



INDIAN SCHOOL MUSCAT

Senior Section

Department of Commerce and Humanities

ELEMENTS OF BUSINESS (154)

Class : IX

Notes-No 1:Steps Involved in Establishing Business

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.

The most appropriate form is determined by weighing the advantages and disadvantages of each type of organisation against one's own requirements.

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.

(a)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.

Examples of this form of business is common in areas of personalised services such as beauty parlours, hair salons and small scale activities like running a retail shop in a locality.

Features of Sole Proprietorship

(i)Formation and Closure: Hardly any legal formalities are required to start a sole proprietary business, though in some cases one may require a license. There is no separate law that governs sole proprietorship. Closure of the business can also be done easily. Thus, there is ease in formation as well as closure of business.

(ii)Liability: Sole proprietors have unlimited liability. This implies that the owner is personally responsible for payment of debts in case the assets of the business are not sufficient to meet all the debts.

(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. He receives all the business profits which become a direct reward for his risk bearing.

(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: Since the owner and business are one and the same entity, 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 of Sole Proprietorship

(i) Quick Decision Making: A sole proprietor enjoys considerable degree of freedom in making business decisions. Further the decision making is prompt because there is no need to consult others. This may lead to timely capitalisation of market opportunities as and when they arise.

(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 the business not only contributes to self-satisfaction but also instils in the individual a sense of accomplishment and confidence in one's abilities.

(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. As sole proprietorship is the least regulated form of business, it is easy to start and close the business as per the wish of the owner.

Demerits of Sole Proprietorship

(i) Limited Resources: Resources of a sole proprietor are limited to his/her personal savings and borrowings from others. Banks and other lending institutions may hesitate to extend a long term loan to a sole proprietor. Lack of resources is one of the major reasons why the size of the business rarely grows much and generally remains small.

(ii) Limited Life of a Business Concern: In the eyes of the law the proprietorship and the owner are considered one and the same. Death, insolvency or illness 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. A poor decision or an unfavourable circumstance can create serious financial burden on the owners. That is why a sole proprietor is less inclined to take risks in the form of innovation or expansion.

(iv) Limited Managerial Ability: The owner has to assume the responsibility of varied managerial tasks such as purchasing, selling, financing, etc. It is rare to find an individual who excels in all these areas. Thus decision making may not be balanced in all the cases. Also, due

to limited resources, sole proprietor may not be able to employ and retain talented and ambitious employees.

(b)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 of Partnership

(i)Formation: The partnership form of business organisation is governed by the Indian Partnership Act, 1932. It comes into existence through a legal agreement wherein the terms and conditions governing the relationship among the partners, sharing of profits and losses and the manner of conducting the business are specified. It may be pointed out that the business must be lawful and run with the motive of profit. Thus, two people coming together for charitable purposes will not constitute a partnership.

(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. Further, the partners are jointly and individually liable for payment of debts.

(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: The partners share amongst themselves the responsibility of decision making and control of day to day activities. Decisions are generally taken with mutual consent. Thus, the activities of a partnership firm are managed through the joint efforts of all the partners.

(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. However, the remaining partners may if they so desire continue the business on the basis of a new agreement.

(vi) Membership: The minimum number of members needed to start a partnership firm is two, while the maximum number, in case of banking industry is ten and in case of other businesses it is twenty.

(vii) Mutual Agency: The definition of partnership highlights the fact that it is a business carried on by all or any one of the partners acting for all. In other words, every partner is both an agent and a principal. He is an agent of other partners as he represents them and thereby binds them through his acts. He is a principal as he too can be bound by the acts of other partners.

Merits of Partnership

(i)Ease of Formation and Closure: A partnership firm can be formed easily by putting an agreement between the prospective partners into place whereby they agree to carry out the business of the firm and share risks. 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. Because an individual is not forced to handle different activities, this not only reduces the burden of work but also leads to fewer errors in judgements. 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. This reduces the anxiety, burden and stress on individual partners.

(v)Secrecy: A partnership firm is not legally required to publish its accounts and submit its reports. Hence it is able to maintain confidentiality of information relating to its operations.

Limitations of Partnership

(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. The liability of partners is both joint and several which may prove to be a drawback for those partners who have greater personal wealth. They will have to repay the entire debt in case the other partners are unable to do so.

(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. As a result, partnership firms face problems in expansion beyond a certain size.

(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. Further, decisions of one partner are binding on other partners. Thus an unwise decision by someone may result in financial ruin for all others. In case a partner desires to leave the firm, this can result in termination of partnership as there is a restriction on transfer of ownership.

(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. However, the remaining partners can enter into a fresh agreement and continue to run the business.

(v)Lack of Public Confidence: A partnership firm is not legally required to publish its financial reports or make other related information public. It is, therefore, difficult for any

member of the public to ascertain the true financial status of a partnership firm. As a result, the confidence of the public in partnership firms is generally low.

Partnership Deed

In order to enter into partnership, a clear agreement with respect to the terms, conditions and all aspects concerning the partners is essential so that there is no misunderstanding later among the partners. Such an agreement can be oral or written. Even though it is not essential to have a written agreement, it is advisable to have a written agreement as it constitutes an evidence of the conditions agreed upon. **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

Types of Partnerships Partnerships

I. 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 say construction of a building or an activity to be carried on for a specified time period is called particular partnership. It dissolves automatically when the purpose for which it was formed is fulfilled or when the time duration expires.

II. 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.

Nature of Business Organisation

If direct personal contact is needed with the customers such as in the case of a grocery store, 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 or appropriate when the same business is carried on a large scale.

