CHARTA LEARNING · LESSON NOTES

# Business forms, ownership and business models

CFA Level I · Corporate Issuers

**You will learn:** What each legal form means for liability, tax and control, how public and private companies differ, what a business model is, and how the usual kinds of model earn and price.

**Running example:** Examples use made-up figures, mostly Ana's bakery (closing with debts of $400,000), plus a $200,000 profit taxed under different forms and a gadget sold at $25.

## 1. Legal forms and liability

- The legal form decides three things: who is liable if the business fails, how profits are taxed, and who decides.
- Sole proprietorship: one owner, no legal line between person and business, unlimited personal liability. General partnership: two or more people under an agreement; each partner can be held responsible for all the debts, even those another partner made.
- Limited partnership: general partners run it and keep unlimited liability; limited partners only invest and can lose only what they put in.
- Corporation: a legal person of its own that can own property, sign contracts and be sued; shareholders have limited liability and lose at most what they paid in. A limited liability company is a hybrid whose rules vary by country.
- On the liability line from unlimited to limited: sole proprietorship, general partnership, limited partnership (the general partner stays left), corporation.

DEBTS $400,000, ASSETS SOLD FOR $150,000: SHORTFALL $250,000

| | | |
|---|---|---|
| **Sole proprietorship** | the owner pays all | **$250,000** |
| **General partnership** | each can be pursued for all | **up to $250,000** |
| **Limited partnership: general partner** | | **$250,000** |
| **Limited partner or shareholder** | nothing beyond stake | **$0** |

**Watch out:** Saying all partners are protected: only limited partners are.

## 2. Tax and control

- Sole proprietorships and partnerships are usually pass-through: the business pays no income tax itself and profit is added to the owners' income, taxed once.
- A corporation pays tax on its own profit, and shareholders pay tax again on dividends: double taxation. Profit it keeps has been taxed once and the second layer waits. State it as typical, not universal; rules differ by country.
- Control: a sole proprietor decides alone, partners decide together. In a corporation shareholders elect a board, which appoints managers. Separating ownership from control allows raising money from thousands of people, perpetual existence and freely sold shares, but creates agency costs when managers act in their own interest.

**Cash to shareholder = profit × (1 − corporate tax) × (1 − dividend tax)**

MADE-UP RATES: OWNER 30%, CORPORATION 25%, DIVIDEND 20%

| | | |
|---|---|---|
| **Profit before tax** | | **$200,000** |
| **Sole proprietor keeps** | 200,000 × (1 − 0.30) | **$140,000** |
| **Corporation after its tax** | 200,000 × (1 − 0.25) | **$150,000** |
| **Shareholder keeps** | 150,000 × (1 − 0.20) | **$120,000** |
| **Combined tax on the profit** | 80,000 ÷ 200,000 | **40%** |

**Watch out:** Saying corporations are always taxed twice.

## 3. Public and private companies

- Public: shares trade in a public market. Private: no public market for the shares. This is not about size: a giant can be private and a tiny firm public.
- Typically public vs private: disclosure heavy vs light; liquidity high vs low; cost of capital lower vs higher; control spread among many vs held close.
- Going public: an initial public offering (IPO, banks sell new shares and raise cash), a direct listing (existing shares start trading, no new money, no underwriting fee), or a merger with a special purpose acquisition company (SPAC, a listed shell that raised cash to buy a business).
- Going private: a leveraged buyout, often by a private equity firm using borrowed money, then delisting.
- Public gives deep capital, liquid shares and a visible price, at the cost of disclosure, rules and short-term pressure. Private gives confidentiality and a long-term focus, at the cost of illiquid shares and harder fundraising. Neither is better.

**LIQUIDITY CHANGES VALUE; THE CASH COST OF AN IPO**

| | | |
|---|---|---|
| **Value if public, $1m a year at 8%** | 1,000,000 ÷ 0.08 | **$12.5 million** |
| **Value if private, required return 8% + 3%** | 1,000,000 ÷ 0.11 | **$9.09 million** |
| **IPO: 10 million shares at $20** | gross proceeds | **$200 million** |
| **Underwriters' fee 7%; legal, audit, listing** | 7% × 200; one-off | **$14 million; $3 million** |
| **Net cash; total cost of raising** | 200 − 14 − 3; 17 ÷ 200 | **$183 million; 8.5%** |

**Watch out:** Mixing up public with big; saying public is always better.

## 4. What a business model is

- A business model is the plan for how a company creates value for customers and turns it into profit. Two companies in the same industry can have accounts that look nothing alike.
- The parts: value proposition (why customers choose you); customers (the specific group served); channels (routes of sale and delivery, which decide who captures margin); revenue streams (how and when customers pay).
- Key resources (assets and skills needed: a brand, a patent, stores, data, people) and cost structure (the main costs, especially fixed versus variable). Revenue less cost is profit.
- Read the model before the ratios: it sets what a normal ratio looks like, so the same ratio can be strong in one model and weak in another. The trap is comparing companies on numbers alone.

**SAME BAG, TWO MODELS: DIRECT AT $80 (PRODUCTION $30, SELLING $20) OR VIA DISTRIBUTOR AT $50 (PRODUCTION $30, SELLING $3)**

| | | |
|---|---|---|
| **Direct: gross margin** | (80 − 30) ÷ 80 | **62.5%** |
| **Distributor: gross margin** | (50 − 30) ÷ 50 | **40.0%** |
| **Direct: operating profit** | $30 per bag × 50,000 | **$1.50 million** |
| **Distributor: operating profit** | $17 per bag × 100,000 | **$1.70 million** |

## 5. Kinds of business model

- Each model answers: who pays, how much and when. Product sales: price per item, once. Razor and blade: sell the main item cheaply to win a stream of consumables.
- Subscription: regular fee for continued access, so revenue recurs and is more predictable, and lenders often lend more against it. Do not judge it by year one.
- Platform: connects buyers and sellers and keeps a take rate. Gross merchandise value (GMV) is what buyers paid, most of which belongs to sellers, so GMV is not revenue.
- A platform reports only its commission (as an agent); a retailer reports the full sale (as a principal), so compare revenue across them with care.
- Advertising: users get the service free and advertisers pay to reach them. Freemium: a free version attracts users and some upgrade, so user counts say little. Franchise: the brand owner sells its brand and system for an upfront fee and a share of sales; the franchisee supplies the capital.

> **Platform revenue = gross merchandise value × take rate**

REVENUE UNDER DIFFERENT MODELS

| | | |
|---|---|---|
| **Subscription, 1,000 customers at $10 a month** | after year 1 / 3 / 5 | **$120k / $360k / $600k** |
| **One-off licence at $360** | all in year 1 | **$360k** |
| **Platform: GMV $800m, take rate 10%** | 10% × 800 | **$80 million** |
| **Retailer selling the same goods** | revenue $800m; gross profit 800 − 600 | **$800 million; $200 million** |
| **Advertising: 10 million users × $6** | | **$60 million** |
| **Freemium: 1m users, 5% pay $8 a month** | 1,000,000 × 5% × 8 × 12 | **$4.8 million a year** |
| **Franchise: 40 outlets × $600,000 × 5% royalty** | | **$1.2 million** |

## 6. Pricing and unit economics

- Cost-plus starts with the cost and adds a mark-up (a 25% mark-up on cost is only a 20% margin on price); it is the most exposed to a rival's price cut.
- Value-based starts from what the product is worth to the customer and is the most defensible. Dynamic pricing moves with demand, timing or stock. Freemium prices the base at zero and charges for upgrades.
- Fixed costs stay the same whatever you sell; variable costs rise with each unit. Price minus variable cost per unit is the contribution per unit.
- Break-even is where revenue equals total cost; to the left is a loss, to the right a profit, and past break-even every extra sale adds its whole contribution.

> **Break-even units = fixed costs ÷ (price − variable cost per unit)**

GADGET: PRICE $25, VARIABLE COST $10, FIXED COSTS $90,000 A YEAR

| | | |
|---|---|---|
| **Contribution per unit** | 25 − 10 | **$15** |
| **Break-even units** | 90,000 ÷ 15 | **6,000** |
| **Check** | revenue 150,000; cost 90,000 + 60,000 | **150,000 both** |
| **Profit at 8,000 units** | 8,000 × 15 − 90,000 | **$30,000** |
| **Cost-plus: cost $40, 25% mark-up** | 40 × 1.25 | **$50** |
| **Value-based: client saves $1,000 a year** | charge | **$200** |

## Key takeaways

- Sole proprietors and general partners have unlimited liability; limited partners and shareholders do not.
- A corporation is typically taxed twice (profit, then dividends); pass-through forms are taxed once.
- Public means liquid shares, cheaper capital and heavy disclosure; private means confidentiality, a long-term focus and illiquidity.
- Read the business model (value proposition, customers, channels, revenue, costs, key resources) before the ratios.
- Platform revenue = GMV × take rate; GMV is not revenue. Subscription revenue recurs.
- Break-even units = fixed costs ÷ contribution per unit.

## Quick check

1. A creditor is owed money by a general partnership. How much can it claim from one partner personally?
   **Answer:** Potentially all of it. Only limited partners are capped.
2. A platform sells $500 million of goods for sellers and keeps 12%. What is its revenue?
   **Answer:** $60 million. The rest belongs to the sellers.
3. Why can a subscription firm often borrow more than a one-off seller?
   **Answer:** Its revenue recurs, so cash flow is more predictable.

Summary notes for the Charta whiteboard lesson. Examples use made-up figures. Watch the full lesson at charta-learning.com.