Chapter 2: Forms of Business Organisation

Exercises — Exercises

Q1 Compare the status of a minor in a Joint Hindu family business with that in a partnership firm.

Joint Hindu family business: membership comes by birth into the Hindu Undivided Family, so a minor can be a co-parcener and a member of the business. No agreement is needed, and the minor's liability is limited to his share in the co-parcenary property. Partnership firm: a partnership rests on a valid contract, and a minor cannot enter a contract, so a minor cannot become a partner. He can, with the consent of all partners, be admitted only to the benefits of the firm. He then shares profits but not losses, his liability is limited to the capital he has contributed, and he cannot take part in management, though he may inspect the accounts. On attaining majority he must decide within six months, by public notice, whether to become a partner; if he does not, he is treated as a full partner with unlimited liability.

Q2 If registration is optional, why do partnership firms willingly go through this legal formality and get themselves registered? Explain.

Registration is optional, but an unregistered firm loses important legal rights. The consequences of non-registration are: (a) a partner of an unregistered firm cannot file a suit against the firm or the other partners; (b) the firm cannot file a suit against third parties; and (c) the firm cannot file a case against its partners. Registration with the Registrar of Firms also gives conclusive proof of the existence of the partnership. To avoid these disadvantages and to be able to enforce claims in court, firms prefer to register, either at the time of formation or at any time during their existence.

Q3 State the important privileges available to a private company.

Privileges of a private company compared with a public company: (1) It can be formed by only two members, whereas a public company needs seven. (2) It need not issue a prospectus, since the public is not invited to subscribe to its shares. (3) Allotment of shares can be made without receiving the minimum subscription, and it can start business as soon as it receives the certificate of incorporation. (4) It needs only two directors, against a minimum of three in a public company; the maximum for both is fifteen. (5) It is not required to keep an index of members, which a public company must do. A private company that breaks the conditions of its definition loses these privileges.

Q4 How does a cooperative society exemplify democracy and secularism? Explain.

Democracy: control rests with an elected managing committee, and members vote to choose who forms it. The principle of 'one man one vote' applies, so every member has equal voting rights whatever the capital contributed. Membership is voluntary, and a member may join or leave freely. The society works on mutual help and welfare, and any surplus is shared among members as dividend under the bye-laws. Secularism: membership is open to all irrespective of religion, caste and gender, so no person is excluded on these grounds. Because it embodies democratic ideals, the government supports it with low taxes, subsidies and cheaper loans.

Q5 What is meant by 'partner by estoppel'? Explain.

A partner by estoppel is a person who is not actually a partner but, through his or her own initiative, conduct or behaviour, gives others the impression that he or she is a partner of the firm. Such a person is held liable for the firm's debts to third parties who extended credit relying on that impression, although he or she contributes no capital, takes no part in management and does not share profits or losses. Example: Rani accompanies her friend Seema, a partner in Simplex Solutions, to a meeting with Mohan Softwares, takes active part in the negotiations and gives the impression of being a partner. If credit is extended to Simplex Solutions on that basis, Rani is liable for its repayment as if she were a partner.

Q6 Briefly explain the following terms in brief. (a) Perpetual succession (b) Common seal (c) Karta (d) Artificial person

(a) Perpetual succession: a company is a creation of law and can be ended only by law, through the winding-up procedure. Members may come and go, or die, but the company continues to exist. (b) Common seal: the official signature of the company. A company is an artificial person and cannot sign for itself, so its seal, used on documents, shows its authority; the chapter lists it as one attribute of a company, alongside separate legal entity and perpetual succession. (c) Karta: the eldest member of the Hindu Undivided Family, who heads and controls the joint Hindu family business. He takes all decisions, which bind the other members, and has unlimited liability. (d) Artificial person: a company is created by law and exists independently of its members. Like a natural person it can own property, incur debts, enter into contracts, and sue and be sued, but it cannot breathe, eat, run or talk.

Q7 What do you understand by a sole proprietorship firm? Explain its merits and limitation?

Sole proprietorship is a form of business organisation owned, managed and controlled by one individual, who receives all the profits and bears all the risks. It is common in personalised services such as beauty parlours and in small retail shops. Merits: (i) quick decision making, since no one needs to be consulted; (ii) confidentiality, as the proprietor need not publish accounts; (iii) direct incentive, because all profit goes to the owner; (iv) a sense of accomplishment from working for oneself; (v) ease of formation and closure, with minimal legal formalities. Limitations: (i) limited resources, restricted to personal savings and borrowings, so the business stays small; (ii) limited life, as death, insanity, imprisonment or bankruptcy of the owner can close it; (iii) unlimited liability, so personal assets can be used to pay debts, which discourages risk-taking; (iv) limited managerial ability, since one person must handle varied tasks and may be unable to retain talented employees.

Q8 Why is partnership considered by some to be a relatively unpopular form of business ownership? Explain the merits and limitations of partnership.

Partnership is considered relatively unpopular because of its limitations: unlimited liability, risk of disputes, limited capital, lack of continuity and low public confidence. Merits: (i) ease of formation and closure, by a simple agreement, with no compulsory registration; (ii) balanced decision making, as partners oversee functions matching their expertise; (iii) more funds, since capital comes from several partners; (iv) sharing of risks among all partners; (v) secrecy, as the firm need not publish its accounts. Limitations: (i) unlimited liability, joint and several, so a wealthy partner may have to repay the entire debt; (ii) limited resources because the number of partners is restricted; (iii) possible conflicts, and one partner's unwise decision binds all; (iv) lack of continuity, as the death, retirement, insolvency or lunacy of a partner ends the firm; (v) lack of public confidence, since financial reports are not published.

Q9 Why is it important to choose an appropriate form of organisation? Discuss the factors that determine the choice of form of organisation.

Each form of organisation has its own advantages and disadvantages, so the form must be chosen by weighing these against one's requirements. A wrong choice can lead to heavy costs, avoidable risk or poor management. Factors: (i) Cost and ease of setting up: sole proprietorship is cheapest and simplest; a company is lengthy and expensive. (ii) Liability: unlimited for proprietors and partners; limited in cooperatives and companies, so a company suits investors. (iii) Continuity: companies, cooperatives and joint Hindu family businesses continue despite death of members; proprietorship and partnership do not. (iv) Management ability: complex operations need the professional management of a company; simple ones suit proprietorship or partnership. (v) Capital: companies raise large funds; a sole proprietor's are limited. (vi) Degree of control: proprietorship gives direct control; partnership and company require sharing it. (vii) Nature of business: personal contact with customers favours proprietorship; large units suit a company; professional services suit partnership. These factors are inter-related and must all be considered together.

Q10 Discuss the characteristics, merits and limitation of cooperative form of organisation. Also describe briefly different types of cooperative societies.

A cooperative society is a voluntary association of persons formed to promote the welfare of members. Characteristics: voluntary membership open to all; compulsory registration giving a separate legal status; limited liability up to capital contributed; control by an elected managing committee; service motive, with surplus distributed as dividend. Merits: equal voting ('one man one vote'); limited liability; stable existence; economy in operations through honorary services and elimination of middlemen; government support; ease of formation. Limitations: limited resources; inefficient management, as experts cannot be paid well; lack of secrecy; government control; differences of opinion among members. Types: consumer societies buy in bulk and sell to members at reasonable prices; producer societies supply inputs to small producers; marketing societies pool and sell members' output; farmers' societies provide better inputs and large-scale farming; credit societies give loans at low interest; housing societies help members build houses at reasonable cost.

Q11 Distinguish between a Joint Hindu family business and partnership.

Formation: a joint Hindu family business arises by birth in the family and needs no agreement, only ancestral property; a partnership arises from a legal agreement and is governed by the Indian Partnership Act, 1932. Members: HUF needs at least two members with no maximum; a partnership needs a minimum of two and at most 50 under present rules. Liability: in HUF only the karta has unlimited liability, others are limited to their share in the co-parcenary property; in a partnership all partners have unlimited, joint and several liability. Control: the karta alone takes decisions, which bind the others; in a partnership decisions are shared, generally by mutual consent. Continuity: HUF continues after the karta's death as the next eldest member takes over; a partnership ends on death, retirement, insolvency or lunacy of a partner unless a fresh agreement is made. Minors: can be members of an HUF but cannot be partners. Registration: not required for HUF; optional for a partnership.

Q12 Despite limitations of size and resources, many people continue to prefer sole proprietorship over other forms of organisation? Why?

Many entrepreneurs still choose sole proprietorship because of its inherent advantages. It needs the least capital and is the cheapest to start, with minimal legal formalities; no separate law governs it, so it is easy to start and close as the owner wishes. Decisions are quick because nobody has to be consulted, which helps in grabbing market opportunities. Information stays confidential, as accounts need not be published. The owner keeps all the profit, which is a strong incentive to work hard, and enjoys personal satisfaction and confidence from working for oneself. Control rests entirely with the owner. The form is best suited to small-scale businesses, such as a neighbourhood store or beauty parlour, where customers demand personalised service. For these reasons it remains popular despite limited resources and unlimited liability.

Q13 In which form of organisation is a trade agreement made by one owner binding on the others? Give reasons to support your answer.

A trade agreement made by one owner binds the others in a partnership firm. The reason is mutual agency: partnership is a business carried on by all or any one of the partners acting for all. Every partner is both an agent and a principal. He is an agent of the other partners because he represents them and binds them by his acts, and a principal because he can himself be bound by the acts of the other partners. So a trade agreement made by one partner in the course of the firm's business binds all the partners, and an unwise decision by one can affect them all. The same does not apply in a sole proprietorship, which has only one owner.

Q14 The business assets of an organisation amount to Rs. 50,000 but the debts that remain unpaid are Rs. 80,000. What course of action can the creditors take if (a) The organisation is a sole proprietorship firm (b) The organisation is a partnership firm with Anthony and Akbar as partners. Which of the two partners can the creditors approach for repayment of debt? Explain giving reasons

The shortfall is Rs. 80,000 - Rs. 50,000 = Rs. 30,000. (a) Sole proprietorship: the owner has unlimited liability and the law does not separate the owner from the business. After the business assets of Rs. 50,000 are used, creditors can recover the remaining Rs. 30,000 from the proprietor's personal assets, such as a personal car. (b) Partnership: partners also have unlimited liability, and it is joint and several. After using the firm's assets, creditors can claim the balance Rs. 30,000 from the personal property of the partners, and they can approach either Anthony or Akbar, or both, since each is individually liable for the whole debt. The partner who pays more than his share can later recover the excess from the other partner according to the partnership agreement.

Q15 Kiran is a sole proprietor. Over the past decade, her business has grown from operating a neighbourhood corner shop selling accessories such as artificial jewellery, bags, hair clips and nail art to a retail chain with three branches in the city. Although she looks after the varied functions in all the branches, she is wondering whether she should form a company to better manage the business. She also has plans to open branches countrywide. (a) Explain two benefits of remaining a sole proprietor (b) Explain two benefits of converting to a joint stock company (c) What role will her decision to go nationwide play in her choice of form of the organisation? (d) What legal formalities will she have to undergo to operate business as a company?

(a) Benefits of remaining a sole proprietor: she keeps complete control and quick decision making with no interference; she keeps all the profits and the business information stays confidential, as accounts need not be published. Formation and operation also involve fewer legal formalities. (b) Benefits of a company: limited liability, so her personal assets are safe from business debts; and greater scope for expansion, as a company can raise large funds from the public and banks. It also offers perpetual existence, professional management and easy transfer of shares. (c) Going nationwide needs large capital and professional management of many functions, which a sole proprietor's limited resources and managerial ability cannot support. So the company form becomes more suitable for expansion. (d) She must incorporate the company under the Companies Act, 2013: prepare several documents, comply with the legal requirements and obtain the certificate of incorporation before functioning. The process is time-consuming, expensive and complicated.