**LESSON 2**

**STARTING A BUSINESS**

**FORMS OF BUSINESS ORGANIZATION**

One of the things that an entrepreneur must consider when going into business is the legal form that the business should take. The three main forms of business organization—proprietorships, partnerships, and corporations—have their own distinct advantages and disadvantages.

This lesson uses Kentucky tourism and the entrepreneurial opportunities it offers to study the advantages and disadvantages of the various forms of business organizations. As students go through the lesson, they will discover how businesses in their communities are organized, and they will learn about some state and local agencies that are available to help them if they should decide to start a business.

Student Learning Objectives:

Identify Kentucky tourist locations and entrepreneurial opportunities

Classify businesses according to how they are organized

Contrast the strengths and weaknesses of the sole proprietorship, partnership, and corporation. Locate state and federal agencies that help entrepreneurs start a business.

Apply the PACED decision making model to an evaluation of the **Different Forms of Business Organization (PACED** - State the P**roblem;** List the **Alternatives** in the first column; List the **Criteria** in the first row; **Evaluate** each alternative by placing an “+” or “-“ in the box below each criteria; and Make your **Decision.)**

**Curriculum Content Standards:**

Kentucky's Learning Goals and Academic Expectations:

2.16 Students observe, analyze, and interpret human behaviors, Social groupings, and institutions to better understand people and the relationships among individuals and among groups.

2.18 Students understand economic principles and are able to make economic decisions that have consequences in daily living.

2.36 Students use strategies for choosing and preparing for a career.

5.1 Students use critical thinking skills such as analyzing, prioritizing, categorizing, evaluating, and comparing to solve a variety of problems in real-life situations.

5.4 Students use a decision-making process to make informed decisions among options.

**EconomicsAmerica Voluntary National Content Standards 14 in Economics**:

Students will understand that entrepreneurs are people who take the risks of organizing productive resources to make goods and services. Profit is an important incentive that leads entrepreneurs to accept the risk of business failure as well as success.

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**Economic Concepts**:

articles of incorporation, certificate of authority, common stock, corporation, entrepreneur, incorporate, initial public offering (IPO), limited liability, limited liability company, partner, partnership, partnership agreement, proprietorship, S-corporation, sole proprietorship, stock, stockholder, franchise, franchisee, unlimited liability

**PREPARE:**

Use the blackline masters at the end of this lesson to make one copy of the following activity sheets for every student in class:

Business Focus: Proprietorships and Partnerships

Business Focus: Incorporating a Business

Business Focus: Opening a Franchise

Activity Sheet 2-1: Classifying Businesses According to Form of Organization

Activity Sheet 2-2: The Partnership Agreement

Activity Sheet 2-3: Advantages and Disadvantages of Different Forms Business Organization

**TEACH:**

Before you start this unit, distribute the **Business Focus: Proprietorships and Partnerships,** and **Business Focus: Incorporating a Business** sheets. Give the students time to review these materials on their own so that they can develop enough background and command of glossary terms (which are defined on the focus sheets) to complete the activities. When you hand them out, remind students that the type of business organization selected by the entrepreneur will help determine his or her eventual success or failure.

**Activity 1: Classifying Businesses**

When an entrepreneur—a person who pursues a risky business opportunity in hopes of obtaining a profit—starts a new business, many decisions must be made. Will I start out on my own? Should I take on a partner? Do I incorporate? A majority of businesses start out as proprietorships with one owner/operator. Some entrepreneurs need the financial backing or expertise of a partner, or co-owner of an unincorporated business, and start a partnership, a form of business owned and managed by two or more individuals who share the profits and losses of the business. Still others choose to incorporate to become a corporation, a legal form of business organization with all the rights and responsibilities of an individual.

1.Distribute Activity Sheet 2-1: Classifying Businesses According to Form of Organization. Direct students to classify the businesses they listed on Activity Sheet 2-1 according to their form of business organization. (Students may need additional time to contact the owner or managers of some businesses in order to determine the form of business organization.)

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**Activity 1: Classifying Businesses (continued)**

2. Ask: "What is the most popular form of business organization?" "Why do the students think that this is so?" (Answers will vary according to the community studied, but sole

proprietorships are likely to be the most numerous—and the smallest with regard to size. Corporations are likely to be the most visible because of their large size and heavy advertising.)

**Activity 2: Completing the Partnership Agreement**

1. Give the students a few minutes to review the Business Focus: Proprietorships and Partnerships material, and then distribute Activity Sheet 2-2: The Partnership Agreement.

2. Ask each group to think about a hypothetical business they could run with startup capital of $10,000. Next, tell them that they will have to find one or more persons who will join with them to become partners.

3. Tell student to complete the partnership form, and warn them to pay particular attention to the possible distribution of losses under Section V. Remind them that, in a real business situation, each partner would be fully responsible for the bad business decisions of the other partners.

4. Ask the groups to describe how the completion of this activity caused them to rethink the concept of the partnership as a form of business organization (Possible answer: they would be extremely careful in choosing their partners).

**Activity 3: Evaluating Different Forms of Business Organization**

1. Distribute copies of the Business Focus: Opening a Franchise. Give the students a few minutes to review the material and then distribute Activity Sheet 2-3: Advantages and Disadvantages of Different Forms of Business Organizations.

2. Tell students that there are only three rows because there are only three types of businesses—the proprietorship, partnership, and corporation. If they want a franchise, they will also choose from one of these alternatives.

3. Have students list as many criteria as they can think of in the columns across the top; groups may even suggest criteria that other groups did not think of, especially if they are working separately.

4. If groups do brainstorm different criteria, consider putting the PACED matrix on the board

with enough columns to accommodate everyone's criteria. (Stated in Student Objectives)

Some sample responses are shown below, note that degrees of difficulty are shown with double plusses and minuses.

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**Teacher’s Suggested Answer Key for Activity Sheet 2-3**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  **CRITERIA****ALTERNATIVES** |  **1.****Cost & Ease****Of Startup** |  **2.****Owner’s** **Liability** |  **3.****Ability to****Raise****Capital** | **4.****Ease of****Transferring****Ownership** |  **5.****Ability to****Grow** |
| **Sole****Proprietorship** |  **+****Very Easy****Little Cost****Just Do It** | **-****100% Liable for own actions** | **-****Most difficult; have to rely on savings, friends, etc.** | **-****Difficult, have to sell the entire business** | **-****Difficult, one owner can only do so much** |
| **Partnership** | **+****Still easy, but need partnership agreement** | **-****100% liable for own action and actions of partner** | **-****A little easier, can take in new partner who contributes** | **-****A little easier, can sell one partner’s ownership** | **+/-****Easier with several owners** |
| **Corporation** | **-****Most difficult, need attorney to set up corporation, issue stock** | **+ +****Corporation is liable for own actions, stockholder can only lose stock** | **+ +****Easiest of all, just sell stock to raise financial capital** | **+****Very easy, just sell stock to transfer ownership** | **+ +****Easiest of all, just hire more workers** |

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**Business Focus: Proprietorships and Partnerships**

The **sole proprietorship**, or **proprietorship**, is the easiest business to open, own, and operate. About all a person has to do is to announce that he or she wants to go into business and then simply do it! The business can be as simple as a lemonade stand in the front yard or as complex as the owner wants to make it. Of course, the owner must be sure to follow local laws and regulations, so the owner must check to see that all permits and licenses are obtained, and that taxes are paid on time.

Proprietorships tend to be very small because the owner, or proprietor, usually runs most aspects of the business operation. For example, the owner of a small business is usually the one that opens the business in the morning and closes up at night. If the business is open on weekends, the proprietor usually works then also. Because of this, most small business owners work long hours, and they usually get to do everything from counting the money to taking out the trash.

Because they are so easy to start and operate, proprietorships are more numerous than either partnerships or corporation. In addition, because the owners do so much of the works themselves, proprietorships tend to be relatively more profitable than partnerships and corporations. A sole proprietor can even hire other employees to help the business so that it can grow. However, this usually means more responsibility for the owner, including managing the employees and making sure that their state, local, and federal taxes along with social security and workman’s compensation (a type of state unemployment tax) are paid.

Proprietorships also have their drawbacks. Because they tend to be small, they often have difficulty raising financial capital. Therefore, most proprietors rely on their savings or borrow from family and friends. Perhaps the biggest drawback of a proprietorship is **unlimited liability**, which means that the owner is fully and totally responsible for the obligations of the business. For example, if a customer sues a proprietor, the proprietor could lose the business, along with his or her car, summer vacation home and other personal property not even related to the business.

Sometimes a business is organized as a **partnership**, an unincorporated business jointly owned by two or more people. This might happen various ways. A proprietor might want to expand a business, but might not be able to secure a loan from a bank. Often the solution is to “join forces” with another person and take in a co-owner who is willing to provide additional financial backing for the business. Alternatively, two or three people might want to start a new business, with the expectation that everyone will bring a unique set of talents and financial contributions to the operation.

When two or more owners are involved, the owners usually have a lawyer file a **partnership agreement** which specifies contributions and responsibilities of each owner, as well as the way in which the profits (or losses) are to be divided. Each partner, like the proprietorship, has unlimited liability, meaning that each partner is fully responsible for the debts and losses of the other owners – so it pays to choose partners carefully.

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**Business Focus: Incorporating a Business**

A **corporation** is a business that operates independent of its owners – a separate entity. An entrepreneur may start a business as one type of business organization and later **incorporate,** or take the legal steps necessary to become a corporation. There are several advantages to the corporate form. First, more money can be raised from many stockholders as opposed to one person. Second, its owners have **limited liability**, meaning that the corporation is fully liable for its debts and stockholders are only liable for the amount they have invested in the company. Unlike the proprietorship and partnership, the stockholder can only lose the value of their stock and not their personal assets if the company goes bankrupt.

In order to incorporate, the entrepreneur must hire an attorney who will file **articles of** **incorporation** with the state or a **certificate of authority** if the headquarters are outside the state. In Kentucky, the attorney will contact the Secretary of State in Frankfort to complete the process. As soon as the business is incorporated certificates of ownership called **stock** or **common stock** are issued to the owners. These shares are proof of ownership and can be transferred or sold to others.

Initially, the founding entrepreneur may own all shares of stock in the corporation, or shares may be given to family members or even employees in the business. Later, the owners may want to “go public” and sell shares of stock to the general public to raise additional financial capital. The very first time the stock is sold to the public is known as an **initial public offering** **(IPO)**. As the corporation grows, these same common shares may be bought and sold on a nationally recognized stock exchange like the New York Stock Exchange or on the Over-the-Counter Market.

Regardless of the type of business organization, the entrepreneur must contact one of the U.S. Internal Revenue Service district offices to obtain an employer identification number. Employers must also contact the Kentucky Department for Employment Services to set up a state unemployment insurance account. State licenses and permits may be obtained from the Business Information Clearinghouse in Frankfort. The entrepreneur must always file a Kentucky Tax Registration Application with the Kentucky Revenue Cabinet.

All businesses-whether they are proprietorship, partnerships, corporations- must comply with varying degrees of regulation. For example, all businesses must comply with local planning and zoning boards, acquire the proper licenses and permits to operate, and pay taxes, social security and workmen’s compensation to the proper authorities. Corporations, however, have an additional burden. Because they are recognized as separate legal entities, they must keep certain accounting records and pay corporate income taxes to both state and federal governments.

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**Business Focus: Opening a Franchise**

A **franchise** is a grant or right to sell a company’s product in a specified region. Franchising occurs when the entrepreneur of an established business grants the right to sell its already-known product or service. This right comes at a cost to the **franchisee**, the owner of the franchise, but the chance of success is generally high because both the franchisee and the company selling the franchise have an interest in seeing the business succeed. Examples include McDonalds, Taco Bell, Papa John’s Pizza, Dillard’s, Pier 1 Imports, Radio Shack and others. Entrepreneur Magazine provides a listing of various franchises available for sale and costs for different regions of the country.

Some entrepreneurs like Kentucky Fried Chicken’s Harland Sanders got into franchising to save his business. The Colonel already had a successful restaurant in Corbin, Kentucky, where he sold fried chicken using his secret recipe of 11 herbs and spices. However, his business nearly failed when a new highway routed traffic away from his location. Rather than close down, Colonel Sanders decided to franchise his business and the rest is history. Today, Kentucky Fried Chicken’s Worldwide Headquarters is open for tours in Louisville, Kentucky, and tourists can visit the Colonel’s restored restaurant and museum in Corbin where it all began.

**A franchise may operate as a sole proprietorship, a partnership, or a corporation**. The owner of a franchise can still be considered an entrepreneur although he or she is selling another company’s product or service. The entrepreneur is still responsible for the startup costs and daily operation of the franchise. The startup costs are usually high, and the franchisee will often have to pay an annual fee to the company in addition to a percentage of total annual sales.

While the initial startup cost and annual fees may appear to be a burden, the entrepreneur benefits because he/she has obtained the right to use the parent company’s name and sell a high-profile product. This enhances the chance of success because the entrepreneur gets to sell a product that, like Kentucky Fried Chicken, has national recognition and is of uniform quality regardless of where it is sold.

Finally, the parent company that issues the franchise also has an interest in seeing the franchisee succeed. Therefore, the parent company often provides expertise concerning location, training, advertising, and other matters that will help increase the chance of a successful operation. One result of these efforts is that the rate of failure among franchises is generally much lower than that of other types of businesses.

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**Activity Sheet 2-1**

**Classifying Businesses According to Form of Organization**

**Directions**: Read and discuss the information on business organization. Discuss the businesses you and your classmates would like to operate. Discuss how you would classify each business. List these businesses under the correct classification.

**The three main types of business organization are:**

 **Proprietorship**: business that is owned and operated by one person

 **Partnership**: business that is owned and operated by two or more people

**Corporation:** business operated as a separate legal entity (operates independent of its owners)

**Proprietorship Partnership Corporation**

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**Activity Sheet 2-2**

**Partnership Agreement**

**I. Company Name: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

 **Address \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

 **Good or service for sale \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**II. Name and address of each partner:**

 **Partner Name Street Address City/State/Zip**

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**III. Money Contributed by Each Partner:**

 **Partner Name Amount of Money Contributed % of Total**

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**TOTAL CONTRIBUTIONS $\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 100%**

**(**Divide amount contributed by total contributions)

**IV. Duties and Responsibilities of Each Partner:**

**Partner Name Duties and responsibilities**

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**V. Distribution of Profit and/or Losses (based on percentage of initial investment)**

**Partner Name Percentage of Profit (or Loss)**

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**Signed By and Agreed To By the Following:**

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Partner #1 Partner #2 Partner #3

**\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Date signed

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**Activity Sheet 2-3**

**Advantages and Disadvantages of Different Forms of Business Organizations**

Directions: Read the two sheets, Business Focus: Incorporation a Business and Business Focus: Proprietorships and Partnerships. Then use the PACED Decision Making Model below to contrast the advantages and disadvantages of the three forms of business organizations. In the space below the model, identify the form of business organization you would use for your business, and explain why you made that choice.

Step 1: State the **Problem** \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Step 2: List the **Alternatives** in the first column.

Step 3: List the **Criteria** in the first row.

Step 4: **Evaluate** each alternative by placing an “+” or “-“ in the box below each

criteria.

Step 5: Make your **Decision:** \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

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|  **CRITERIA****ALTERNATIVES** |  |  |  |  |  |
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