

SAMPLE MATERIALS

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LESSON **17** HOW FINANCIAL INSTITUTIONS
HELP BUSINESSES GROW
HIGH SCHOOL

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Lesson Description

The students read two case studies about the financing of businesses, contrasting modern approaches with approaches from the 1870s. Using transparencies, the students discuss the advantages of the corporate form of business organization over sole proprietorships and partnerships, while also discussing modern financial institutions that help American business firms grow.

Business firms often need to borrow money to cover short-term expenses and to expand. Several financial institutions have evolved to help businesses borrow money. Corporations, which have limited liability, have created incentives that encourage investors to provide financing for business growth.

Concepts

- Bond
- Corporation
- Federal Reserve System
- Investment bank
- Limited liability
- Partnership
- Sole proprietorship
- Stock
- Venture capital

Objectives

Students will:

1. Recognize the importance of financing to business firms.
2. Evaluate the advantages of the corporate form of business organization over sole proprietorships and partnerships.
3. List several financial institutions that can help business firms grow.

Time Required

45 minutes

Materials

- A transparency of Visuals 1, 2, 3 and 4
- A copy of Activities 1 and 2 for each student

Procedure

1. Tell the students that businesses often need money. New businesses need money to start up, and established businesses need money to cover short-term expenses, expand into new markets or introduce new products. In response to these needs, a system of financial markets and institutions has evolved in the United States. These financial markets and institutions have supported business growth and played a leading role in making the U.S. economy one of the most successful in the world.

2. Ask the students to speculate about how they would raise money to start a small business — a lawn-care and landscaping firm, for example, or a specialty clothing store.

Answers might include financing it out of savings, borrowing money or finding a partner who has money to invest.

3. Write two terms on the board: *Sole Proprietorship* and *Partnership*. Tell the students that most businesses in the United States today are sole proprietorships (in which one person owns a business) or partnerships (owned by two or more persons). Ask the students to speculate about why sole proprietorships and partnerships are attractive to many people who start up businesses. After some discussion of their responses, **display Visual 1**; reveal only the top half of the *Sole proprietorship* section, to identify advantages. Discuss the list of advantages and compare them with the students' earlier speculations. Then reveal the top half of the *Partnership* section, to identify advantages; also discuss this list briefly.

4. Tell the students that sole proprietorships and partnerships also have disadvantages. **Display Visual 1 again** — this time revealing the lists of disadvantages. Discuss the disadvantages briefly.

5. To illustrate the importance of these disadvantages, **distribute copies of Activity 1**. Tell the students to read the case study and identify the problems that caused Henry Heinz's first business to fail in 1875.

6. After the students have read Activity 1, discuss their responses to the Questions for Discussion. **Ask:**

- A. Why do you think that Heinz, Noble & Company failed?

Most likely the company failed because of the difficulty it faced in obtaining credit.

B. Would some of the problems that the partners faced be easier to overcome today than they were in 1875?

Businesses today have more ways to obtain credit. Point out that businesses today also have different forms of organization that allow them to raise more money when they need it.

7. **Display Visual 2** to reinforce the points made in Activity 1:

- Heinz's product sold well, both before and after the bankruptcy. Heinz's problems were not caused by falling sales; they were caused by short-term expenses that he probably could have handled if it had not been so difficult to borrow money at that time.
- Once Heinz had processed the unusually large harvest of cucumbers and cabbages, he would have been able to sell the products over a period of time and raise enough revenue to pay off short-term loans.
- Some students may say that Heinz should not have expanded so rapidly. Suggest to them that the most successful businesses owners or managers are often those who take risks in order to become more profitable.
- Be sure to note the personal problems that Heinz faced because of the bankruptcy. Tell the students that sole proprietors and partners are personally liable for the debts of their businesses, and that their personal assets, such as homes and savings, can be used to pay their creditors.

8. Tell the students that, in Heinz's day, even quite large businesses were operated as single proprietorships or partnerships. The H. J. Heinz Company, for example, did not become a corporation until 1905. But the corporation is a form of business organization that has many advantages over the single proprietorship or partnership, especially when it comes to raising money. Explain that a business becomes a corporation by submitting a charter to a state government. Some corporations are privately owned, or closely held; in such corporations, all the shares are owned by a small number of individuals, often family members or the managers of the company. Publicly owned corporations, on the other hand, are owned by a relatively large number of shareholders, most of whom have no connection with the company beyond the desire to make a profitable investment from owning shares of it.

9. **Display and discuss Visual 3**, emphasizing these points:

- When a single proprietor dies or decides to stop doing business, the business dies, too. In a partnership if one partner decides to leave a firm, the other partner(s) must

buy him or her out. But a corporation is said to have unlimited life. Any individual shareholder can sell out his or her shares easily, but the corporation continues to do business just as before.

- Single proprietors and partners have unlimited liability for the debts of their business. All their personal assets can be seized and sold to pay the creditors of the business. However, the liability of the shareholders in a corporation is limited to the amount of their investments. If a corporation goes bankrupt, shareholders may lose the amount of money they spent to purchase their shares, but they are not responsible for the debts of the firm.
- These characteristics of the corporate form of business organization reduce the risk faced by investors, thus making it easier for corporate firms to raise money. In most cases, the only individuals willing to invest in a sole proprietorship or partnership are local people who know the owner(s) of the firm and are able to observe its day-to-day operations.

10. **Distribute copies of Activity 2** and ask the students to read it. When they have finished their reading, ask them to compare and contrast the experiences of Henry Heinz and Michael Dell in building their businesses.

Both offered products that consumers wanted, and both businesses grew rapidly. However, because his business was incorporated, Dell did not risk the personal losses that Heinz suffered, and Dell was able to obtain financing more easily as his business expanded.

11. Discuss the students' responses to the question posed at the end of Activity 2. **Ask:**

How did modern financial markets make it possible for Dell to grow as rapidly as it did?

Students might mention stock markets or bond markets as examples of modern financial institutions. In response, tell the students that stock and bond markets did exist in Heinz's time, but Heinz couldn't access them. Other important institutions unavailable to Heinz include venture capital firms and investment banks.

12. **Display Visual 4.** Tell the students that although some large businesses were organized as corporations in Heinz's time, few businesses other than railroads used that type of organization. Even the great steel industrialist Andrew Carnegie ran his business as a partnership. In contrast, Michael Dell found it easy and inexpensive to incorporate in 1983.

13. Tell the students that bond markets and stock markets are often called anonymous or impersonal markets because

they make it easy for individuals and institutions to invest money in businesses with which they have no personal familiarity. In Heinz's time, most investors limited themselves to government bonds or railroad bonds. Until the 1920s, few people except those closely involved with a particular corporation, such as managers or members of a closely held family firm, owned any corporate shares. Over the years, both stock and bond markets have grown much larger as regulations have been developed to give potential investors better information about the safety and profitability of individual companies. More uniform accounting practices and the rise of private rating services to evaluate risks have also encouraged more investors to enter stock and bond markets. Impersonal markets make it much easier for growing businesses like Dell Computer to raise the financial capital they need to support their expansion.

Investment banks like the one Michael Dell used to sell company stock appeared only at the end of the nineteenth century. Venture capital firms, which raise money for start-up companies, are a more recent innovation.

14. Remind the students of the problems Henry Heinz faced in getting bank loans during the depression that followed the Panic of 1873. In the nineteenth century, banks did not have the protection of belonging to the Federal Reserve System, which began operating in 1914. Banks today are less reluctant to lend in bad economic times because they are able to draw on Federal Reserve funds to support their loans.

Closure

Ask the students to identify the businesses that would probably use each of the following methods of financing.

- Which businesses would tend to use personal funds or borrowing from friends and relatives?
New businesses, sole proprietorships and partnerships.
- Which businesses would tend to use funds raised by a venture capital firm?
Businesses that are growing but not yet well known.
- Which businesses would tend to use bank loans?
Any business, depending on the size of the loan and the creditworthiness of the borrower.
- Which businesses would tend to use stock or bond issues?
Businesses that are incorporated and (in the case of issues that are publicly marketed) fairly large and well known.

Assessment

Multiple-Choice Questions

1. Which form of business organization protects investors from losing their personal assets if the business fails?
 - a. A partnership
 - b. A corporation*
 - c. An investment bank
 - d. A sole proprietorship
2. Venture capital firms raise money for
 - a. established family businesses.
 - b. large, well-known corporations.
 - c. state and local governments.
 - d. new and growing businesses.*
3. Which kind of business firm is able to raise money in impersonal markets, like the stock market and the bond market?
 - a. A partnership
 - b. A corporation*
 - c. A sole proprietorship
 - d. All of the above
4. Which financial institution assists business firms in raising money by helping them to plan and sell new issues of stocks and bonds?
 - a. The Federal Reserve System
 - b. Venture capital firms
 - c. Investment banks*
 - d. The World Trade Organization

Essay Questions

1. What advantages does a corporate form of business organization have over sole proprietorships and partnerships?
Students should discuss transferability of shares, unlimited life, limited liability and the ability to issue stocks and bonds that can be sold in impersonal markets.
2. Why do new businesses use the services of venture capital firms rather than issuing stocks and bonds?
Buyers of stocks and bonds may not be willing to take the risk of investing in firms that are not well-known and have not yet established a record of success.



LESSON 17 VISUAL 1

ADVANTAGES AND DISADVANTAGES OF SOLE PROPRIETORSHIPS AND PARTNERSHIPS

<p><i>Sole proprietorship:</i> A business owned and managed by one individual. The owner receives all the profits and bears all the losses.</p>	<p><i>Advantages</i></p> <ul style="list-style-type: none"> • Ease of starting and going out of business • Control over profits and business operations • Pride of ownership • Lower taxes (no corporate income taxes)
	<p><i>Disadvantages</i></p> <ul style="list-style-type: none"> • Unlimited liability • Difficulty in raising financial capital • Responsibility for all losses • Management knowledge may be limited
<p><i>Partnership:</i> A business owned and managed by two or more individuals. The owners receive all the profits and bear all the losses.</p>	<p><i>Advantages</i></p> <ul style="list-style-type: none"> • Easier to raise financial capital • Partners may combine skills • Pride of ownership • Lower taxes (no corporate income taxes)
	<p><i>Disadvantages</i></p> <ul style="list-style-type: none"> • Shared profits • Possible conflicts between partners • Possible instability after death of a partner • Unlimited liability



LESSON 17 VISUAL 2

HENRY HEINZ IN A PICKLE

- Heinz's product sold well, both before and after the bankruptcy. Heinz's problems were not caused by falling sales; they were caused by short-term expenses.
- If Heinz had been able to borrow money at that time, he probably could have handled his short-term expenses.
- Most successful business owners take risks in order to become more profitable.
- Sole proprietors and partners are personally liable for the debts of their businesses.



LESSON 17 VISUAL 3

ADVANTAGES OF A CORPORATION

- Transferability of shares and unlimited life
- Limited liability
- Ability to issue stocks and bonds



LESSON 17 VISUAL 4

MODERN FINANCIAL INSTITUTIONS IN THE UNITED STATES

- Corporations
- Bond markets
- Stock markets
- Investment banks
- Venture capital firms
- The Federal Reserve System



LESSON 17 ACTIVITY 1

HENRY HEINZ IN A PICKLE

Today the catsup, pickles, vinegar and many other food products sold by the H. J. Heinz Company are known all over the world. But success didn't come easily for the company's founder, Henry J. Heinz.

In 1869, Henry Heinz, a young businessman from the Pittsburgh area, went into partnership with L.C. Noble to process and bottle horseradish, pickles, vinegar and similar food products. The business prospered because of the high quality of its products, and soon the partners were establishing sales offices, warehouses and factories as far away as St. Louis and Chicago. But Heinz, Noble & Company expanded quickly at a time when the country was experiencing a serious depression. Businesses normally borrow money to buy supplies and meet other short-term costs of production, paying back loans out of the money made from selling the goods they produce. But by 1875, banks were reluctant to lend because of depression conditions. Heinz pledged his father's house and brickyard in order to get funds to pay his short-term expenses.

The final blow came after Heinz signed a contract to purchase all the cucumbers and cabbages produced by a major Illinois supplier. An unexpectedly large harvest in 1873 drove up the company's costs of purchasing. Even though sales of company products continued to be strong, the partnership was unable to pay its daily expenses.

As rumors of the partnership's difficulties spread, several local creditors filed fraud charges (later dismissed) against Heinz, the only partner living in Pittsburgh. Heinz was arrested. Shortly after his release, the partnership declared bankruptcy. The firm's equipment was sold to pay creditors, as was Heinz's father's home. By the end of the year, Henry Heinz was begging local grocers for credit so that he could put food on the family's table.

In early 1876, Heinz persuaded his brother John and cousin Frederick to finance a new food processing business, F. & J. Heinz Company. Under the terms of the bankruptcy law, Henry could not be a partner until his debts were discharged, but he managed the firm as a salaried employee. F. & J. Heinz bought back much of the equipment that had been sold by the bankrupt Heinz and Noble firm. The new company soon began to prosper, and Henry was able to repay his debts and become a partner in the firm.

QUESTIONS FOR DISCUSSION

- A. Henry Heinz's original company supplied high quality products that people wanted and were willing to pay for, and yet the firm went bankrupt. Why do you think that Heinz, Noble & Company failed?

- B. Would some of the problems that the partners faced be easier to overcome today than they were in 1875?



LESSON 17 ACTIVITY 2

MICHAEL DELL BUILDS A BUSINESS

In 1983, 18-year-old Michael Dell began operating a computer business in his college dorm room at the University of Texas in Austin. Today Dell Computer Corporation is one of the largest computer manufacturers and distributors in the world. Michael was a smart and determined young man, but he also had help from the U.S. financial markets as he moved from dorm room to corporate boardroom.

Michael Dell saw a business opportunity in selling computers and components directly to customers, rather than going through retail distributors. He began by buying components and assembling them to customer specifications, and soon he had sales between \$50,000 and \$80,000 a month. In May 1984, after finishing his freshman year, he incorporated his business in Texas with an initial capitalization of \$1,000.

In the first years of the business, the company's growth was financed by company earnings and loans from Dell's family. During that time, the firm began to design and produce its own computers, but it continued to sell its products directly to business firms, government agencies and individuals. Dell Computer Corporation's rapid expansion soon required more financial capital than the business could generate. Dell hired Lee Walker, an Austin venture capitalist, as the president and chief executive officer of Dell Computer Corporation. A venture capital firm raises money for new businesses that are not yet large or well known enough to issue successful stock or bond offerings. Walker immediately established a line of credit for the firm at Texas Commerce Bank.

Dell Corporation continued to grow, entering the British market in 1987. In the fall of 1987, Goldman Sachs, a large investment bank, worked with Dell on a private stock placement. An investment bank is an organization that helps businesses design offerings of stocks or bonds and arranges for the sale of the securities to investors. In a private placement, stocks are made available to a small group of investors. Dell Corporation raised \$21 million through this stock issue in October 1987. The following June, Dell "went public"—that is, again working with an investment bank, it sold a new issue of stock to the public for \$30 million. The total market value of the corporation was estimated at about \$85 million.

By the year 2000, only 17 years after Michael Dell began assembling computer components in his dorm room, Dell Computer Corporation had annual sales of more than \$25 billion. The company operated not only in the United States but also in Europe, Canada and Latin America.

QUESTION FOR DISCUSSION

How did modern financial markets make it possible for Dell to grow as rapidly as it did?