered into for a single venture/undertaking and has come to an end.
- Death, bankruptcy of any partner or by the court order.

## **Types of partners**

- In a *general* partnership, all partners have unlimited liability. That is the partners are personally liable to all obligations of the firm. Conversely, in a limited partnership, the firm has some partners whose liability is limited to cash or property they contributed to the partnership.
- *Limited* partners are only investors in the partnership and do not participate in its management, but because they have invested in the business, they share its profits or losses. A limited partnership has at least one general partner, or partners who manage the business. These partners receive a salary, share the profits or losses of the business and have unlimited liability.
- *Active partner*- this is the person who shares in capital contribution, business management, profit, losses and liabilities. The public knows the person.
- *Silent partner*- is a limited partner who does not take part in management of the business; however, he/she is disclosed to the public as being a partner.
- *Secret partner*- this is a partner who participates in the management of the business, but he/she is kept secret as being a partner in the business.
- *Quasi partner*- this is the person who contributes no capital but is presented to the public as being a partner. This partner may even share profits and losses but does take part in the management of the partnership.
- *Nominal partner*- this is a partner who allows his/her name to be identified with the business. The partner contributes no capital and does not take part in the management of the business.

## **Limited companies**

- Corporation is a distinct, legal entity in itself that has a legal life separate from its owners.
- A corporation is a legal organization with assets and liabilities separate from those of its owner(s).
- The corporation can enter contracts, borrow money, sue and be sued and pay taxes just like a person. This is the most common form of business.
- A company may have as few as two members/ shareholders with no limitation on the membership ceiling.

When registering a company there are several documents that should be submitted to the Registrar of Companies, these are:

### **1). Memorandum of Association**

It should state the following;

- (a) The name of the company, with "limited" as the last word of the name in the case of a company limited by shares or by guarantee; and
- (b) That the registered office of the company; and
- (c) The objects of the company.

### **2) Statement of capital**

This state is the share capital the company wishes to have. The total value of all the shares (nominal share capital) needs also to be stated in this document. If there is any classification or types of shares it should be outlined in this document.

### **3) Articles of Association**

This is concerned with the internal administration of the company. Those setting up the company need to decide on the rules they wish to be included in their article. Matters that are normally dealt with in the articles are;

#### **4) Form indicating particulars of directors and secretary**

This contains details of first directors and secretary, their date of birth, occupation and details of other directorship, they have held within the last five years. They must sign and date the form.

#### **5) Notice of proposed registered office**

In this form the notice of the proposed registered office must be indicated.

#### **6) Declaration of compliance and the prescribed registration fees**

This is a statutory declaration of compliance with all the legal requirements relating to the incorporation of a company and any fee that ought to be paid has been cleared.

#### **7) Copy of the company name approval**

The name that was approved during the search must be filled in with the Registrar of Companies.

#### **Advantages of a limited company**

- Shareholders have limited liability (can only lose what they have put in the business).
- Additional capital can be raised through issuing more shares (right issue).
- More access to additional capital from external lenders.
- Company name is protected by law.
- Perpetual existence.
- Democratic management.
- Easy transfer of ownership.

#### **Disadvantages**

- Employees may feel distant from their owners.
- Company records are open to the public e.g. annual records- financial disclosure.
- Expensive to form a company.
- Decision making is complex due to the number of people involved.
- Affairs are strongly controlled according to companies Acts.

- Double taxation, after a company pays its corporate tax, its owners pay personal taxes on any distributions of its profits they receive from the corporation in the form of stock dividend.
- Agency problem- when managers do not act as responsible agents for the shareholders who own the business.

### **Other types of business Ownership**

- **Joint venture-** is a partnership between companies formed for a specific undertaking
- **Franchises-** a special form of licensing that we will handle in depth in the next topic.
- **C Corporation**
  - This is considered to be a separate taxpaying entity. Hence it files its own returns and pays corporation tax.
- **S Corporation**
  - This is not a tax paying entity. Instead, much like a partnership, it is treated as a ‘pass through’ entity. The profit and losses flow through the corporation to the individuals and are reflected in their personal income tax returns.

### **Limited Liability Company (LLC)**

- This is a hybrid entity with both characteristics of partnerships and corporations. The corporation consists of members who are also its managers unless they designate one person to sole manage the corporation. It is governed by Uniform Limited Liability Company Act (in US), which members can alter.

### **Chapter Review**

- There is no one form of business that can be said to be the best.
- One needs to consider the objective of starting a business first, then evaluate the advantages and disadvantages that are associated with each form.
- We also need to realize that some countries may not have all the forms that we described
- In the next topic we look at franchising in detail within the context of entrepreneurship.

### **Reflection Questions**

- 1) Distinguish a general partner from a limited partner.

- 2) Examine the appropriate scenario where each form of business discussed in this chapter would apply
- 3) Describe a franchise and identify its advantages and disadvantages.
- 4) Detail the basic steps that must be taken to start a company in your country.
- 5) Recommend the best form of business to your five friends who want to build an apartment complex and are not concerned about limited liability.