



# learnkwniy

## **Chapter 2**

### **Forms of Business Organisation**

## **INTRODUCTION**

**If one is planning to start a business or is interested in expanding an existing one, an important decision relates to the choice of the form of organisation.**

**Various forms of business organisations from which one can choose the right one include:**

- (a) Sole proprietorship,**
- (b) Joint Hindu family business,**
- (c) Partnership,**
- (d) Cooperative societies, and**
- (e) Joint stock company.**

## **SOLE PROPRIETORSHIP**

**Sole proprietorship refers to a form of business organisation which is owned, managed and controlled by an individual who is the recipient of all profits and bearer of all risks. This is evident from the term itself. The word “sole” implies “only”, and “proprietor” refers to “owner”. Hence, a sole proprietor is the one who is the only owner of a business.**

### **Features**

**Salient characteristics of the sole proprietorship form of organisation are as follows:**

**(i) Formation and closure:** There is no separate law that governs sole proprietorship. Hardly any legal formalities are required to start a sole proprietary business. Closure of the business can also be done easily.

**(ii) Liability:** Sole proprietors have unlimited liability.

**(iii) Sole risk bearer and profit recipient:** The risk of failure of business is borne all alone by the sole proprietor. However, if the business is successful, the proprietor enjoys all the benefits.

**(iv) Control:** The right to run the business and make all decisions lies absolutely with the sole proprietor. He can carry out his plans without any interference from others.

**(v) No separate entity:** In the eyes of the law, no distinction is made between the sole trader and his business, as business does not have an identity separate from the owner. The owner is, therefore, held responsible for all the activities of the business.

**(vi) Lack of business continuity:** The sole proprietorship business is owned and controlled by one person, therefore death, insanity, imprisonment, physical ailment or bankruptcy of the sole proprietor will have a direct and detrimental effect on the business and may even cause closure of the business.

## **Merits**

**Sole proprietorship offers many advantages.**

**(i) Quick decision making:** A sole proprietor enjoys considerable degree of freedom in making business decisions. There is no need to consult others.

**(ii) Confidentiality of information:** Sole decision making authority enables the proprietor to keep all the information related to business operations confidential and maintain secrecy. A sole trader is also not bound by law to publish firm's accounts.

**(iii) Direct incentive:** A sole proprietor directly reaps the benefits of his/her efforts as he/she is the sole recipient of all the profit.

**(iv) Ease of formation and closure:** An important merit of sole proprietorship is the possibility of entering into business with minimal legal formalities. There is no separate law that governs sole proprietorship.

### **Limitations**

**(i) Limited resources:** Resources of a sole proprietor are limited to his/ her personal savings and borrowings from others.

**(ii) Limited life of a business concern:** The sole proprietorship business is owned and controlled by one person, so death, insanity, imprisonment, physical ailment or bankruptcy of a proprietor affects the business and can lead to its closure.

**(iii) Unlimited liability:** A major disadvantage of sole proprietorship is that the owner has unlimited liability. If the business fails, the creditors can recover their dues not merely from the business assets, but also from the personal assets of the proprietor.

## **JOINT HINDU FAMILY BUSINESS**

**Joint Hindu family business is a specific form of business organisation found only in India. It refers to a form of organisation wherein the business is owned and carried on by the members of the Hindu Undivided Family (HUF). It is governed by the Hindu Law.**

**The business is controlled by the head of the family who is the eldest member and is called karta. All members have equal ownership right over the property of an ancestor and they are known as co-parceners.**

### **Features**

**(i) Formation:** For a joint Hindu family business, there should be atleast two members in the family and ancestral property to be inherited by them. It is governed by the Hindu Succession Act, 1956.

**(ii) Liability:** The liability of all members except the karta is limited to their share of co-parcenary property of the business. The karta, however, has unlimited liability.

**(iii) Control:** The control of the family business lies with the karta. He takes all the decisions and is authorised to manage the business. His decisions are binding on the other members.

**(iv) Continuity:** The business continues even after the death of the karta as the next eldest member takes up the position of karta, leaving the business stable.

**(v) Minor Members:** The inclusion of an individual into the business occurs due to birth in a Hindu Undivided Family. Hence, minors can also be members of the business.

### **Merits**

**(i) Effective control:** The karta has absolute decision making power.

**(ii) Continued business existence:** The death of the karta will not affect the business as the next eldest member will then take up the position.

**(iii) Limited liability of members:** The liability of all the coparceners except the karta is limited to their share in the business, and consequently their risk is well-defined and precise.

**(iv) Increased loyalty and cooperation:** Since the business is run by the members of a family, there is a greater sense of loyalty towards one other.

### **Limitation**

**(i) Limited resources:** The joint Hindu family business faces the problem of limited capital as it depends mainly on ancestral property.

**(ii) Unlimited liability of karta:** The karta suffers from the disadvantage of having unlimited liability. His personal property can be used to repay business debts.

**(iii) Dominance of karta:** The karta individually manages the business which may at times not be acceptable to other members.

**(iv) Limited managerial skills:** Since the karta cannot be an expert in all areas of management, the business may suffer as a result of his unwise decisions.

## **PARTNERSHIP**

The Indian Partnership Act, 1932 defines partnership as “the relation between persons who have agreed to share the profit of the business carried on by all or any one of them acting for all.”

### **Features**

**(i) Formation:** The partnership form of business organisation is governed by the Indian Partnership Act, 1932.

**(ii) Liability:** The partners of a firm have unlimited liability. Personal assets may be used for repaying debts in case the business assets are insufficient.

**(iii) Risk bearing:** The partners bear the risks involved in running a business as a team. The reward comes in the form of profits which are shared by the partners in an agreed ratio. However, they also share losses in the same ratio in the event of the firm incurring losses.

**(iv) Decision making and control:** Decisions are generally taken with mutual consent.

**(v) Continuity:** Partnership is characterised by lack of continuity of business since the death, retirement, insolvency or insanity of any partner can bring an end to the business.

**(vi) Number of Partners:** The minimum number of partners needed to start a partnership firm is two. According to section 464 of the Companies Act 2013, maximum number of partners in a partnership firm can be 100, subject to the number prescribed by the government. As per Rule 10 of The Companies (miscellaneous) Rules 2014, at present the maximum number of members can be 50.

### **Merits**

**(i) Ease of formation and closure:** There is no compulsion with respect to registration of the firm. Closure of the firm too is an easy task.

**(ii) Balanced decision making:** The partners can oversee different functions according to their areas of expertise. As a consequence, decisions are likely to be more balanced.

**(iii) More funds:** In a partnership, the capital is contributed by a number of partners. This makes it possible to raise larger amount of funds as compared to a sole proprietor and undertake additional operations when needed.

**(iv) Sharing of risks:** The risks involved in running a partnership firm are shared by all the partners.



**(v) Secrecy:** A partnership firm is not legally required to publish its accounts and submit its reports.

### **Limitations**

**(i) Unlimited liability:** Partners are liable to repay debts even from their personal resources in case the business assets are not sufficient to meet its debts.

**(ii) Limited resources:** There is a restriction on the number of partners, and hence contribution in terms of capital investment is usually not sufficient to support large scale business operations.

**(iii) Possibility of conflicts:** Partnership is run by a group of persons wherein decision making authority is shared. Difference in opinion on some issues may lead to disputes between partners.

**(iv) Lack of continuity:** Partnership comes to an end with the death, retirement, insolvency or lunacy of any partner. It may result in lack of continuity.

**(v) Lack of public confidence:** A partnership firm is not legally required to publish its financial reports or make other related information public. As a result, the confidence of the public in partnership firms is generally low.

### **TYPES OF PARTNERS**

A partnership firm can have different types of partners with different roles and liabilities.

**(i) Active partner:** An active partner is one who contributes capital, participates in the management of the firm, shares its profits and losses, and is liable to an unlimited extent to the creditors of the firm.

**(ii) Sleeping or dormant partner:** Partners who do not take part in the day to day activities of the business are called sleeping partners. A sleeping partner, however, contributes capital to the firm, shares its profits and losses, and has unlimited liability.

**(iii) Secret partner:** A secret partner is one whose association with the firm is unknown to the general public. He contributes to the capital of the firm, takes part in the management, shares its profits and losses, and has unlimited liability towards the creditors.

**(iv) Nominal partner:** A nominal partner is one who allows the use of his/her name by a firm, but does not contribute to its capital. He/she does not take active part in managing the firm, does not share its profit or losses but is liable, like other partners, to the third parties, for the repayments of the firm's debts.

**(v) Partner by estoppel:** A person is considered a partner by estoppel if, through his/her own initiative, conduct or behaviour, he/she gives an impression to others that he/ she is a partner of the firm.

**(vi) Partner by holding out:** A partner by 'holding out' is a person who though is not a partner in a firm but knowingly allows himself/herself to be represented as a partner in a firm.

## **TYPES OF PARTNERSHIPS**

Partnerships can be classified on the basis of two factors, viz., duration and liability. On the basis of duration, there can be two types of partnerships: 'partnership at will' and 'particular partnership'. On the basis of liability, the two types of partnership include: one 'with

**limited liability’ and the other one ‘with unlimited liability’. These types are described in the following sections.**

### **Classification on the basis of duration**

**(i) Partnership at will:** This type of partnership exists at the will of the partners. It can continue as long as the partners want and is terminated when any partner gives a notice of withdrawal from partnership to the firm.

**(ii) Particular partnership:** Partnership formed for the accomplishment of a particular project is called particular partnership. It dissolves automatically when the purpose for which it was formed is fulfilled or when the time duration expires.

### **Classification on the basis of liability**

**(i) General Partnership:** In general partnership, the liability of partners is unlimited and joint. The partners enjoy the right to participate in the management of the firm and their acts are binding on each other as well as on the firm. Registration of the firm is optional. The existence of the firm is affected by the death, lunacy, insolvency or retirement of the partners.

**(ii) Limited Partnership:** In limited partnership, the liability of at least one partner is unlimited whereas the rest may have limited liability. Such a partnership does not get terminated with the death, lunacy or insolvency of the limited partners. The limited partners do not enjoy the right of management and their acts do not bind the firm or the other partners. Registration of such partnership is compulsory.

## **PARTNERSHIP DEED**

The written agreement which specifies the terms and conditions that govern the partnership is called the partnership deed. The partnership deed generally includes the following aspects:

- **Name of firm**
- **Nature of business and location of business**
- **Duration of business**
- **Investment made by each partner**
- **Distribution of profits and losses**
- **Duties and obligations of the partners**
- **Salaries and withdrawals of the partners**
- **Terms governing admission, retirement and expulsion of a partner**
- **Interest on capital and interest on drawings**
- **Procedure for dissolution of the firm**
- **Preparation of accounts and their auditing**
- **Method of solving disputes**

## **Registration**

Registration of a partnership firm means the entering of the firm's name, along with the relevant prescribed particulars, in the Register of firms

**kept with the Registrar of Firms. It provides conclusive proof of the existence of a partnership firm.**

**It is optional for a partnership firm to get registered. In case a firm does not get registered, it is deprived of many benefits. The consequences of non-registration of a firm are as follows:**

**(a) A partner of an unregistered firm cannot file a suit against the firm or other partners,**

**(b) The firm cannot file a suit against third parties, and**

**(c) The firm cannot file a case against the partners.**

**In view of these consequences, it is therefore advisable to get the firm registered. According to the India Partnership Act 1932, the partners may get the firm registered with the Registrar of firms of the state in which the firm is situated. The registration can be at the time of formation or at any time during its existence. The procedure for getting a firm registered is as follows:**

**1. Submission of application in the prescribed form to the Registrar of firms. The application should contain the following particulars:**

- **Name of the firm**
- 
- **Location of the firm**
- **Names of other places where the firm carries on business**
- **The date when each partner joined the firm**
- **Names and addresses of the partners**
- **Duration of partnership**

**This application should be signed by all the partners.**

**2. Deposit of required fees with the Registrar of Firms.**

**3. The Registrar after approval will make an entry in the register of firms and will subsequently issue a certificate of registration.**

## **COOPERATIVE SOCIETY**

**The word cooperative means working together and with others for a common purpose. The cooperative society is a voluntary association of persons, who join together with the motive of welfare of the members. The cooperative society is compulsorily required to be registered under the Cooperative Societies Act 1912.**

### **Features**

**The characteristics of a cooperative society are listed below.**

**(i) Voluntary membership:** The membership of a cooperative society is voluntary. A person is free to join a cooperative society, and can also leave anytime as per his desire.

**(ii) Legal status:** Registration of a cooperative society is compulsory. This accords a separate identity to the society which is distinct from its members.

**(iii) Limited liability:** The liability of the members of a cooperative society is limited to the extent of the amount contributed by them as capital.

**(iv) Control:** In a cooperative society, the power to take decisions lies in the hands of an elected managing committee.

**(v) Service motive:** The cooperative society through its purpose lays emphasis on the values of mutual help and welfare.

### **Merits**

**(i) Equality in voting status:** Irrespective of the amount of capital contribution by a member, each member is entitled to equal voting rights.

**(ii) Limited liability:** The liability of members of a cooperative society is limited to the extent of their capital contribution.

**(iii) Stable existence:** Death, bankruptcy or insanity of the members do not affect continuity of a cooperative society.

**(iv) Economy in operations:** The members generally offer honorary services to the society. As the focus is on elimination of middlemen, this helps in reducing costs.

**(v) Support from government:** The cooperative society exemplifies the idea of democracy and hence finds support from the Government in the form of low taxes, subsidies, and low interest rates on loans.

**(vi) Ease of formation:** The cooperative society can be started with a minimum of ten members. The registration procedure is simple involving a few legal formalities. Its formation is governed by the provisions of Cooperative Societies Act 1912.

### **Limitations**

**(i) Limited resources:** Resources of a cooperative society consists of capital contributions of the members with limited means.

**(ii) Inefficiency in management:** Cooperative societies are unable to attract and employ expert managers because of their inability to pay them high salaries.

**(iii) Lack of secrecy:** As a result of open discussions in the meetings of members as well as disclosure obligations as per the Societies Act, it is difficult to maintain secrecy about the operations of a cooperative society.

**(iv) Differences of opinion:** Internal quarrels arising as a result of contrary viewpoints may lead to difficulties in decision making.

### **Types of Cooperative Societies**

Various types of cooperative societies based on the nature of their operations are described below:

**(i) Consumer's cooperative societies:** The consumer cooperative societies are formed to protect the interests of consumers. The members comprise of consumers desirous of obtaining good quality products at reasonable prices. It purchases goods in bulk directly from the wholesalers and sells goods to the members, thereby eliminating the middlemen. Profits, if any, are distributed on the basis of either their capital contributions to the society or purchases made by individual members.

**(ii) Producer's cooperative societies:** These societies are set up to protect the interest of small producers. The members comprise of producers desirous of procuring inputs for production of goods to meet the demands of consumers. The society aims to fight against the big capitalists and enhance the bargaining power of the small producers.



**Profits among the members are generally distributed on the basis of their contributions to the total pool of goods produced or sold by the society.**

**(iii) Marketing cooperative societies:** Such societies are established to help small producers in selling their products. The members consist of producers who wish to obtain reasonable prices for their output. It pools the output of individual members and performs marketing functions like transportation, warehousing, packaging, etc., to sell the output at the best possible price. Profits are distributed according to each member's contribution to the pool of output.

**(iv) Farmer's cooperative societies:** These societies are established to protect the interests of farmers by providing better inputs at a reasonable cost. The aim is to gain the benefits of large scale farming and increase the productivity. Such societies provide better quality seeds, fertilisers, machinery and other modern techniques for use in the cultivation of crops.

**(v) Credit cooperative societies:** Credit cooperative societies are established for providing easy credit on reasonable terms to the members. The members comprise of persons who seek financial help in the form of loans. The aim of such societies is to protect the members from the exploitation of lenders who charge high rates of interest on loans. Such societies provide loans to members out of the amounts collected as capital and deposits from the members and charge low rates of interest.

**(vi) Cooperative housing societies:** Cooperative housing societies are established to help people with limited income to construct houses at reasonable costs.

### **JOINT STOCK COMPANY**

**A company is an association of persons formed for carrying out business activities and has a legal status independent of its members. A company can be described as an artificial person having a separate legal entity, perpetual succession and a common seal. The company form of organisation is governed by The Companies Act, 2013.**

## **Features**

**The definition of a joint stock company highlights the following features of a company.**

**(i) Artificial person:** A company is a creation of law and exists independent of its members. It is, therefore, called an artificial person.

**(ii) Separate legal entity:** From the day of its incorporation, a company acquires an identity, distinct from its members. Its assets and liabilities are separate from those of its owners. The law does not recognise the business and owners to be one and the same.

**(iii) Formation:** Incorporation of companies is compulsory under The Companies Act 2013 or any of the previous company law, as state earlier.

**(iv) Perpetual succession:** A company being a creation of the law, can be brought to an end only by law. It will only cease to exist when a specific procedure for its closure, called winding up, is completed. Members may come and members may go, but the company continues to exist.

**(v) Control:** The management and control of the affairs of the company is undertaken by the Board of Directors, which appoints the top management officials for running the business.

**(vi) Liability:** The liability of the members is limited to the extent of the capital contributed by them in a company.

**(vii) Common seal:** The company being an artificial person cannot sign its name by itself. Therefore, every company is required to have its own seal which acts as official signature of the company. Any document which does not carry the common seal of the company is not a binding on the company.

**(viii) Risk bearing:** The risk of losses in a company is borne by all the shareholders.

### **Merits**

The company form of organisation offers a multitude of advantages, some of which are discussed below.

**(i) Limited liability:** The shareholders are liable to the extent of the amount unpaid on the shares held by them.

**(ii) Perpetual existence:** Existence of a company is not affected by the death, retirement, resignation, insolvency or insanity of its members as it has a separate entity from its members.

**(iii) Scope for expansion:** A company has large financial resources. Further, capital can be attracted from the public as well as through loans from banks and financial institutions. Thus there is greater scope for expansion.

**(iv) Professional management:** A company can afford to pay higher salaries to specialists and professionals. It can, therefore, employ people who are experts in their area of specialisations.

## **Limitations**

**The major limitations of a company form of organisation are as follows:**

**(i) Complexity in formation:** The formation of a company requires greater time, effort and extensive knowledge of legal requirements and the procedures involved.

**(ii) Lack of secrecy:** The Companies Act requires each public company to provide from time-to-time a lot of information to the office of the registrar of companies. It is, therefore, difficult to maintain complete secrecy about the operations of company.

**(iii) Numerous regulations:** The functioning of a company is subject to many legal provisions and compulsions. This reduces the freedom of operations of a company and takes away a lot of time, effort and money.

**(iv) Delay in decision making:** Companies are democratically managed through the Board of Directors which is followed by the top management, middle management and lower level management. Communication as well as approval of various proposals may cause delays not only in taking decisions but also in acting upon them.

**(vii) Conflict in interests:** There may be conflict of interest amongst various stakeholders of a company.

## **TYPES OF COMPANIES**

### **Private Company**

**A private company means a company which:**

- (a) restricts the right of members to transfer its shares;**
- (b) has a minimum of 2 and a maximum of 200 members, excluding the present and past employees;**
- (c) Does not invite public to subscribe to its securities and**

**It is necessary for a private company to use the word private limited after its name.**

**The following are some of the privileges of a private limited company as against a public limited company:**

- 1. A private company can be formed by only two members.**
- 2. There is no need to issue a prospectus as public is not invited to subscribe to the shares of a private company.**
- 3. Allotment of shares can be done without receiving the minimum subscription. The company can start business as soon as it receives the certificate of incorporation.**
- 4. A private company needs to have only two directors. However the maximum number of directors for both types of companies is fifteen.**
- 5. A private company is not required to keep an index of members while the same is necessary in the case of a public company.**

### **Public Company**

**A public company means a company which is not a private company. As per The Companies Act, a public company is one which:**

**(a) Has a minimum of 7 members and no limit on maximum members.**

**(b) Has no restriction on transfer securities; and**

**(c) Is not prohibited from inviting the public to subscribe to its securities.**

**However, a private company which is a subsidiary of a public company is also treated as a public company.**

### **CHOICE OF FORM OF BUSINESS ORGANISATION**

**(i) Cost and ease in setting up the organisation:** As far as initial business setting-up costs are concerned, sole proprietorship is the most inexpensive way of starting a business. However, the legal requirements are minimum and the scale of operations is small. In case of partnership also, the advantage of less legal formalities and lower cost is there because of limited scale of operations. Cooperative societies and companies have to be compulsorily registered. Formation of a company involves a lengthy and expensive legal procedure. From the point of view of initial cost, therefore, sole proprietorship is the preferred form as it involves least expenditure. Company form of organisation, on the other hand, is more complex and involves greater costs.

**(ii) Liability:** In case of sole proprietorship and partnership firms, the liability of the owners/partners is unlimited. This may call for paying the debt from personal assets of the owners. In joint Hindu family business, only the karta has unlimited liability. In cooperative societies and companies, however, liability is limited and creditors can force payment of their claims only to the extent of the company's assets. Hence, from the point of view of investors, the company form of organisation is more suitable as the risk involved is limited.

**(iii) Continuity:** The continuity of sole proprietorship and partnership firms is affected by such events as death, insolvency or insanity of the owners. However, such factors do not affect the continuity of business

**in the case of organisations like joint Hindu family business, cooperative societies and companies.**

**(iv) Management ability:** A sole proprietor may find it difficult to have expertise in all functional areas of management. In other forms of organisations like partnership and company, there is no such problem.

**(v) Capital considerations:** Companies are in a better position to collect large amounts of capital by issuing shares to a large number of investors. Further, from the point of view of expansion, a company is more suitable because of its capability to raise more funds and invest in expansion plans.

**(vi) Degree of control:** If direct control over operations and absolute decision making power is required, proprietorship may be preferred. But if the owners do not mind sharing control and decision making, partnership or company form of organisation can be adopted.

**(vii) Nature of business:** If direct personal contact is needed, proprietorship may be more suitable. For large manufacturing units, however, when direct personal contact with the customer is not required, the company form of organisation may be adopted. Similarly, in cases where services of a professional nature are required, partnership form is much more suitable.