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# UNIT 3    FORMS OF BUSINESS ORGANISATION II

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## 3.0    OBJECTIVES

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By the end of this Unit, you should be able to:

- state the features of an ideal form of business organisation
- compare the forms of business organisation
- outline the criteria for the choice of form of business organisation.

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## 3.1    INTRODUCTION

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You learnt in Unit 2 that there are four forms of business organisation, viz (i) sole proprietorship, (ii) partnership, (iii) joint stock company, and (iv) cooperative society. You have also learnt about the merits and limitations of each of these four forms.

Sole proprietorship and partnership have the advantages from the point of view of control, secrecy, motivation, ease of formation, and low cost of organisation. But they suffer from the drawbacks of limited resources, limited managerial abilities with unlimited liability. The company form of organisation, on the other hand, has the advantages of more resources, limited liability and diverse managerial abilities.

When you plan to set up a new business, you have to decide which form of organisation is more suitable for the proposed business. For this you have to critically analyse the suitability of each forms of organisation in the light of the nature of the proposed business. This is a very crucial decision because it determines the power and responsibility of the entrepreneur and the division of profits and losses. Once it is chosen, it is very difficult and expensive to change it. In this Unit you will learn about the requisites of a good form of organisation, compare the four forms of organisations, analyse the factors influencing the

choice of organisation form, and decide which form is the most suitable in a given situation.

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### 3.2 REQUISITES OF AN IDEAL FORM OF BUSINESS ORGANISATION

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Before we discuss how to select a particular form of business organisation in a given situation, we should know the essentials of an ideal form of organisation. This may help you in the evaluation of each form of organisation in the right perspective and take the final decision about the choice of a particular form more judiciously. The requisites of an ideal form of organisation are as follows:

- 1) **Ease of Formation:** An important factor for preferring a particular form of organisation to another is the ease with which a business can be brought into existence. The comparative ease of difficulty in forming a particular form of organisation mainly depends on three factors: (i) formation expenses by way of registration fee, stamp duty, fees of legal experts, charges involved in the drafting of documents, obtaining licences, etc., (ii) legal formalities, and (iii) procedural delays, etc. Unless it is very essential, it is better to go for an organisation which is easy to form.
- 2) **Scope of raising capital:** The choice of organisation mainly depends on the amount of capital required which is determined by the nature of business and the scale of operations. For example, if you want to open a retail shop in groceries, the amount capital needed will not be much. But if you want to set up a sugar factory, you may require a large amount of capital. Ideal form of organisation is one which provides scope for raising the amount of capital as and when required.
- 3) **Extent of liability:** You know that the element of risk and uncertainty is prevalent in each business. In view of this, normally, the businessmen prefer limited liability. Obviously, limited liability is considered as an important feature of a good form of organisation. However, a certain amount of risk is also found to be important to provide the needed spur for initiative, drive, and involvement in business. Many times, the absence of such spur leads to weakness, inefficiency and even dishonesty on the part of management personnel.
- 4) **Flexibility of operations:** The form of organisation should be very flexible and adaptable to changing business conditions without much difficulty or complication. For example, if you want to expand your business, diversify or modernise the plant and equipment, the organisation should be able to meet all requirements.
- 5) **Stability and continuity:** Stability and long life of business is desirable from the point of view of owners, employees, and customers. Employees always prefer a stable and continuous employment. If the business is stable, the owner should be able to formulate plans for the future and to make investments paying for a considerable length of time. From the customers' point of view also, regular supply of goods and services is expected to meet their needs. An ideal form of organisation is one which provides reasonable amount of stability to the business.

- 6) **Effectiveness of management:** As you know that the success of any business enterprise depends on the efficiency of management. Managerial efficiency depends on skills, motivation, flexibility, adaptability, etc. It is difficult for an individual to possess all these qualities.
- 7) **Extent of government control and regulations:** If the governmental control and regulations are too many, the enterprise may have to divert a lot of time, money and energy for complying with legal formalities and instructions. In some cases there may be too much interference by the government officials in the day-to-day business of the firm. No doubt, the investors, creditors, and customers trust the business enterprises whose activities are properly regulated by the government. But too much government interference is not favoured by the entrepreneurs because it mars their initiative and disrupts the working of their business.
- 8) **Business secrecy:** In business, it is important to maintain business secrets without leaking them out to competitors. Therefore, a form of organisation which enables retention of business secrets is preferred to the one wherein business secrets are difficult to preserve.
- 9) **Tax burden:** Business taxes like sales tax, excise duty, and customs duty are charged on certain products and services. Hence, such taxes affect all forms alike and they will not affect the choice. But the income tax liability is different from one form of organisation to the other. Naturally, the form of organisation which attracts the minimum amount of this tax liability is considered as an ideal form. From this point of view, company form of organisation is considered to be best because it enjoys a number of tax reliefs which are not available in case of other forms of organisation.
- 10) **Ownership prerogatives:** Some persons have a very strong desire to control the entire business activities themselves and place a great value upon their right of personal leadership. Some persons are desirous of sharing the responsibilities and risks of a business. Some people may want to own a part of the capital without a strong desire to control the affairs of the business. You can also find some persons who are not ready to bear the business risk. An ideal form of organisation takes care of such prerogatives of the owners.

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### 3.3 COMPARISON OF VARIOUS FORMS OF ORGANISATIONS

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You have learnt that an ideal form of organisation should have the features of easy formation, limited liability, scope to raise enough capital, business secrecy, flexibility, stability in operations, less governmental controls, less tax burden, etc. You know there are four basic forms of organisations viz., (1) sole proprietorship, (2) partnership, (3) company, and (4) cooperative society. In the light of the above features identified for an ideal form of organisation, let us now compare the features of these four forms of organisations. With such comparison, probably, we can identify that form of organisation which fulfils all the ideal features. Look at the Table 3.1 and compare the features of the four forms of business organisations.

**Table 3.1: Comparative Study of Different Forms of Organisation**

S. Basis of Comparison	Sole Proprietorship	Partnership	Private Limited Company	Public Limited Company	Cooperative Organisation
1 Formation	Easiest. No legal formalities required	Quite easy. No rigid legal formalities	Difficult due to legal formalities	Quite difficult due to many legal formalities	Few legal formalities are involved
2 Legal status	No separate legal status	No separate legal status	Separate legal status	Separate legal status	Separate legal status
3 Membership	Single owner	Minimum is 2 Maximum is 10 in banking business and 20 in others	Minimum 2 and maximum 50	Minimum 7 and no maximum limit	Minimum 10 and no maximum limit
4 Capital	Very limited capital	Limited capital	Larger capital resources	Any amount of capital can be raised	No substantial
5 Management and ownership	Owner management	Owner management	Control, risk and ownership generally go together	Complete separation of management from ownership	Not managed by all members
6 Managerial expertise	Very limited expertise	Limited expertise	Scope for expertise	Very wide scope for expertise	Scope for expertise
7 Owner's liability	Unlimited	Unlimited	Limited	Limited	Limited subject to By-laws
8 Basis of profit sharing	Fully enjoyed by owner	Shared by partners as per agreement	Shared by owners in the proportion of shares held	Shared by owners in the proportion of shares held	Volume of business by each member
9 Ownership transfer	At will and relatively easy	Restricted and relatively difficult	Restricted and relatively difficult	At will and very easy	Restricted
10 Business stability	Depends upon the life of owner	Depends upon the life, insolvency, retirement of partners	Perpetual existence. Death, insolvency of the members does not effect the life	Perpetual existence. Death, insolvency of the members does not effect the life	Death, insolvency of its members does not effect the life
11 Business secrets	Full secrecy	Secret shared by the partners	Secrets shared by the members	Exposed to public	Exposed to members
12 State regulations	Almost nil	Very little	Considerable regulations	Excessive regulations	Considerable regulations
13 Tax liability	No special income tax	No special income tax	Heavily taxed and income is double taxed	Heavily taxed and income is double taxed	Exemption from income tax
14 Flexibility	It is an elastic organisation. There is no need of written documents	It can be changed only by the consent of all partners. It requires partnership deed which can be changed by the consent of all the partners	It is an elastic organisation	It is an unelastic organisation. Its Memorandum of Association is difficult to change. It can be changed through the permission of the Govt.	It is an unelastic organisation. Its Memorandum of Association is difficult to change. It can be changed through the permission of Govt.
15 Auditing of accounts	Not required	Not required	Compulsory	Compulsory	Compulsory
16 Winding up	At will	At will	Under the Act	Under the Act	Under the Act

If you carefully analyse Table 3.1, you will realise that no single form of organisation is having all the ideal features. You can find each form of organisation having some of these features. Each form is good in some aspects and not good in other respects. For instance, sole proprietorship and partnership forms of organisations are considered good from the point of view of ease of formation, freedom from government regulations, ownership interest, retention of business secrets, etc. But the same features are not prevalent much in company form and cooperative form of organisations. Company form and cooperative form are ideal from the point of view of limited liability, scope of raising capital, professionalised management, continuity of life, etc. So, it is difficult to treat any one form as ideal in all respects and suitable in all situations.

### Check Your Progress A

- 1) List the features of an ideal form of business organisation.

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- 2) State whether the following statements are True or False

- i) An ideal form of organisation is one which has complicated legal formalities at the time of formation. ....
- ii) Unlimited liability is an important feature of an ideal form of organisation. ....
- iii) Organisation should be flexible and adaptable to changing businesses conditions .....
- iv) Too much governmental control is not ideal. ....
- v) An ideal form of organisation should ensure stable and continuous life to the business. ....
- vi) Retention of business secrets is one of the essential features of a good form of organisation. ....
- vii) The form of organisation which attracts more tax burden is desirable. ....

- 3) Fill in the blanks.

- i) ..... form is the easiest and ..... form is the most difficult in formation.
- ii) Membership of owners is the highest in ..... form and the lowest in ..... form.
- iii) Scope to raise capital is very limited in ..... form .....

- iv) Income is exempted from tax for ..... from of organisation.
- v) Owners liability is unlimited in ..... forms
- vi) Business secrets are maintained in ..... forms.
- vii) State regulations are the maximum in ..... form.
- viii) Business secrets are mostly exposed in ..... form.

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### 3.4 CRITERIA FOR THE CHOICE OF ORGANISATION

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By comparing the four forms, we realised that none of them is ideal in all respects. Each form of organisation is good in some respects and not good in other respects. It means that looking for one best form of organisation will be like looking for a shirt that fits everybody in the family. Thus, a particular form of organisation which is suitable in one situation may not be suitable in other situations. So, the best form of organisation is one which fulfils the requirements of a particular business in a satisfactory manner. The basic consideration governing the selection is the attainment of the objectives decided upon by the entrepreneur. Since these objectives also vary from one business to the other, no single form of organisation can be considered as the best suited for all kinds of business.

Now let us analyse what considerations help us in making our choice of the form of business organisation. The decision regarding the choice of organisation assumes importance at two stages of business.

- a) At the time of starting a business
- b) At the time of expansion.

#### 3.4.1 Criteria at the Time of Starting a Business

Choice of a suitable form of business organisation assumes great importance at the time of initiating or launching a new business enterprise because it is the form of organisation which ultimately determines the power and responsibility of the entrepreneur. The choice is dependent on the following factors.

- 1) **Nature of business:** Choice of a suitable form of organisation is dependent on the nature of the proposed business. The organisational requirements are different for different types of business. For example, a big cement manufacturing activity and a retail cement shop cannot have the same form of organisation. Similarly, the form of organisation suitable for a textile mill is not suitable for a tailoring shop.
- 2) **Volume of business:** The expected volume of business also influences the decision about the suitable form of organisation. If the volume of business is small, you need small amount of capital and run less risk. In that case, sole proprietorship may be quite suitable. But if the volume is large, you need more capital and run more risk which a single owner may find it difficult to cope with. So, partnership form or a company form would be considered more suitable.
- 3) **Area of operation:** The area of operation of the business also influences the choice of form of organisation. If the area is limited and confined to a

particular locality, the suitable form of organisation may be sole proprietorship. In case the area is widespread, the suitable form may be a joint stock company.

- 4) **Desire for control:** The extent of control and supervision will also determine the choice of organisation. If it is desired to have a direct control over the business operations, a sole proprietorship or a partnership form of business should be adopted. In case if you feel that there is no need for direct control, the company form of organisation is the best.
- 5) **Capital requirements:** The form of organisation will also depend on the extent of financial requirements of the business. A business which requires a small amount of capital can be organised on sole proprietorship or partnership basis. But if the financial requirements are huge, then the joint stock company form of organisation may be preferred.
- 6) **Extent of risk and liability:** You know business operations involve risk. If the promoters of a business enterprise are deterred by the risk involved, they will start the business on the basis of a limited liability. That means they can go for a company. In case they have capacity to bear the risk involved, it can be organised on sole proprietorship or partnership basis.
- 7) **Government regulations:** As you know the governmental controls and regulations are more in company form and cooperative form of organisations compared to the remaining two forms. If you do not want too much government control and regulation, you should choose either sole proprietorship form or partnership form.

### 3.4.2 Criteria at the Time of Expansion

Growth is a normal phenomenon in business. When your business is successful, naturally, you may plan to expand it. The expansion programmes may have the following implications.

- i) Need for larger financial resources.
- ii) Need for internal reorganisation and control.
- iii) Need for specialised services like communication, accounting, marketing, etc.
- iv) Increase in governmental controls and regulations.
- v) Increase in tax liability.
- vi) Increase in the problem of control and coordination

In fact the nature of these problems will depend upon the nature of the existing business and type of expansion programme undertaken. To implement your expansion programme, you can either continue with the existing form of organisation or adopt a new form of organisation. Whatever alternative you choose, it must be able to meet all requirements of expansion. If your existing business is organised as a sole proprietor concern, you can think about employing a manager or taking a partner. In case it is a partnership firm, you may have to choose between increasing the number of partners or converting it into a private limited company. Similarly, if your existing business is in the form of private company, you have the choice of converting it into a public limited company or not.

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### 3.5 CHOICE OF FORM OF ORGANISATION

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On the basis of the above discussion, we can conclude that the small business like grocery stores, hair dressers, small restaurants and hotels, small auto workshops, stationery shops, confectionaries, bakeries, dry cleaners, shoe manufacture and suppliers, small electric and electronics repair shops, barbers, tailors, etc., are predominantly sole trade organisations. The reasons for preferring sole proprietorship form of organisation for these types of businesses are abundantly clear. They function on small scale, cater to the needs of a limited market or deal with a restricted number of customers or dealers, and require a very limited capital. Moreover, they require the personalised attention of the owners to deal with a face-to-face situation. The managerial supervision can be tackled easily by the owner himself and the owner generally likes to be his own boss and active manager.

Business on a relatively larger scale is generally organised as partnership firm. Service enterprises like auto workshops, larger restaurants and hotels, large scale retail houses and medium scale industrial organisations are generally organised under partnership form. In these cases, the entrepreneurs would like to pool their capital, skills, experience, etc. as partners of a firm. The internal organisation of such undertakings is looked after by the partners who specialise in a particular activity in the enterprise.

In those enterprises where the risk involved is quite significant and scale of operation is medium, the likely choice will be the private company. Transport undertakings, hire purchase units, finance and leasing companies, medium scale manufacturing companies are generally organised as private limited companies. In these undertakings the requirements of capital are larger as compared to those of a partnership firm.

For large scale business operations, the most suitable form of business organisation is the public limited company. The large scale manufacturing plants, large transport undertakings, engineering and electronic companies, departmental stores, multiple shops, etc., are usually organised on the basis of public limited company. The principal reasons are the necessity of larger capital and the large amount of risk involved.

On the other hand, the cooperative form of organisation is suitable when the interest of a particular segment of society is to be promoted. Thus, the cooperative form of organisation is used largely for consumers, producers, farmers, etc.

#### Check Your Progress B

- 1) List the factors influencing the choice of organisation at the time of starting a business unit.

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- 2) State whether the following statements are True or False
- i) Higher the business volume, the lower is the capital requirement .....
  - ii) Sole trader or partnership forms are desirable when direct control of business is preferred .....
  - iii) Nature of the business does not have any influence on the choice of organisation form .....
  - iv) If the area of operation is very wide, partnership form is ideal .....
  - v) Company form is suitable in case of limited liability is desired .....
  - vi) Raising of capital to an unlimited extent is possible through public limited company .....
  - vii) Government regulations are more in the case of company form of organisation .....
- 3) Put a (  $\checkmark$  ) mark against correct answer.
- i) Suitable form of business organisation for a very small business is sole proprietorship/ company form.
  - ii) For large scale manufacturing business, suitable form of organisation is partnership/company form.
  - iii) Suitable form of organisation for medium size retail cloth business is partnership/company form
  - iv) To raise small amount of capital, suitable form is sole trade form/ cooperative form
  - v) If the risk element is very high, suitable form of organisation is partnership/private limited company

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### 3.6 LET US SUM UP

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The features of an ideal form of business organisation are ease of formation, limited liability, scope to raise enough capital, maintenance of business secrecy, flexibility, stability in operations, less governmental controls, less tax burden, higher managerial efficiency, and more ownership interest.

Comparison of the four forms of organisations shows that none of these forms have all the ideal features. Each form of organisation is good in some respects and not good in other respects. Sole proprietorship and partnership forms are ideal from the point of view of ease of formation, governmental controls, ownership interest, business secrecy, and flexibility. Company and cooperative forms are ideal from the point of view of limited liability, scope of raising capital, managerial efficiency, stability, and continuity of operations.

As none of the four forms is ideal in all respects, the entrepreneur has to choose the suitable form of organisation in the light of the objectives of his business. For choosing a suitable form of organisation at the time of launching the new business, the entrepreneur has to consider the nature of business, volume of business, area of operation, capital requirements, degree of control desired, expected life of business and desired level of governmental regulations. At the time of the expansion, depending on the situation, the entrepreneur can either continue the existing form or adopt a new form of organisation.

Based on the analysis it is concluded that the sole proprietorship is the suitable form for small business. If business is relatively larger, partnership is the proper form of organisation. Private limited company is ideal for medium sized business and public company is suitable for large scale business. The cooperative form of organisation is suitable when the interest of a particular segment of the society is to be looked after

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### 3.7 SOME USEFUL BOOKS

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Bhushan, Y.K., 1987. *Fundamentals of Business Organisation and Management*, Sultan Chand & Sons: New Delhi. (Part Two, Chapter 4).

Ramesh, M.S. 1985. *Principles & Practice of Modern Business Organisation, Administration & Management*, Kalyani Publishers: New Delhi. (Volume I, Chapter 10).

Singh B.P., and T.N. Chhabra 1988. *Business Organisation and Management*, Kitab Mahal: Allahabad. (Part One, Chapter 10).

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### 3.8 ANSWERS TO CHECK YOUR PROGRESS

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- A) 1. See Section 3.2
2. i) False (ii) False (iii) True (iv) True (v) True  
vi) True (vii) False
3. i) Sole trader, public limited company  
ii) Public limited company cooperative, sole trader  
iii) Sole trader  
iv) Cooperative  
v) Sole trade and partnership  
vi) Sole trade and partnership  
vii) Public limited company  
viii) Public limited company
- B) 2 (i) False (ii) True (iii) False (iv) False (v) True (vi) True  
vii) True
- 3 (i) sole proprietorship (ii) company form (iii) partnership  
(iv) sole trader form (v) private limited company

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### 3.9 QUESTIONS FOR PRACTICE

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- 1) Explain the features of an ideal form of business organisation. Which form can be considered to be an ideal in all respects?
- 2) None of the four forms of business organisations has all the features of an ideal form of organisation. Discuss.
- 3) Explain the factors determining the choice of the form of business organisation.
- 4) You plan to start a business. How would you choose the suitable form of organisation for your business?
- 5) Company form of organisation is the most ideal form for all types of businesses Discuss.
- 6) A partnership firm has decided to expand its business which requires more capital and expertise. Should it take more partners or convert it into a private limited company-Give your advice with suitable arguments.

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But, do not send your answers to the University. These are for your practice only.