DEPARTMENT OF COMMERCE (CA)

Business Organization and Management (Semester-III)

II-B.COM (CA) Sub code-18BCA35S

UNIT-II

Forms of Business Organization: Sole Proprietorship – Partnership – Joint Stock Company – Features - Advantages and Disadvantages.

One of the first decisions that you will have to make as a business owner is how the business should be structured. All businesses must adopt some legal configuration that defines the rights and liabilities of participants in the business's ownership, control, personal liability, life span, and financial structure. This decision will have long-term implications, so you may want to consult with an accountant and attorney to help you select the form of ownership that is right for you.

In making a choice, you will want to take into account the following

- Your vision regarding the size and nature of your business.
- The level of control you wish to have.
- The level of "structure" you are willing to deal with.
- The business's vulnerability to lawsuits.
- Tax implications of the different organizational structures.
- Expected profit (or loss) of the business.
- Whether or not you need to re-invest earnings into the business.
- Your need for access to cash out of the business for yourself.

Forms of business organization
There are four basic legal forms of organization Sole Proprietorship; Partnerships; Corporations and Limited Liability Company follows. Please also review this summary of non-tax factors to consider.

Sole Proprietorship

The vast majority of small businesses start out as sole proprietorships. These firms are owned by one person, usually the individual who has day-to-day responsibility for running the business. Sole proprietorships own all the assets of the business and the profits generated by it. They also assume complete responsibility for any of its liabilities or debts. In the eyes of the law and the public, you are one in the same with the business.

Features of Sole Proprietorship

1. Lack of Legal Formalities
A sole proprietorship does not have a separate law to govern it. And so there are not many special rules and regulations to follow. Furthermore, it does not require incorporation or registration of any kind. In fact, in most cases, we need only the license to carry out the desired business. And just like in its formation, there is hardly any legal process involved in its closure. All in all, it allows for ease of doing business with minimum hassles.

2. Liability
Since there is no separation between the owner and the business, the personal liability of the owner is also unlimited. So if the business is unable to meet its own debts or liabilities, it will fall upon the proprietor to pay them. For instance, he may have to sell all of his personal assets (like his car, house, other properties etc) to meet the debts or liabilities of the business.

3. Risk and Profit
The business owner is the only risk bearer in a sole proprietorship. Since he is the only one financially invested in the company. As a result, he must also bear all the risk. In other words, if the business fails or suffers losses he will be the one affected. However, he also enjoys all the profits from the business. He does not have to share his profits with any other stakeholders since there are none. So he must bear the full risk in exchange for enjoying full profits.

4. No Separate Identity
In legal terms, the business and the owner are one and the same. No separate legal identity will be bestowed upon the sole proprietorship. So the owner will be responsible for all the activities and transactions of the business.

5. Continuity
As seen above the business and the owner has one identity. So a sole proprietorship is entirely dependent on its owner. The death, retirement, bankruptcy. insanity, imprisonment etc will have an effect on the sole proprietorship. In such situations, the proprietorship will cease to exist and the business will come to an end.

6. Complete secrecy
Since the entire control and decision-making power vests in the hands of the sole trader, business secrets can be maintained to the maximum extent.

Advantages of a Sole Proprietorship

- Easiest and least expensive form of ownership to organize.
- Sole proprietors are in complete control, and within the parameters of the law, may make decisions as they see fit.
- Profits from the business flow-through directly to the owner's personal tax return.
- The business is easy to dissolve, if desired.

Disadvantages of a Sole Proprietorship

- Sole proprietors have unlimited liability and are legally responsible for all debts against the business. Their business and personal assets are at risk.
- May be at a disadvantage in raising funds and are often limited to using funds from personal savings or consumer loans.
- May have a hard time attracting high-caliber employees, or those that are motivated by the opportunity to own a part of the business.
- Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income (only partially as an adjustment to income).

Partnerships

In a Partnership, two or more people share ownership of a single business. Like proprietorships, the law does not distinguish between the business and its owners. The Partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, or what steps will be taken to dissolve the partnership when needed; Yes, its hard to think about a "break-up" when the business is just getting started, but many partnerships split up at crisis times and unless there is a defined process, there will be even greater problems. They also must decide up front how much time and capital each will contribute, etc.

Features of Partnership

1. **Agreement** The partnership arises out of an agreement between two or more persons.
2. **Profit sharing** There should be an agreement among the partners to share the profits of the business.
3. **Lawful business** The business to be carried on by a partnership must always be lawful.
4. **Membership** There must be at least two persons to form a partnership. The maximum number is 20. But in case of banking business the maximum is 10 members.
5. **Unlimited liability** The liability of every partner is unlimited, joint and several.
6. **Principal-agent relationship** Every partner is an agent of the firm. He can act on behalf of the firm. He is responsible for his own acts and also for the acts done on behalf of the other partners.
7. **Collective management** The firm and the partners are one. When a contract is made in the name of the firm all the partners are responsible for it individually and collectively.
8. **Non-transferability of shares** A partner cannot transfer his share of interest to others without the consent of the other partners.

Advantages of a Partnership

- Partnerships are relatively easy to establish; however time should be invested in developing the partnership agreement.
- With more than one owner, the ability to raise funds may be increased.
- The profits from the business flow directly through to the partners' personal tax return.
- Prospective employees may be attracted to the business if given the incentive to become a partner.
- The business usually will benefit from partners who have complementary skills.

Disadvantages of a Partnership

- Partners are jointly and individually liable for the actions of the other partners.
- Profits must be shared with others.
- Since decisions are shared, disagreements can occur.
- Some employee benefits are not deductible from business income on tax returns.
- The partnership may have a limited life; it may end upon the withdrawal or death of a partner.

Joint Stock Company

The simplest way to describe a joint stock company is that it is a business organization that is owned jointly by all its shareholders. All the shareholders own a certain amount of stock in the company, which is represented by their shares.

Professor Haney defines it as "a voluntary association of persons for profit, having the capital divided into some transferable shares, and the ownership of such shares is the condition of membership of the company." Studying the features of a joint stock company will clarify its structure.

Features of a Joint Stock Company

1. Artificial Legal Person

A company is a legal entity that has been created by the statues of law. Like a natural person, it can do certain things, like own property in its name, enter into a contract, borrow and lend money, sue or be sued, etc. It has also been granted certain rights by the law which it enjoys through its board of directors.

However, not all laws/rights/duties apply to a company. It exists only in the law and not in any physical form. So we call it an artificial legal person.

2. Separate Legal Entity

Unlike a proprietorship or partnership, the legal identity of a company and its members are separate. As soon as the joint stock company is incorporated it has its own distinct legal identity. So a member of the company is not liable for the company. And similarly, the company will not depend on any of its members for any business activities.

3. Incorporation

For a company to be recognized as a separate legal entity and for it to come into existence, it has to be incorporated. Not registering a joint stock company is not an option. Without incorporation, a company simply does not exist.

4. Perpetual Succession

The joint stock company is born out of the law, so the only way for the company to end is by the functioning of law. So the life of a company is in no way related to the life of its members. Members or shareholders of a company keep changing, but this does not affect the company's life.

5. Limited Liability

This is one of the major points of difference between a company and a sole proprietorship and partnership. The liability of the shareholders of a company is limited. The personal assets of a member cannot be liquidated to repay the debts of a company.

A shareholder liability is limited to the amount of unpaid share capital. If his shares are fully paid then he has no liability. The amount of debt has no bearing on this. Only the company's assets can be sold off to repay its own debt. The members cannot be made to pay up.

6. Common Seal

A company is an artificial person. So its day-to-day functions are conducted by the board of directors. So, when a company enters any contract or signs an agreement, the approval is indicated via a common seal. A common seal is engraved seal with the company's name on it. So, no document is legally binding on the company until and unless it has a common seal along with the signatures of the directors.

7. Transferability of Shares

In a joint stock company, the ownership is divided into transferable units known as shares. In case of a public company the shares can be transferred freely, there are almost no restrictions. And in a public company, there are some restrictions, but the transfer cannot be prohibited.

Advantages of a Joint Stock Company

- One of the biggest drawing factors of a joint stock company is the limited liability of its members. their liability is only limited up to the unpaid amount on their shares. Since their personal wealth is safe, they are encouraged to invest in joint stock companies
- The shares of a company are transferable. Also, in the case of a listed public company they can also be sold in the market and be converted to cash. This ease of ownership is an added benefit.
- Perpetual succession is another advantage of a joint stock company. The death/retirement/insanity/etc does affect the life of a company. The only liquidation under the Companies Act will shut down a company.
- A company hires a board of directors to run all the activities. Very proficient, talented people are elected to the board and this results in effective and efficient management. Also, a company usually has large resources and this allows them to hire the best talent and professionals.

Disadvantages of a Joint Stock Company

- One disadvantage of a joint stock company is the complex and lengthy procedure for its formation. This can take up to several weeks and is a costly affair as well.
- According to the Companies Act, 2013 all public companies have to provide their financial records and other related documents to the registrar. These documents are then public documents, which any member of the public can access. This leads to a complete lack of secrecy for the company.
- And even during its day to day functioning a company has to follow a numerous number of laws, regulations, notifications, etc. It not only takes up time but also reduces the freedom of a company
- A company has many stakeholders like the shareholders, the promoters, the board of directors, the employees. the debenture holders etc. All these stakeholders look out for their benefit and it often leads to a conflict of interest.

Difference between Partnership and Joint stock company

1. The members of the partnership firm are called partners whereas the members of company are called shareholders.
2. The partnership business is to be governed by the Indian Partnership Act, 1932 whereas the business of the company is determined by Indian Companies act, 2013
3. Partnership firm is created by contract between two or more persons whereas company is created by law i.e registration.
4. The rules of a partnership are to be registered by the state government whereas in the case of the company it is to be regulated by the central government.
5. Registration of a firm is not necessary whereas the company's registration is mandatory.
6. The mandatory document in case of partnership is partnership deed whereas in the case of a company the mandatory document is the memorandum of association and articles of association.
7. A partnership firm is not a separate legal entity from its partners whereas a company is a separate legal entity.
8. Partners have unlimited liability whereas shareholders have limited liability.
9. Seal (Stamp) is not required for partnership whereas in case of company stamp is required.
10. In case of partnership, management is to be done by active partners whereas in case of company management is done by the board of directors.
11. Decree against a firm can be executed against partners whereas decree can't be executed against shareholders.
12. In the case of a private company, the word is to be used Pvt. Ltd and in case of a public company, the word is to be used Ltd. only whereas such words are not required in case of partnership.
13. A partnership firm has to maintain accounts as per the conditions stated in partnership deed whereas a company should maintain accounts and auditing of accounts by a certified Chartered Accountant.
14. The name of the partnership firm can be changed easily by having discussion between the partners and by following the simple procedure provided in s.60 whereas the name of the company can't be changed easily and prior approval of the central government is required.

Reference:

1. Fundamentals of Business Organization - Y.K. Bhusan and tayal
2. www.yourarticlelibrary.com

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