3

FORMS OF BUSINESS ORGANISATION

Introduction

Legal Forms of Business
   - Sole Proprietorship
   - Partnership
   - Company
   - Not-for-Profit Organisation

Factors Influencing Organisation Structure
   - Set-up Time/Cost
   - Liability of Members
   - Taxation
   - Business Continuity
   - Management Control
   - Ability to Transfer Ownership
   - Ability to Raise Finance

Financial Reporting Implications

Summary

Introduction

It is important that owners and managers understand the legal environment in which businesses operate, not only as regards their own business but with respect to other firms with whom they have business dealings. This chapter considers the advantages and disadvantages of different business organisation structures and their accounting and financial management implications.

Legal Forms of Business

Business firms can operate under a number of different legal forms. The main forms are sole proprietorships, partnerships, limited liability companies and not-for-profit organisations. These are discussed below.
### Sole Proprietorship

A sole proprietorship (also referred to as a sole trader) is a business which is owned by one person and is the simplest form of business organisation. The sole trader has complete ownership of the firm's assets and is personally responsible (subject to certain limitations) for the liabilities of the business. The rewards in the form of profits from the business accrue solely to the business owner. It is very easy to start business as a sole proprietor. Normally the business will be in the name of the owner and there are no legal requirements to be met before operations commence. It should be noted that in some countries, for example, Australia, registration of the business name is necessary for sole proprietorships if the firm is not operating under the owner’s name. A sole proprietorship can continue as long as the owner wishes it to do so. It will of course terminate on the death of the owner since it is not a separate legal entity. A sole proprietorship business usually relies almost entirely on the enthusiasm and managerial ability of the business owner.

### Partnership

A partnership is a form of business organisation where two or more people participate in the management and contributed capital of a business entity and share in the profits. A partnership is thus a form of co-ownership but it is not a separate legal entity. In most cases the number of partners is small, although some partnerships of professional practices may have more than 70 partners, for example, lawyers, doctors, accountants. The formation of a partnership may be for the purpose of obtaining additional capital or for pooling of business experience or technical expertise. Generally the partners are jointly liable for the debts of the partnership. It is thus essential that an individual enters into a partnership arrangement only when they have total confidence in the other partners.

It is common practice, although not a legal requirement, for partnerships to have a partnership agreement which sets out the terms, rights and obligations of partners. For example, a partnership agreement will typically include:

- names of partners and the business name
- nature and purpose of the partnership business
- duration of the partnership
- capital contributions of each partner
- the manner in which profits and losses are to be shared between partners
- the extent of drawings permitted by partners
- the part each partner is to play in management of the partnership business
- the manner in which interest is to be paid on partners’ capital and advances
- the manner in which business accounting records are to be maintained and audited
- the extent of salaries to be paid to partners
- provisions relating to admission and retirement of partners
- provisions relating to death or bankruptcy of a partner
- provisions concerning settlement of disputes between partners
- banking, accounting and legal services to be used by the partnership as well as signing authority details.
In the event that a partnership agreement is not prepared, or if the agreement does not cover a particular matter, then the provisions of partnership law normally take effect. Some of the more common provisions of partnership law relate to an equal sharing of profit between partners, an equal contribution of capital between partners and an equal say in the running of the partnership business. Partnership law does not provide for payment of interest on partners' capital but does allow for interest to be paid on advances to the partnership business.

Company

A company is a separate legal entity. As such, it is able to hold property in its own name, sue and be sued, and function separately from its owners. Individuals contribute capital to a company and are known as shareholders. It is the shareholders in the company who elect company directors who in turn will appoint managers for the day to day running of the business.

An important difference between a company and a sole trader or partnership is that of limited liability. The liability of a shareholder for the debts of the company is limited to the amount which they have agreed to contribute by way of capital and also includes funds they have not yet been asked to contribute. This latter amount is referred to as uncalled capital. It should be noted that for small businesses operating as companies, the notion of limited liability is in some cases misleading. Generally the shareholders of a small business will, as a condition of lending, be required to make personal guarantees for the debts of the business. Another important distinction of the company form of business organisation is that it has unlimited life. This means it is not affected by the death or withdrawal of a particular shareholder from the business.

The formation of a company is more complicated than it is for a sole trader or partnership. Formation procedure for a company must follow statutory requirements and is therefore normally handled by a lawyer.

In New Zealand two acts, the Companies Act 1993 and the Financial Reporting Act 1993, are the primary sources of legislation for the control of companies. The requirements in these pieces of legislation make significant changes to the nature of companies and the way that they report. Furthermore, they mark a significant shift in the company law in New Zealand from an essentially British model to a more USA-oriented model for company reporting.

Some important changes resulting from these acts include:

- A company now has a constitution.
- Authorised capital no longer exists, nor does the concept of par value.
- When new shares are issued, the Board must establish a fair price and sign a certificate attesting to the fairness.
- The office of Company Secretary disappears.
- A company may buy back its own shares.
- Distributions may be made to shareholders as long as a solvency test is met, this test covers both liquidity and the solvency of the balance sheet.
- Directors are more liable to shareholders than they were in the past.
• Directors’ duties are now specified in the Act rather than scattered amongst many sources. Essentially they have a duty of care, must act in good faith for the company, must use their powers for a proper purpose and beware of trading when insolvent.


In summary, there have been significant changes to the legislation surrounding companies and their reporting and much of the change results in placing a greater onus on the Directors to take more responsibility for the solvency of the company, and this applies irrespective of company size.

Not-for-Profit Organisation

Not-for-profit organisations take a variety of different forms; for example, trade associations, social clubs, trade unions, churches, sports clubs. Not-for-profit organisations vary considerably in terms of their complexity and size and can range from sports clubs with a small membership to nationwide organisations such as the YWCA or the Plunket Society. Many not-for-profit organisations undertake a wide variety of trading or business activities.

Some not-for-profit organisations are incorporated societies. Incorporation means that the club or society is considered as a separate legal entity, in much the same way as a company. It has registered rules governing its operation and creditors will look to the society for payment and not to the individual members. An unincorporated society is not a legal entity and can be regarded as simply a collection of individuals jointly carrying out a particular activity. Since unincorporated societies cannot hold property in their own name the members can individually be sued. Thus, it is normal that when even small groups organise for non-profitable aims they incorporate the organisation. It should be noted that not-for-profit organisations having charitable, religious or educational objectives tend to be incorporated as charitable trusts rather than as incorporated societies.

Factors Influencing Organisation Structure

Having considered the major forms of business structure, it is necessary to consider factors which influence the eventual structure of a business entity. The factors which should be considered in relation to different forms of organisation are straightforward. However, it is not always clearcut as to which is the most appropriate structure for a particular business purpose. The elements which should be considered in determining the form of business organisation are summarised in Exhibit 3.1.
<table>
<thead>
<tr>
<th></th>
<th>Sole Trader</th>
<th>Partnership</th>
<th>Company</th>
<th>Not-for-Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Setup Time/Cost</strong></td>
<td>Nil</td>
<td>Nil, but partnership</td>
<td>Moderate cost, need</td>
<td>Unincorporated, nil.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>agreement recommended</td>
<td>approval for name, memorandum, articles of association</td>
<td>Incorporated, similar to a company</td>
</tr>
<tr>
<td><strong>Liability of members</strong></td>
<td>Unlimited</td>
<td>Unlimited, but may be</td>
<td>Limited, see earlier re: personal guarantees</td>
<td>Unincorporated, unlimited.</td>
</tr>
<tr>
<td><strong>(risk)</strong></td>
<td></td>
<td>modified by agreement</td>
<td></td>
<td>Incorporated, limited</td>
</tr>
<tr>
<td><strong>Taxation</strong></td>
<td>Owner taxed on profit</td>
<td>Partners taxed on share of</td>
<td>Company taxed, tax</td>
<td>Tax sometimes payable on</td>
</tr>
<tr>
<td></td>
<td></td>
<td>profits</td>
<td>imputed on dividends</td>
<td>trading profits</td>
</tr>
<tr>
<td><strong>Business Continuity</strong></td>
<td>Ceases on death of owner</td>
<td>Ceases on death of any</td>
<td>Perpetual existence</td>
<td>Perpetual existence</td>
</tr>
<tr>
<td></td>
<td></td>
<td>partner</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Management Control</strong></td>
<td>Rests largely with owner</td>
<td>Shared by partners, but</td>
<td>Delegated to Directors</td>
<td>Delegated by members to Executive</td>
</tr>
<tr>
<td></td>
<td>but manager may be</td>
<td>may differ by agreement.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>employed</td>
<td>Manager may be</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>appointed</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Ability to Transfer</strong></td>
<td>As required</td>
<td>Requires consent of all</td>
<td>Freely transferable,</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>Ownership</strong></td>
<td></td>
<td>partners</td>
<td>possible restrictions in small</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>private companies</td>
<td></td>
</tr>
<tr>
<td><strong>Ability to Raise Finance</strong></td>
<td>Restricted capital, lending criteria more rigorously applied</td>
<td>More than one capital contributor, lenders more willing to contribute as less perceived risk</td>
<td>Diverse ownership and wider capital base possible. Favoured by lenders</td>
<td>Borrowing difficult for unincorporated societies</td>
</tr>
<tr>
<td><strong>Number of Owners</strong></td>
<td>One</td>
<td>Two to 25 except for</td>
<td>One or more</td>
<td>Not applicable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>professional partnerships</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Set Up Time/Cost

Sole traders and unincorporated not-for-profit organisations are very similar in terms of set up time and cost. A club, society or individual can start business almost immediately without incurring any cost. For partnerships a written agreement is normally drawn up, possibly by a lawyer, and therefore legal costs and some time delays are likely to be incurred. The most lengthy time delay and cost is associated with the formation of a company. The process of company formation is carried out by a lawyer and preparation of the Constitution takes time; but given the unlimited life of a company the time and costs incurred in setting up are not significant.

### Liability of Members

Sole traders and partnerships have unlimited liability. That is, creditors of these businesses can look to the individual(s) for the payment of debts. Certain protections are however permitted under bankruptcy law to ensure that an individual does not lose absolutely everything that he or she owns. However, personal assets may be sold to pay the debts of the business. In the case of partnerships, the actions of one partner can force all the partners into bankruptcy. Shareholders in a company have limited liability; in other words, their liability is limited to the amount of uncalled capital on the shares to which they have subscribed. In many smaller companies, personal guarantees by owners and directors will be required as a condition of lending which can largely negate the limited liability protection.
Chapter 3: Forms of Business Organisation

Taxation

For sole traders, the owner is taxed on the total profit of the firm for a particular period. The situation for partnerships is essentially the same in that partners are taxed on their share of the profits, at personal tax rates. For companies, double taxation used to exist whereby the company was taxed on its profits and the dividends were also taxed in the hands of the shareholders. This arrangement prejudiced the company when compared with a sole trader. Further, there existed little justification for the double taxation besides revenue gathering. It was possible to have two organisations providing identical services, differing only in name and business form, but one being subject to greater taxation than the other. The problem of double taxation still exists in some countries.

Taxation imputation has now been introduced into New Zealand whereby credit is given to the individual taxpayer for the tax that was deducted from company profits before arriving at the retained earnings out of which the dividend was paid.

Example

A company pays 33 cents in the dollar on its income. Dividends are then paid out of this tax paid profit. The shareholders receive $100 in dividends and these would be disclosed in the tax return as $149 \[100/(1 - .33)\] and a tax credit (similar in some ways to the effect of PAYE) for $49 would be claimed.

Business Continuity

Sole traders and partnerships have limited life: both cease on the death of the owner or partner. A company, on the other hand, has perpetual existence and can continue indefinitely as can not-for-profit organisations. The company form of business organisation has thus a significant advantage in terms of continuity.

Management Control

Management control rests totally with the owner in a sole trader situation. He or she is able to do as they wish as far as the business is concerned. In a partnership, authority is shared equally, in principle, although this may be modified by the partnership agreement. For companies, the members elect directors at an Annual General Meeting and it is the directors who have the authority for the day to day running of the business. In not-for-profit organisations, management authority is delegated by members to an elected executive.

Ability to Transfer Ownership

Sole traders can transfer ownership of the business as they wish. The price will be set by negotiation between the buyer and seller. Partnerships, on the other hand, being personal relationships, normally require the consent of all parties before an ownership interest can be transferred to another party. When one considers the unlimited liability of partnerships it is not surprising that transfer of ownership interest requires this consent. Interest in companies is normally freely transferable. However, small private companies may have particular restrictions in their Articles of Association on the transfer of shares, simply because they are essentially still limited liability businesses with very much a personal relationship between
shareholders. Therefore, in small private companies, ownership interests may only be transferred with the consent of the other shareholders.

**Ability to Raise Finance**

It can be difficult for sole traders to raise finance since there is only one source of capital and lenders tend to be more rigorous in applying lending criteria. Statistics show that small businesses, which include most sole traders, cease business within the first five years. Sole traders also find it difficult to give adequate security for their borrowing. In partnerships there are a number of different ownership interests contributing capital which makes the raising of finance easier. In addition, lenders have recourse to all of the partners. Companies have the opportunity to have a large number of shareholders who expect a return on their funds and it is generally not difficult for a public company to obtain finance through the sharemarket. Lenders normally favour a company form of organisation although for small companies it is quite common for personal guarantees to be sought in addition to the securities that are able to be offered by the company. Security for loans in terms of debentures and securities over stock and plant are available only to the company form of organisation. It is generally difficult for not-for-profit organisations to raise finance and particularly for those which are not incorporated.

**Financial Reporting Implications**

The same basic principles of accounting apply to all forms of business organisation, whether we are dealing with a manufacturer, a retailer, a service organisation or a sports club - all need similar financial recording systems. Differences do, however, arise in the area of financial reporting. Sole proprietors and partners are normally closely involved in the management of their business. It is therefore most likely that they will have access to the financial information they require and will be in a position to determine (or at least influence) the format and content of financial reports prepared by the firm.

The reporting of financial information to company shareholders or to members of not-for-profit organisations fulfills a different need. In these organisations the directors and executive are acting as stewards on behalf of the members in general and will have (or at least should have) regular financial reports to assist them in the management process. Annual financial statements will normally be prepared for shareholders or members. These statements provide the only check as to good stewardship on the part of the directors/executive. Responsibility for preparation of these financial statements rests with the directors or executive and it is normal, and indeed desirable, that these statements be examined and reported on by an independent party, an auditor, in order to add to their credibility.

Financial reporting for companies is regarded as being of particular importance. Company and Securities legislation contains minimum financial reporting requirements. This is supplemented by professional statements of standard accounting practice and stock exchange listing requirements for those companies whose shares are listed on the Stock Exchange.
Financial reporting is only part of the responsibility of public sector organisations. The public sector makes up a large part of the economy of any country, and their accountability is not solely driven by financial accounting. Chapter 22 discusses this sector in greater detail.

Summary

There are many forms of business organisation and a number of factors must be borne in mind when deciding on the most appropriate organisation structure for a venture.

Matters such as set-up time/cost, legal liability, taxation, business continuity, management control, ability to transfer ownership and ability to raise finance must all be carefully considered when a business venture is being established. If one is in the business of extending credit, then the legal form of the business requesting finance is very important.

Glossary of Key Terms

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td>A separate legal business entity.</td>
</tr>
<tr>
<td>Partnership</td>
<td>A business owned by more than one person.</td>
</tr>
<tr>
<td>Sole Proprietor</td>
<td>A business owned by a single individual.</td>
</tr>
</tbody>
</table>

Selected Readings


Questions

3.1 Define the following terms:
   a. Sole trader
   b. Partnership
   c. Company
   d. Not-for-profit organisation

3.2 List four advantages of the partnership business form over that of a sole trader.

3.3 Identify five factors which are likely to be outlined in a ‘Partnership Agreement’.

3.4 What is the nature of the liability in a partnership?

3.5 What are the main differences which affect the accounting and financial needs of:
   a. A sole trader and a partnership?
   b. A company and a partnership?

3.6 Explain why more business firms operate as companies than partnerships. Why do accounting and legal practitioners operate as partnerships?

3.7 Does a partnership pay tax? Explain your answer.

3.8 Prepare an executive summary for delivery at the Annual Meeting of the Slow Foxtrot Club on the advantages and disadvantages of incorporation.

3.9 Discuss the significance of the limited liability of company shareholders.
3.10
You and two friends have decided to go into business together. Select a business activity with which you are familiar, describe the nature of the business, draw up a report discussing alternative business forms and make recommendations for a preferred structure as it relates to the needs of the particular business.

3.11
Give a brief description of each of the following forms of business organisation and state two advantages of each.

a. Partnership
b. Company
c. Sole Trader