**HARAMAYA UNIVERSITY**

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**Introduction**

When starting a new venture or restructuring an existing enterprise, selecting the right legal form is crucial. This overview explores the three fundamental forms: sole proprietorship, partnership, and corporation.

Understanding these forms empowers entrepreneurs to make informed decisions and establish a solid foundation aligned with their goals for future growth and success.

The Three basic legal forms of businesses are :

1. **Sole proprietor ship**

A business structure where a single individual owns and operates the enterprise. In this form, the owner assumes unlimited personal liability for the business's debts and obligations, and the business itself is not considered a separate legal entity distinct from its owner

**Characteristics**

* Owned and controlled by a single individual, who retains full authority over business decisions and operations
* The owner of a sole proprietorship is personally liable for all debts and obligations of the business, risking personal assets in case of financial liabilities

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* As the sole decision-maker, the owner has the autonomy to make quick and direct decisions without the need for extensive consultations or consensus

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* The owner of a sole proprietorship retains all profits financial benefits without the need for profit-sharing generated by the business, allowing for direct with partners or shareholders

**Example**

Let's say John is a freelance graphic designer who operates his business as a sole proprietorship. He works independently, taking on design projects for various clients. As a sole proprietor, John has complete control over his business decisions and retains all the profits. However, he is also personally liable for any debts or legal obligations associated with his business. For example, if John fails to deliver a project as promised and a client sues him for damages, his personal assets could be at risk

**Pro**

* Easiest and least expensive business structures to establish, requiring minimal legal formalities and paperwork, making them accessible to aspiring entrepreneurs
* As the sole owner, you have full control over all aspects of the business, including decision-making, operations, and strategic direction, allowing for quick and agile responses to market changes
* Business income and expenses are reported on the owner's personal tax return, eliminating the need for separate corporate tax filings and potential double taxation

**Cons**

* **Limited Access to Capital**

Sole proprietors may face challenges in accessing external funding or capital compared to larger business entities. The reliance on personal savings, loans, or credit limits the ability to raise substantial funds for business growth or investment

* **Unlimited Liability**

The owner of a sole proprietorship is personally liable for all business debts and legal obligations. This places their personal assets at risk, potentially leading to financial loss in the event of business liabilities or lawsuits

* **Limited Expertise and Resources**

Sole proprietors often face limitations in terms of expertise and resources.

They must handle all aspects of the business themselves, from operations to marketing, which can be overwhelming and lead to a lack of specialized skills or knowledge in certain areas

1. **Partnership**

A business entity formed by two or more individuals who agree to contribute resources, share profits and losses, and jointly manage the business. There are two main types of partnerships: general partnerships and limited partnerships.

**Characteristics**

* Partnerships involve two or more individuals who jointly own and operate the business, pooling their resources, skills, and expertise.
* Partnerships distribute profits and losses among partners based on the agreed-upon terms outlined in the partnership agreement.
* Partnerships require collaborative decision-making, with partners sharing responsibilities and participating in the strategic direction and day-to- day operations of the business.
* Each partner in a partnership holds unlimited obligations, potentially risking personal assets in personal liability for the partnership's debts and case of financial liabilities or legal issues

**Examples**

Imagine two friends, Sarah and Mark, who decide to start a restaurant together. They form a partnership to pool their resources and expertise. Sarah takes care of the culinary aspects, while Mark manages the finances and marketing. They share the profits and losses according to their agreed-upon partnership agreement. In this case, both Sarah and Mark are personally liable for any debts or legal issues the restaurant may face. For instance, if the restaurant fails to pay its suppliers, both partners can be held personally responsible

**Pro**

* Partnerships allow for the pooling of resources, skills, and knowledge, enabling partners to bring diverse perspectives and expertise to the business, leading to improved decision- making and operational efficiency.
* Partners can contribute capital and share financial responsibilities, reducing the burden of financing the business solely on one individual and potentially increasing access to funding
* Partnerships enjoy pass-through taxation, where profits and losses are passed directly to partners, avoiding double taxation at the business level and allowing for potential tax advantages and flexibility in allocating income.

**Cons**

* **Unlimited Liability :**

Each partner is personally liable for the partnership's debts and legal obligations, meaning personal assets are at risk. Partners may be held responsible for the actions or decisions of other partners, potentially leading to financial loss.

* **Potential Disagreements:**

Conflicts and disagreements among partners can arise, affecting decision- making, business operations, and even personal relationships. Disputes over profit sharing, workload, or strategic direction may impact the smooth functioning of the partnership

* **Shared Profits :**

Partnerships involve the sharing of profits among partners. While this fosters collaboration, it also means that individual partners may receive a smaller portion of the overall profits compared to being a sole proprietor, depending on the agreed upon profit-sharing arrangement.

1. **Corporation**

A legal entity that is separate and distinct from its owners. It is owned by shareholders who elect a board of directors to oversee the management of the company.

**Characteristics**

* Corporations have a distinct legal identity separate from their owners, providing limited liability protection and continuity beyond shareholder changes.
* Ownership in corporations is represented by shares, enabling transferability and proportional ownership rights based on shareholding.
* Corporations are managed by a board of directors, who appoint officers and executives responsible for day-to-day operations and decision-making.
* Corporations can raise capital by issuing stocks and markets for business expansion and investment bonds, attracting investors and accessing financial opportunities.

Example

Let's consider a multinational technology company like Apple Inc. Apple is a publicly traded corporation with numerous shareholders. The company is managed by a board of directors, who are elected by the shareholders. Apple has limited liability, which means that shareholders are generally not personally responsible for the company's debts or legal liabilities.

**Pro**

* Have perpetual existence separate from their shareholders. The death or departure of individual shareholders does not affect the continuity of the corporation, allowing for long-term stability and succession planning.
* Can raise capital by issuing stocks and bonds, attracting investors and accessing financial markets. This ability to raise funds from a wider pool of investors provides greater potential for business expansion and growth.
* Shareholders in a corporation have limited personal liability for the company's debts and legal obligations

**Cons**

* **Complexity and Formalities :**

Corporations entail legal complexity, requiring articles of incorporation, shareholder meetings, record- keeping, and adherence to extensive reporting, governance, and regulatory obligations.

* **Double Taxation :**

Corporations may face double taxation, where corporate profits are subject to corporate income tax, and dividends distributed to shareholders are taxed again at the individual level, potentially reducing overall profits available to shareholders.

* **Increased Government Oversight:**

Corporations are subject to greater government scrutiny and regulations compared to other business forms.

Compliance with legal and reporting requirements can be more demanding, involving additional costs and administrative burdens for the corporation.

**Conclusion**

In conclusion, understanding the three fundamental legal forms of business—sole proprietorship, partnership, and corporation—is essential for entrepreneurs. Each form brings its own set of advantages and disadvantages, ranging from liability protection and shared decision- making to access to capital and regulatory complexities. By carefully considering the characteristics of each form, entrepreneurs can make informed choices that align with their goals, resources, and risk tolerance, setting a solid foundation for their business ventures.