

# Forms of Business Organisation

## Forms of Business Organisation

### Forms of Business Organisation

The following are the various forms of business organisation:



- Sole proprietorship
- Joint Hindu family business
- Partnership
- Cooperative society
- Joint stock company

#### ❖ Sole Proprietorship

➤ **Meaning:** Sole proprietorship is a form of business that is **owned, managed and controlled by a single individual** (known as the sole proprietor) who is the sole recipient of all the profits earned by the business and bears all the losses.

## ➤ Features of sole proprietorship

### Features of Sole Proprietorship



- No legal formalities while forming or closing the business
- Owner has unlimited liability
- Owner is single recipient of all the risks & profits of the business
- Business & owner has same identity
- Owner takes all decisions independently
- Lack of business continuity

1. **No legal formalities are involved** in forming or closing down a sole proprietorship business.
2. A sole proprietor **has unlimited liability**, which implies that the personal assets of the proprietor will be used in case the business assets fall short of the amount required for debt payments.
3. The sole proprietor is the **single recipient of all the profits of the business and bears all the risks**.
4. He or she **takes all the business decisions independently** and enjoys total control over the business operations.
5. The sole proprietorship business **has no legal identity separate from its owner**.
6. **It lacks business continuity** in the sense that such situations as the death, ailment or bankruptcy of the sole proprietor may cause its closure.

## ➤ Merits of sole proprietorship

A sole proprietor enjoys the following benefits.

1. **Ease of formation and closure of business**, as no legal formalities are required for setting up or for closing down the business
2. **Complete and independent control** over the business, thereby enabling quick decision-making
3. **A direct incentive** to operate the business efficiently and effectively, being the sole

recipient of the profits

4. **High confidentiality**, as the sole proprietor is not bound by the law to publish the accounts

5. **A feeling of satisfaction and self-confidence**, as he or she is responsible for the gains in the business

6. **High flexibility in operations**, because, as the sole owner, he or she can readily adapt to the changes in the business environment

7. **Minimum government regulations**

➤ **Limitations of sole proprietorship:**

The following are a few limitations of a sole proprietor firm.

1. **Limited capital** in the form of only the personal savings and borrowings of the proprietor

2. **Lack of specialisation** in various managerial functions as the proprietor manages the business all alone

3. **Risk to the personal assets** of the proprietor, as these assets may be used for debt repayments if there is any shortage of funds

4. **Risk of closure** caused by such situations as the death, ailment or bankruptcy of the sole proprietor or other adverse situations

5. **High probability of wrong decisions**, because the proprietor is the sole decision-maker

➤ **Suitability of sole proprietorship**

The sole proprietor form of business is suitable in the following instances:

- The business requires limited capital and managerial skills.
- There is a need to maintain personal relations with the customers
- The demand for the products is highly elastic and open to the market conditions.
- The proprietor wants to earn a living using his or her own skills.

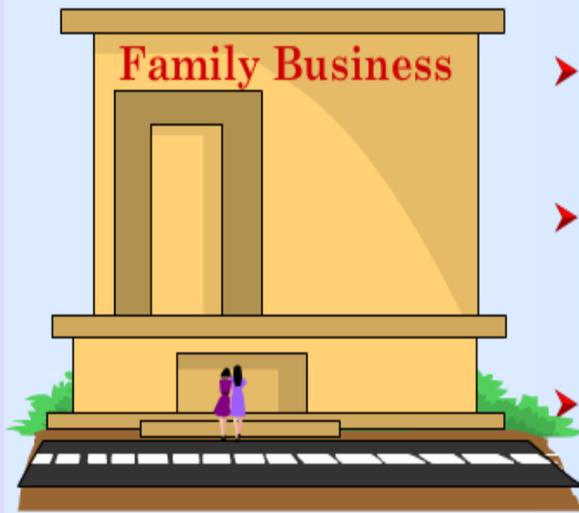
❖ **Joint Hindu Family Business**

➤ **Meaning:** The Joint Hindu family business is a form of business organisation that is

- Jointly **owned and run by the members of a Hindu undivided family**
- Governed by the **Hindu Succession Act, 1956**
- Controlled by the **karta** (the eldest member and head of the family) with all the other members (co-partners) enjoying equal ownership rights over the business property

➤ **Features of a joint Hindu family business**

## Features of a Joint Hindu Family Business



- Enjoys continued existence
- Requires minimum of 2 members
- *Karta* is head & has unlimited liability
- Decisions of *karta* are binding
- A minor has membership rights

1. It **enjoys continued existence** and remains unaffected by the death, insolvency or insanity of the **karta**. In such situations, the next eldest member takes over the business responsibilities.
2. It **requires a minimum of two members** with some ancestral property.
3. The **karta, being the head of the joint Hindu family, has unlimited liability** over the business, while the **other members have limited liability** to the extent of their share in the family business.
4. The **decisions of the karta are binding** on all the members of the family business.
5. **A minor also has membership rights** in the business—that is, membership in the family business is acquired by the virtue of birth.

### ➤ Merits of a joint Hindu family business

The following points highlight the advantages of a joint Hindu family business.

1. Complete control by the **karta** enables **proper administrative control and quick decision-making**.
2. A joint Hindu family business **enjoys continued business existence** and is not affected by such events as the death, insolvency or insanity of the **karta** as in such situations the next eldest person takes over the **karta's** responsibilities and becomes the **karta**.
3. The **liability of all the members or co-partners (except the karta) is limited to the extent of their share** in the family business.

4. As the business is run by the members of a family, there exist **greater cooperation and loyalty**.

➤ **Limitations of a joint Hindu family business**

1. It enjoys **limited resources** to the extent of the ancestral property inherited by the members.
2. The **karta has unlimited liability** in the family business—that is, his personal property can be used in case the business assets are not sufficient to repay debts.
3. **There exists dominance by the karta**, in the sense that all the decisions are taken by him, which at times may not be acceptable to other members of the family.
4. **Managerial skills are limited**, because it is not necessary that the **karta** has expertise in all the fields of operation of the business.
5. The **continuity of the business depends on the continuity of the joint family**. In case the family breaks up, the business ceases to exist.

❖ **Partnership**

➤ **Meaning:** A partnership is a form of business organisation in which two or more individuals agree to form a business by pooling their resources and share the profits between them.

➤ **Features of a partnership**

## Features of Partnership



- Governed by Indian Partnership Act, 1932
- Liability of partners is unlimited.
- Business risks & profits are shared
- Decisions are taken jointly
- Lack of continued existence
- Requires minimum of 2 adult members
- Mutual association of 2 or more members

1. The formation of a partnership is governed by the **Indian Partnership Act, 1932**, and a partnership comes into existence with a legal agreement that includes all the conditions governing the partnership.
2. A partnership is **a mutual association of two or more individuals** who agree to jointly undertake certain business operations and share the profits and losses.
3. The **liability of all the partners is unlimited**.
4. **The business risks as well as the profits are shared among the partners**.
5. Business **decisions are taken by jointly** by the partners.
6. A partnership **does not enjoy continued existence** as the death, lunacy, insolvency or insanity of any of the partners brings an end to the partnership. However, the rest of the partners may decide to continue business under a new partnership agreement.
7. A partnership **requires the existence of a minimum of two adult members**, who agree to share profits and losses.

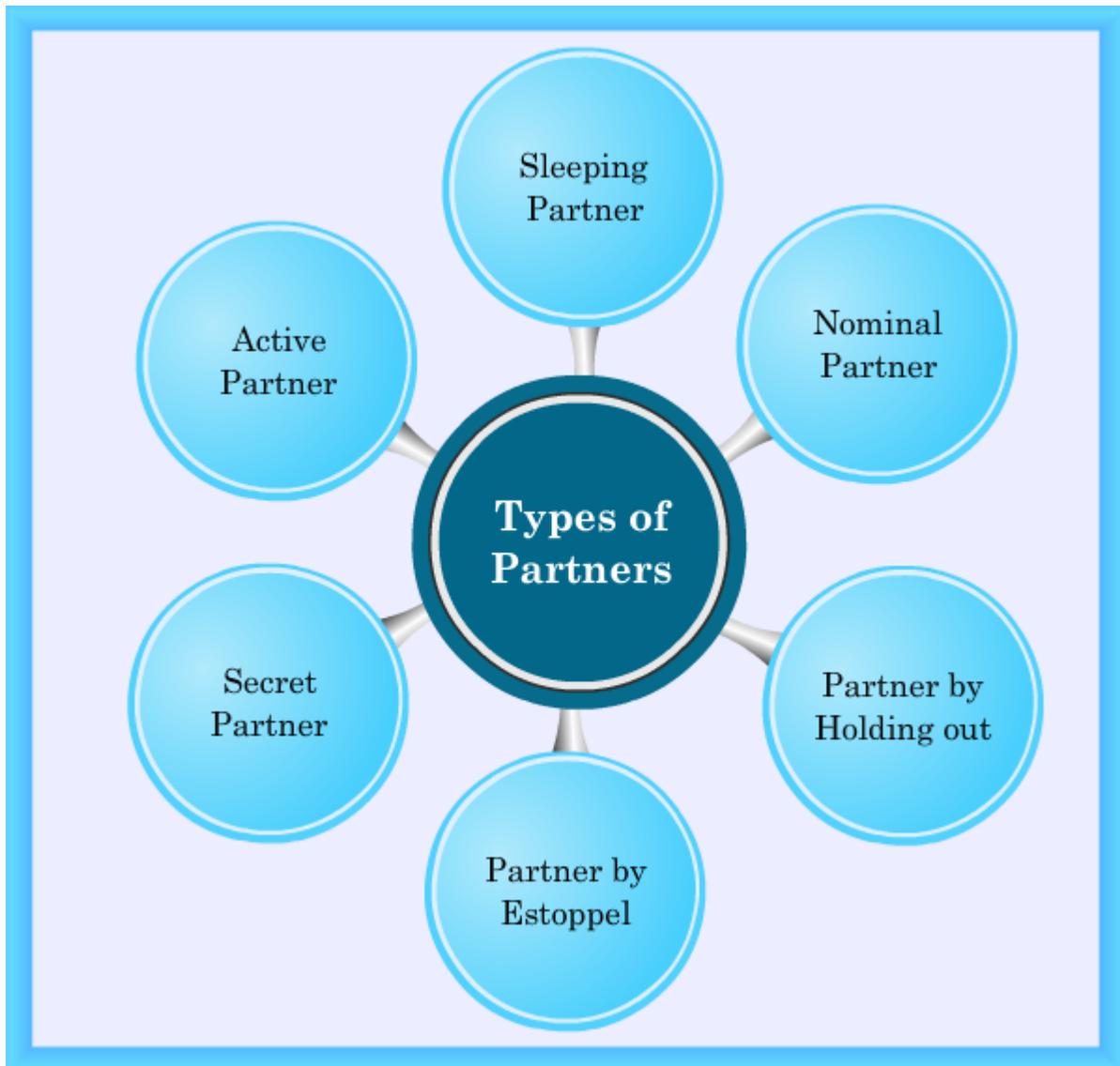
➤ **Merits of a partnership**

1. The **formation and closure** of a partnership are procedures free from problems—its formation does not require mandatory registration and it can be ended at any time with the mutual consent of all the partners.
2. **Decision-making is balanced** as all the decisions are taken collectively by all the partners.
3. The **risks are shared by all the partners**, thereby reducing the burden on any single partner.
4. As the partners pool their capital and resources, there is **greater availability of funds** for the business.
5. As the partnership firm is not required to publish its accounts or submit reports legally, **confidentiality and secrecy of information are maintained**.
6. There are not many restrictions laid down under the Partnership Act, and therefore a partnership **enjoys greater flexibility**.

➤ **Limitations of a partnership**

1. **All the partners have unlimited liability**—that is, if the firm's assets fall short of the requirement for the repayment of the firm's debts, then the personal assets of the partners can be used.
2. **The availability of finance is limited**, because of the restrictions imposed on the following fronts:
  - i. The maximum number of partners allowed in a partnership firm by definition.
  - ii. The maximum number of new partners who can be admitted into the firm.
3. As decision-making is shared among the partners, there may arise **differences in their views and, therefore, conflicts**.
4. **Continuity** of business may be affected by situations such as the retirement, death or insolvency of any of the partners, which would lead to the closure of the partnership firm.
5. As a partnership firm is not required to publish its account or reports legally, it **faces lack of public faith and confidence**.

➤ **Types of partners**



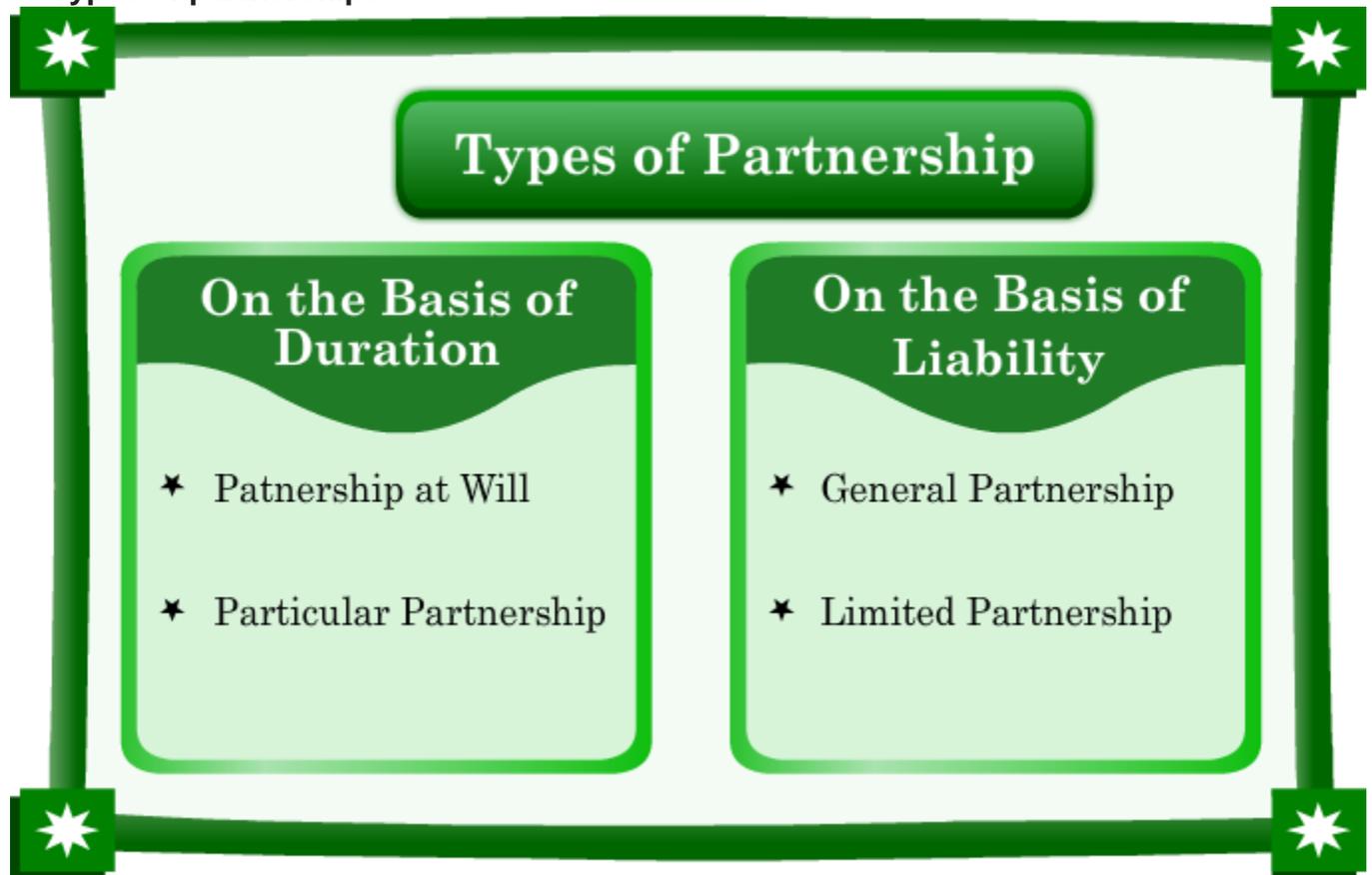
The types of partners are differentiated on the basis of the following points.

- Capital contribution
- Participation in management
- Profit and loss sharing

The following table depicts the various types of partners:

<i>Partners</i>	<i>Capital contribution</i>	<i>Participation in management</i>	<i>Profit and loss sharing</i>
<b>Active partner</b>	✓	100% ✓	✓
<b>Sleeping partner</b>	✓	✗	✓
<b>Secret partner</b>	✓	Secretly ✓	✓
<b>Nominal partner</b>	✗	✗	✗
<b>Partner by estoppels</b>	✗	✗	✗
<b>Partner by holding out</b>	✗	✗	✗

➤ Types of partnerships



<b>Types of partnership</b>	
<i><b>On the basis of duration</b></i>	<i><b>On the basis of liability</b></i>
<p>1. <b>Partnership at will:</b> Exists as long as the partners wish to carry on the partnership, and ends when a partner gives notice to the firm of withdrawal of his/her partnership from the business</p>	<p>1. <b>General partnership:</b> Partners have unlimited liability</p> <ul style="list-style-type: none"> <li>• Registration is optional</li> <li>• Is affected by the death, lunacy, insolvency or retirement of any of the partners</li> </ul>
<p>2. <b>Particular partnership:</b> Formed for the accomplishment of a particular project and ends as soon as the project is completed or at the maturity of the time duration for which the partnership was formed</p>	<p>2. <b>Limited partnership:</b> Liability of the partners is limited to the share agreed by them in the partnership agreement</p> <ul style="list-style-type: none"> <li>• Must be compulsorily registered with the Registrar of Firms</li> </ul>

➤ Partnership deed

A partnership deed is a document containing all the terms and conditions of a partnership. Preparation of a partnership deed prevents misunderstandings and conflicts among the partners.

A partnership deed generally has the following **components**:

- i. Name of the firm
- ii. Nature of the business activities and the place where they take place
- iii. Duration of the partnership
- iv. Capital contributed by each partner
- v. Profit- and loss-sharing ratio
- vi. Duties and responsibilities of the partners
- vii. Salary to be paid to each partner and the amount of withdrawals permitted
- viii. Terms of admission and expulsion of a partner, and terms for retirement
- ix. Interest earned on capital and interest charged on drawings
- x. Steps to be followed at the time of dissolution of the partnership
- xi. Account preparation and auditing
- xii. Methods of solving disputes in the business and among the partners

#### ➤ **Registration**

The following are the **steps** that a partnership firm (for example, 'Nag Ltd.')

 must follow in order to get itself registered with the Registrar of Firms.

**Step 1: Submitting an application** containing all the important details, and duly signed by the partners of Nag Ltd., to the Registrar of Firms. The application should contain the following information.

- i. Name of the firm
- ii. Location of the firm
- iii. Names of places where the firm carries out its business
- iv. Dates of joining of all the partners
- v. Name and address of each partner
- vi. Duration of partnership

**Step 2: Depositing the application and the fees prescribed** with the Registrar of Firms.

After Nag Ltd. completes the two steps mentioned above, the Registrar of Firms examines the documents, enters the name of the firm in the Register of Firms and issues a certificate of registration to Nag Ltd.

#### ➤ **Consequences of non-registration of a partnership firm**

- a. **Partners cannot file a suit against any third party**; however, other firms can file a suit against the partnership firm.
- b. **The firm cannot file a suit against partners**; moreover, a partner of a non-registered firm cannot file a case against his/her co-partners or the firm.
- c. **The firm cannot file a suit against other firms** and cannot enforce its claims against a third party in a court.

#### **Role of minor in partnership firm**

As per the Partnership Act, 1923, **no minor can be a partner in a partnership firm**. However, **with the consent of all the partners, a minor can be admitted to share the profits** of the firm. But the minor cannot be asked to either contribute capital or bear the losses incurred by the business.

#### ➤ **Suitability of a partnership**

- Where the business operates on a small or medium scale
- In case a need is felt to maintain a personal touch with customers
- Where individuals with qualifications decide to form a partnership by contributing capital

### ❖ Cooperative Society

#### ➤ Meaning

- A cooperative society is formed when individuals **voluntarily** come together to protect and promote their common interests.
- It is **managed by an elected body** known as the managing committee .
- Elections in a cooperative society are based on the principle of '**one member, one vote**'.

#### ➤ Features of a cooperative society

### Features of a Cooperative Society



- Has a separate legal entity.
- Democratic form of organisation.
- Membership is on voluntary basis.
- Liability of members is limited.
- Serve social values & welfare.

i. As registration of a cooperative society is compulsory under the Cooperative Societies Act, 1912, it has a **separate legal entity**. This has the following implications.

- It can hold properties in its own name and enter into contracts.
- It can sue others and can be sued by others.

ii. A cooperative society is a **democratic form of organisation** as it is managed and controlled by a managing committee that is elected by the members of the society on the principle of 'one member, one vote'.

iii. The **membership is on voluntary basis** and is not affected by caste, gender or religious considerations.

iv. The **degree of liability of a member is limited to the extent of the amount of capital contributed** by him or her.

v. Cooperative societies are basically established to promote the common interest of the members and **serve social values and welfare**.

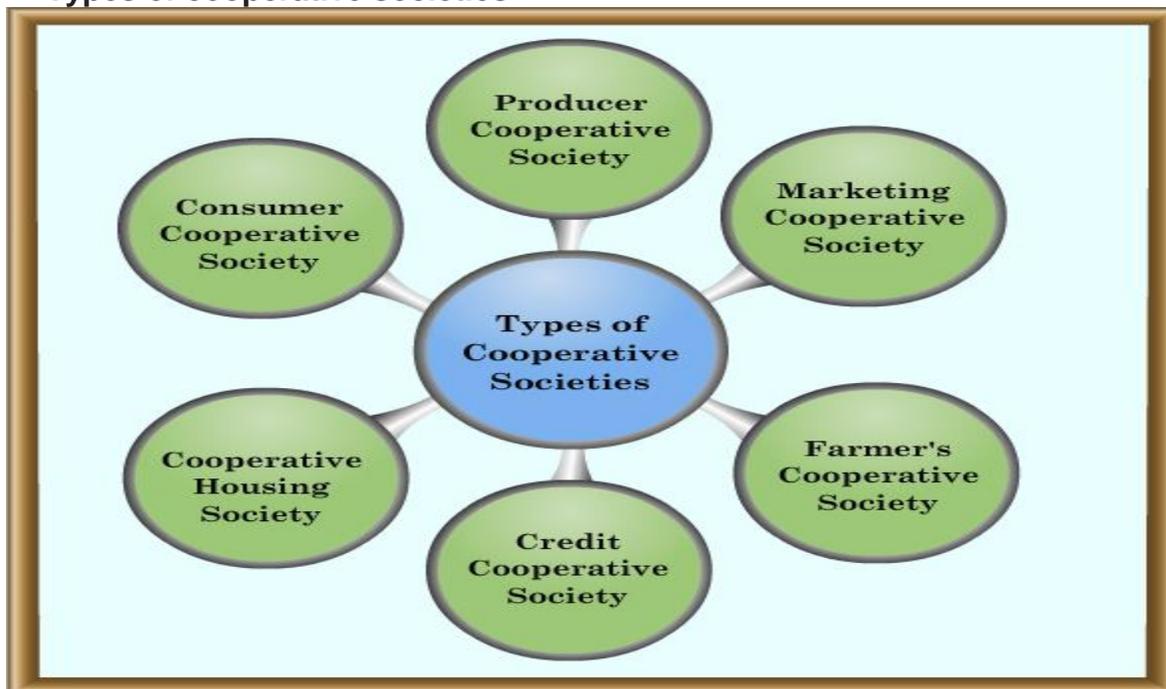
➤ **Merits of a cooperative society**

- i. **The formation of a cooperative society is a simple procedure** as it requires the induction of only 10 adult members. The registration procedure is also quite simple.
- ii. **A cooperative society enjoys continued existence** and remains unaffected by the death, insolvency or insanity of its members. This is because it enjoys the status of a separate legal entity that is considered distinct from its members.
- iii. It serves the **value of equality through its policy of 'one member, one vote'** regardless of the share of capital contributed by the individual members.
- iv. Members have **limited liability** to the extent of capital contributed by them.
- v. As a cooperative society is established for social welfare and exemplifies democracy, it enjoys **government support** in the form of low taxes and interest rates, subsidies, etc.
- vi. As the services offered by a cooperative society eliminate the need for middlemen, they help the members reduce **the cost of their business operations**.

➤ **Limitations of a cooperative society**

- i. A cooperative society is **subject to the rules and regulations as imposed by the cooperative departments** of the state government concerned.
- ii. As the management of a cooperative society generally comprises part-time or inexperienced people, it lacks **efficiency in management**.
- iii. The total **resources are limited** to the extent of the capital contribution by its members.
- iv. In view of the open discussions and meetings, a cooperative society **lacks secrecy in operations**.
- v. Because of differences of opinions, **conflicts among the members may arise**.

➤ **Types of cooperative societies**



<b>Type of cooperative societies</b>	<b>Objective</b>
<i>Consumer cooperative societies</i>	To provide goods at reasonable prices to the member consumers
<i>Producer cooperative societies</i>	To procure raw materials and other inputs at low costs and supply them to small producers
<i>Marketing cooperative societies</i>	To pool the output of each member and perform certain marketing functions for them, such as transportation, labelling, packaging and warehousing
<i>Farmers' cooperative societies</i>	To pool the resources of small farmers so as to enable them to reap the benefits of large-scale operations and ensure the availability of better and advanced inputs at low rates to them
<i>Credit cooperative societies</i>	To ensure the availability of credit to the members at reasonable interest rates and on reasonable terms
<i>Cooperative housing societies</i>	To ensure the provision of residential accommodation to the members at reasonable rates

#### ❖ **Joint Stock Company**

A joint stock company is a form of business organisation wherein a group of persons form an association in order to perform business activities together. It is considered to be the most superior form of business organisation.

#### ➤ **Features of a joint stock company**

Features of a Company



- **Artificial person**
- **Separate legal identity**
- **Formation requires legal formalities**
- **Enjoys perpetual succession**
- **Management is under Board of Directors**
- **Liability of owners is limited**
- **Use of common seal**
- **Risks are shared jointly.**

- i. A **joint stock company is regarded as an artificial person**. Unlike human beings, a company cannot sign its documents, cannot negotiate with its customers and cannot breathe or talk. But, like human beings, a company has a life of its own that is truly independent of the lives of its members.
- ii. It is considered to be a **separate legal entity** distinct from its members, and can, therefore, carry out business in its own name and own assets in its own name.
- iii. The **formation of a joint stock company requires the fulfilment of certain legal formalities** that are mandatory under the Indian Companies Act, 1956.
- iv. A joint stock company enjoys **perpetual succession** and is not affected by such situations such as the death, retirement or insolvency of any of the members of the company.
- v. **The management and control are under the elected board of directors, and ownership lies in the hands of the shareholders.**
- vi. The **liability of the owners (shareholders) is limited** to the amount of capital invested by them in the business.
- vii. The board of directors use the **common seal** (official signature of the company) on all the important official documents to validate them.
- viii. Just as the profits are shared in the form of dividends, the **risks are also shared jointly by the shareholders.**

➤ **Merits of a joint stock company**

- i. The **liability of the shareholders is limited** to the amount paid by them for the shares purchased.
- ii. A joint stock company **enjoys perpetual existence** and does not face closure by itself even if all its members pass away.
- iii. **The capital can be easily expanded** by issuing fresh, new shares.
- iv. Generally, a joint stock company hires **professionals and specialised managers** for handling its complex operations.
- v. The **ownership of shares is freely transferable** in a company, which acts as an incentive for investors to invest in the company.

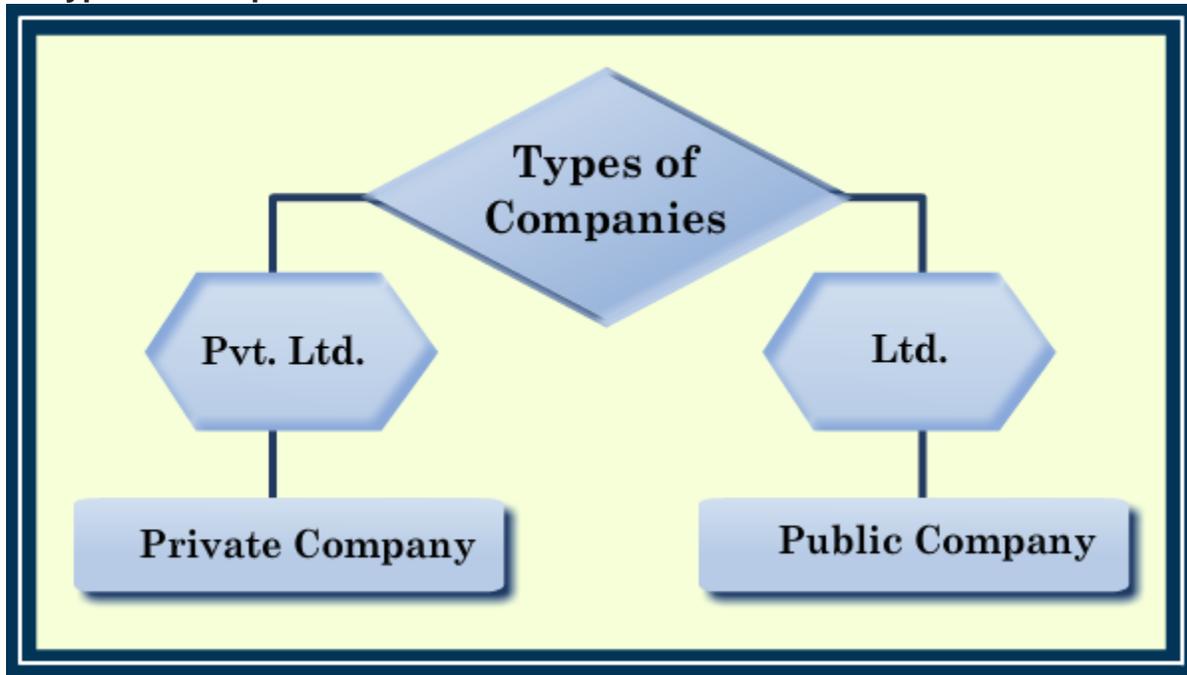
➤ **Limitations of a joint stock company**

- i. Its **formation requires the completion of a large number of procedures and formalities**, which make the procedure lengthy and expensive.
- ii. It **lacks secrecy** because of the mandatory requirement of submission of information about its operations to the Registrar of Companies.
- iii. It **has an impersonal work environment**, in which the management and ownership are separated. The compensation of the management is not directly affected by the profits of the company, and it is often difficult for the owners to keep a track of all the business operations.
- iv. **Many regulations must be followed**, such as auditing of accounts, voting and filling of reports and documents, which restricts the operational freedom.
- v. The hierarchy system followed often **delays decision-making**.
- vi. A joint stock company follows an **oligarchic management style**—it is owned by the shareholders, whereas its management and control are handled by the board of directors. Moreover, the owners have little influence over the control and functions of

the company.

vii. The separation of ownership and management often results in ***situations of conflict***.

### ➤ Types of companies



#### **Private company**

A private company has the following features.

- i. It is formed with a ***minimum of two members and a maximum of 50 members***.
- ii. It can ***start business operations right from the day of receipt of the certificate of incorporation***.
- iii. It has a ***minimum paid-up capital of Rs. 1 lakh*** or a higher paid-up capital as may be prescribed by its articles.
- iv. It ***does not issue shares to the public***.
- v. It ***uses the short form 'Pvt. Ltd.'*** (private limited) with its name.

#### **Public company**

A public company has the following features.

- i. It is ***formed with a minimum of seven members***. There is no limit on the maximum number of members.
- ii. It has a ***minimum paid-up capital of Rs. 5 lakh***. However, this amount is prescribed from time to time.
- iii. Its ***shares are feely transferable*** from one party to another.
- iv. It is ***permitted to invite the general public to subscribe to its shares***.

### ➤ Privileges enjoyed by a private company over a public company

- a. ***Lesser number of members required***: A private company requires only two members for formation, whereas a public company requires at least seven members.
- b. ***Commencement of business***: A private company can start its business operations

right from the day of receipt of the certificate of incorporation. On the other hand, it is mandatory for a public company to obtain a certificate of commencement along with a certificate of incorporation before starting business.

**c. No restriction on advancing loans to the directors:** In a private company, there is no restriction on the amount of loans that can be granted to the directors and no prior permissions are required to be sought for advancing such loans. In contrast, a public company has to seek permission from the government before advancing loans to its directors.

**d. Lesser number of directors required for operations:** A private company can continue operations with just two directors, whereas a public company must have at least three directors to continue its operations.

**e. Issue of prospectus:** In the case of a private company, there is no need to issue a prospectus to the general public as they are not invited to subscribe to the shares. However, it is a necessity in the case of a public company.

**f. Allotment of shares:** A private company can allot its shares even though it has not received the minimum subscription. However, this is not the case with a public company, which needs to receive the minimum subscription before it can allot its shares.

**g. Index of members:** Keeping an index of the members and employees is not mandatory for a private company, but it is necessary in the case of a public company.

#### ❖ Difference between different forms of business organisations

<i>Basis of difference</i>	<i>Sole proprietorship</i>	<i>Partnership</i>	<i>Joint Hindu family business</i>	<i>Cooperative societies</i>	<i>Company</i>
<b>Formation</b>	Easy formation	Easy formation	Easy formation	Lengthy and difficult	Lengthy and difficult
<b>Members</b>	1 - Owner	Minimum - 2; maximum - 0 for banks, 20 for others	Minimum - 2; maximum - no limit	Minimum -10; maximum - no limit	Minimum, private - 2, public - 7; maximum, private - 50, public - no limit
<b>Capital contribution</b>	Limited	Limited, but comparatively higher than in sole proprietorship	Ancestral property	Limited to the capital contribution of members	Large
<b>Regulating Act</b>	No such act	Hindu Law and Hindu Succession Act, 1956	Indian Partnership Act, 1932	Companies Act, 1956	Cooperative Societies Act, 1912, or State Cooperative Act

<b>Liability</b>	Unlimited	Unlimited but joint	Unlimited for <i>karta</i> , limited for others	Limited	Limited
<b>Separate legal identity</b>	No, owner and business are one	No	No	Yes	Yes
<b>Control</b>	Managed by owner	Managed by partners	Managed by <i>karta</i>	Managed by elected representatives	Managed by board of directors
<b>Continuity</b>	Unstable	Comparatively stable	Stable	Stable	Stable

### ❖ Choice of Form of Business Organisation

#### ➤ Why this choice is important

- There are **various forms of business organisation**, and each has its own merits and demerits.
- **Business factors**, namely, need for funds, risk involved, amount of profits and legal obligations, have a bearing on the form of business organisation chosen.
- **There are differences in the long-term growth prospects** of different forms of business organisation.

#### ➤ Factors to be considered while choosing a form of business organisation

### Factors to be Considered while Choosing a form of Business Organisation

- Nature of Business Activity
- Degree of Control
- Degree & Specialisation of Managerial Abilities
- Extent of Liability
- Cost & Ease of Formation
- Continuity
- Capital Consideration

#### 1. Nature of business activity

- If the business requires **direct personal contact** with customers, then **sole proprietorship is the best choice**.
- If the business **does not require direct personal contact**, then a **partnership or a company** should be chosen.

## **2. Degree of control**

- If **direct and a high degree control** is required, then **sole proprietorship**
- If **sharing of decision-making power** is acceptable, then **partnership or company**

## **3. Degree and specialisation of managerial abilities:**

- If the business operations are large and **require specialised and skilled professionals**, then a **company**
- If the business operations are not very **complex and the scale of operations is also not very large**, then **sole proprietorship**

## **4. Extent of liability**

- If the **liability of the owner or the partners is unlimited** then, **sole proprietorship and partnership**
- If the **liability of the members is limited** to the amount of the shares held, then **company**

## **5. Cost and ease of formation**

- A **sole proprietorship** or **partnership firm** requires **a limited sum of money and is easy to form**.
- A **company or cooperative society** involves the completion of **a large number of legal formalities, incurring a high cost**.

## **6. Continuity**

- A family business, cooperative society and a company are not affected by situations such as the death or insanity of the owners.
- A sole proprietorship and a partnership are affected by the death of the owners.

## **7. Capital considerations**

- Companies and partnerships find it easy to raise more capital.
- Sole proprietorships and joint Hindu family businesses have no provision for capital expansion.

## **Formation of a Company**

The following sequential stages are involved in the formation of a company.

# Stages in Formation of a Company



- a. **Promotion** of the company
- b. **Incorporation** of the company as a separate legal entity
- c. **Subscription of capital** in the form of shares and debentures
- d. **Commencement of business** after the completion of the formalities mentioned above.

## ❖ Stage of Promotion of a Company

### ➤ Meaning

- The stage of promotion refers to the process of discovering the idea of formation of a company and developing it into a concrete form.
- The stage starts when an individual or a group of individuals discovers an idea for a business that has the potential to be converted into a successful business opportunity.

### ➤ Who is a promoter

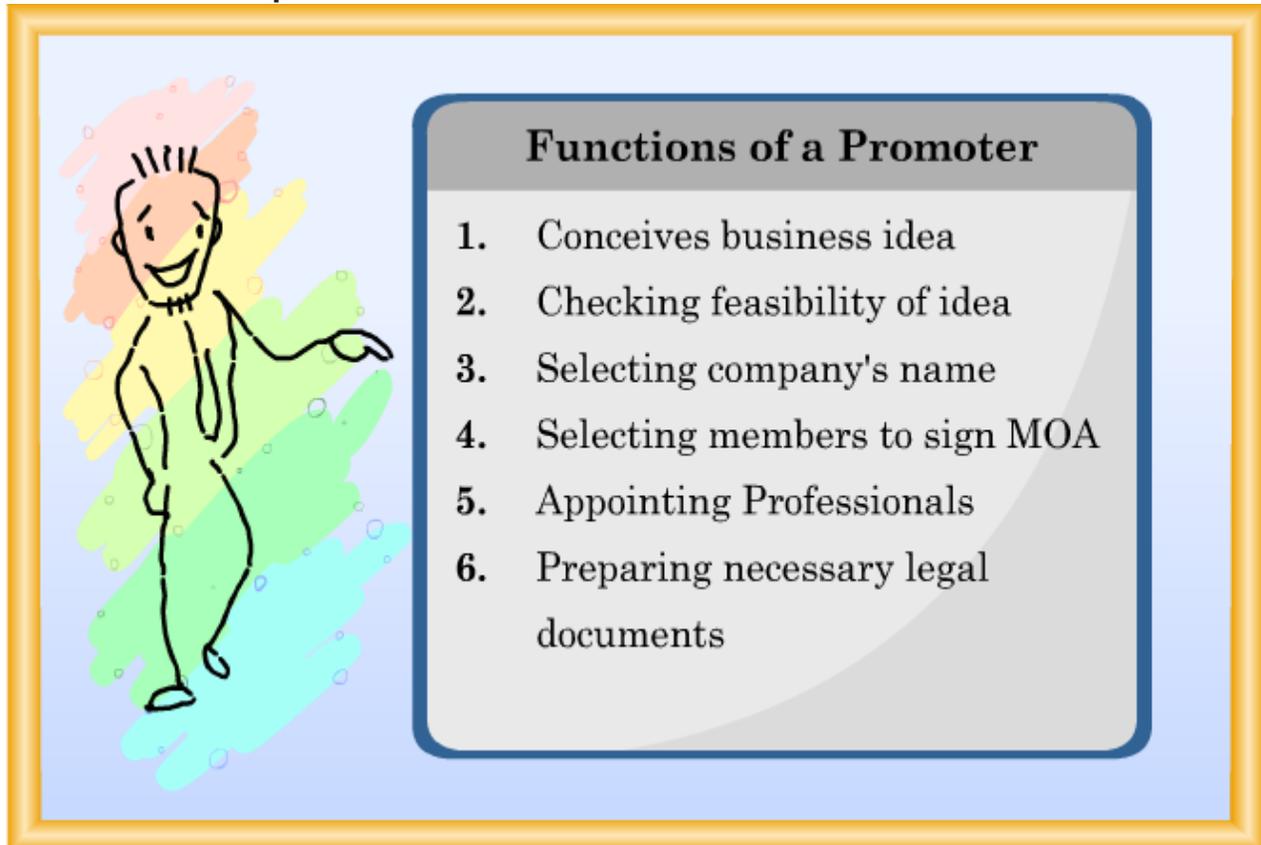
A promoter is an individual who (or group of individuals which)

- **Discovers the idea** for a business and considers that it has the potential to be a successful business opportunity
- **Takes the initiative** to form a company on the basis of a given idea or project and

takes the steps necessary in this regard

• **Is responsible for analysing the future prospects** of the company and **acquires the inputs** necessary to establish the company, such as labour, capital and machinery

### ➤ Functions of a promoter



The following are the functions of a promoter.

i. **Conceiving the business idea** for the formation of a company, which is then analysed for profitability or economic feasibility

ii. **Checking the feasibility of the idea** on the following grounds

a. **Technical feasibility:** Checking whether the technology or raw material required to execute the project is easily accessible or not

b. **Financial feasibility:** Assessing the cost of implementing the idea as against the availability of funds

c. **Economic feasibility:** Assessing the probability of success of the business

iii. **Selecting the company's name** and securing approval for the proposed name by submitting an appropriate application suggesting at least three names in order of preference to the Registrar of Companies of the state concerned

**iv. Selecting the members to sign the memorandum of association (MoA)**, thereby selecting the first directors of the company

**v. Appointing professionals**—bankers, brokers, solicitors and underwriter, for preparing the documents necessary for the formation of the company

**vi. Preparing all the necessary legal documents** (such as the MoA, articles of association and consent of directors) and submitting them to the Registrar of Companies

➤ **Position of a promoter**

The following legal liabilities of the promoters towards the company highlight their legal position with respect to the company.

a. They are **neither the trustees nor the agents of the company** that they are forming.

b. They **cannot make any secret profits** by making deals on behalf of the company.

c. They **are legally liable for any untrue statement** filed in the prospectus of the company.

d. They **cannot claim the expenses incurred by them** during the promotion of the company.

e. **The company may or may not indemnify the promoters for the payments made before its incorporation** and may instead choose to allot shares to them as compensation for their services.

➤ **Documents required to be submitted**

The following are the important documents that must be submitted by the company at the promotion stage of formation:

**i. Memorandum of association (MoA)**

- Refers to a document that regulates the activities of a company that has been incorporated

- Mentions the activities that the company can legally undertake

- Must be signed by at least seven members in the case of a public company and by two persons in the case of a private company

**ii. Articles of Association (AoA)**

- Defines the rules and regulations of the company along with the relation of the company to its members

- Can be altered by a special resolution passed by the members

(An act beyond the AoA can be ratified by the members if it does not violate the MoA.)

**iii. Consent of the proposed directors**

- Refers to a document duly signed by the proposed directors stating that they agree to be the directors of the company

- States that these proposed directors will buy and make necessary payments for the qualification shares

**iv. Agreement:** Refers to an agreement signed by the company for the appointment of its managing director, director or manager.

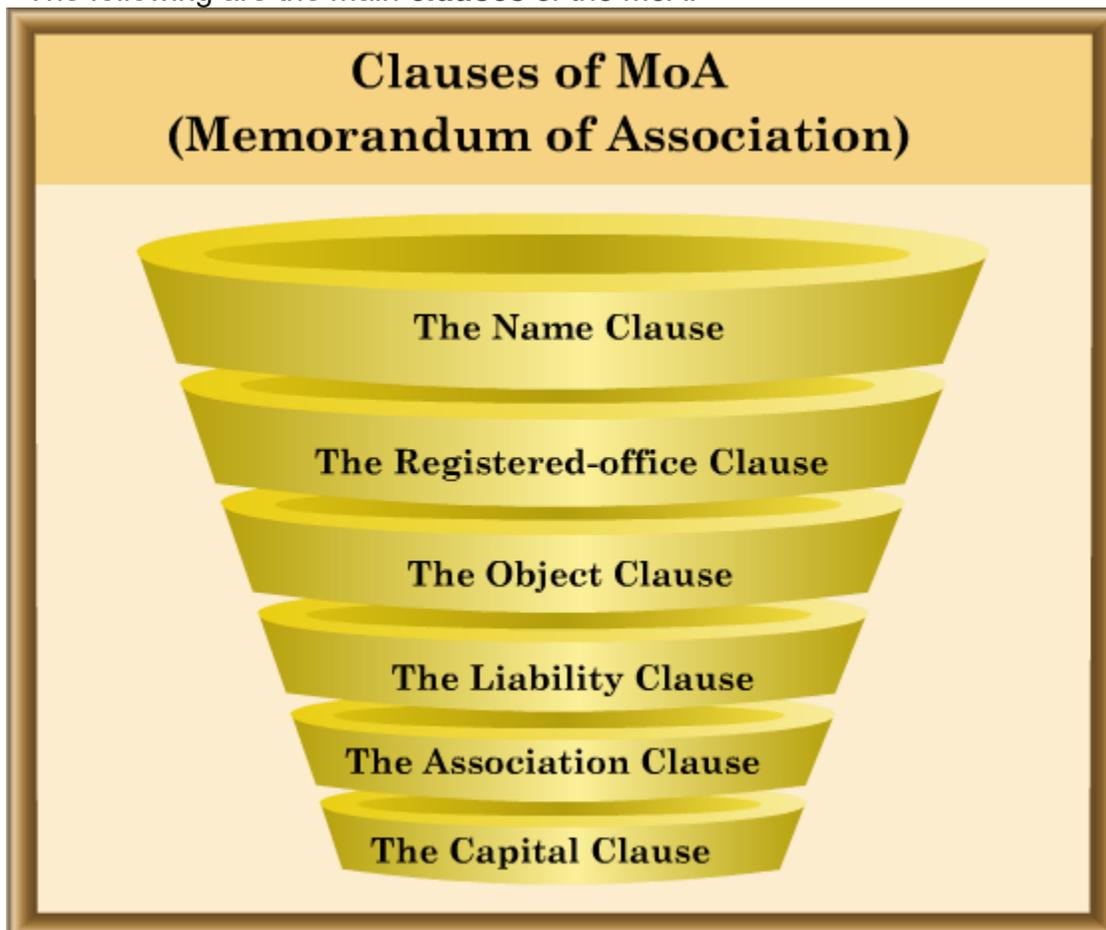
**v. Statutory declaration**

- Is a declaration that all the necessary documents have to be submitted with the Registrar in order to get the company registered
- Must be signed by an advocate of the High Court concerned or an advocate of the Supreme Court or a full-time chartered accountant or by the directors of the company whose names are mentioned in the AoA.

**vi. Payment of fees:** The requisite fee (depending on the amount of authorised share capital) must be submitted for the registration of the company under the Indian Companies Act, 1956.

**❖ Memorandum of Association (MoU)**

- Highlights the company's main **objectives and goals**
- **Regulates the activities of the incorporated company** such that the company can legally undertake only those activities mentioned in the MoA
- Must be **signed by at least seven members in the case of a public company and by two persons in the case of a private company**
- The following are the main **clauses** of the MoA.



**a. The name clause:** This clause includes the name of the company that has been approved by the Registrar of Companies and is the name by which the company will be known.

**b. Registered-office clause:** It mentions the name of the state where the registered office of the company is situated. The address must be submitted within 30 days of incorporation of the company.

**c. Objects clause:** This clause defines the main objective of the company. The company cannot undertake any activity that is not stated in the objects clause. The objects clause is further divided into the following two sub-clauses.

**i. The main-objects clause:** It lists the main objects for which the company is formed. Any clause that is essential for the achievement of the main objectives is considered valid even if it is not contained in the sub-clause.

**ii. Other-objects clause:** Objects that are not included in the main-objects clause can be included in this sub-clause. If a company wants to initiate a business activity that is mentioned in this clause, it is required to pass either an ordinary resolution or a special resolution to get the consent of the central government.

**d. Liability clause:** This clause states the liability of each shareholder according to the amount not paid by them for the shares they own.

**e. Capital clause:** It defines the authorised capital of the company that it can raise through the issue of shares, along with the division of the number of shares.

**f. Association clause:** The association clause contains the statement by the signatories to the MoA, giving their approval to be a part of the company and to buy the qualification shares of the company.

❖ **Distinguish between ‘memorandum of association’ and ‘articles of association’.**

<b>Basis of difference</b>	<b>Memorandum of association (MoA)</b>	<b>Articles of association (AoA)</b>
Objective	Defines the character of a company and the scope of its activities	Defines the rules and regulation of the company
Position	The main document, which is subordinate to the Companies Act	A subsidiary document, which is subordinate to both MoA and the Companies Act

Relationship	Establishes the relation between the company and outsiders	Defines the relation of the company to its members
Alteration	Altering the MoA requires the approval of a statutory authority	The AOA can be easily altered by passing a resolution
Ratification	Acts beyond MoA cannot be ratified	Acts beyond the AoA can be ratified by the members if these acts do not violate the MoA
Necessity	Is a necessary document	Is a secondary document

#### ❖ **Stage of Incorporation**

The stage of incorporation consists of applying for and obtaining the certificate of incorporation after which the company becomes a valid entity in the eyes of the law.

#### ❖ **Documents Required at the Incorporation Stage**

The following documents need to be submitted for the incorporation of a company.

- a. Memorandum of association
- b. Articles of association
- c. Written approval of the proposed directors to function as directors and an undertaking to buy the qualification shares
- d. An agreement naming the proposed managing director or a manager or a full-time director, if any
- e. A copy of the letter obtained from the Registrar concerned, approving the company's name proposed.
- f. A legal confirmation by the law stating the submission of all documents and requirements for registration
- g. The exact address of the registered office
- h. Documentary evidence of payment of the registration fee

#### ❖ **Effect of Certificate of Incorporation**

When the certificate of incorporation is issued, the existence of the company is considered to be valid despite any flaw in its registration process or formation. This certificate is conclusive in nature in the following senses.

- a. A company **legally comes into existence** or becomes a separate legal entity on the date stated in its certificate of incorporation.
- b. The certificate acts as **compelling confirmation of the regularity of the incorporation** of the company even if there is any flaw in its registration process.

c. The certificate provides **conclusive evidence of the existence of a company**, and a company can immediately commence its business once its certificate of incorporation is issued.

The following points highlight the **usefulness of the certificate of incorporation**:

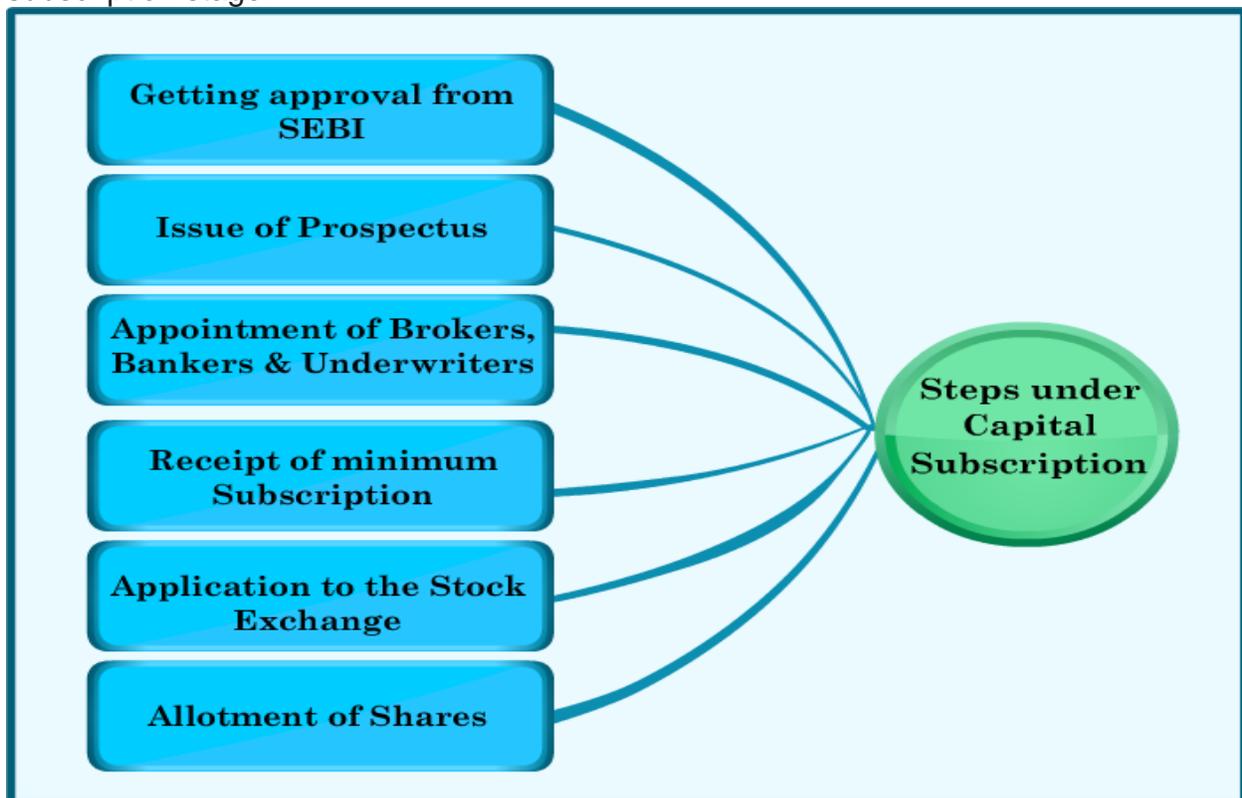
- i. **A company legally comes into existence**—that is, it becomes a legal entity—on the date mentioned in its certificate of incorporation.
- ii. The certificate **confirms the legitimacy of the incorporation** of the company even if there is any flaw in its registration process.
- iii. A private company can **immediately commence business** once its certificate of incorporation is issued.

#### ❖ **Stage of Capital Subscription**

The stage of capital subscription involves raising capital from the public through the subscription of shares.

#### ➤ **Steps under capital subscription**

The following are the steps that must be followed by a company at the capital subscription stage.



i. **Securing approval from SEBI**, for which SEBI ensures that all the relevant information is disclosed to the investors and that no material information is hidden.

ii. **Issuing a prospectus** containing all the necessary information required by the investor for taking the investment decision. A copy of the prospectus is also to be

submitted to the Registrar of Companies.

**iii. Appointing brokers, bankers and underwriters** for selling the shares, collecting the money received on the application of shares and purchasing the shares of the company in the event of under-subscription by the public, respectively.

**iv. Receiving the minimum subscription** (at least 90 per cent of the size of issue before allotting the shares so as to prevent the company from starting business without adequate funds for investment. If a company fails to receive the minimum amount, it is bound to return the application money to the applicants).

**v. Submitting an application to the stock exchange** for permission to trade its shares. If within 10 weeks of closure of subscription of application the permission is not granted, then the company is bound to return the application money to the applicants.

**vi. Allotting shares** by granting allotment letters to the applicants, and returning or adjusting towards allotment any excess money received on applications.

➤ **Statement in lieu of prospectus:** This statement is filed with Registrar of Companies in case the public company decides not to raise capital from the public and, instead, raises capital through friends, relatives or private arrangements.

#### ❖ **Stage of Commencement of a Business**

This stage consists of the completion of the formalities and commencement of business by the company.

#### ➤ **Documents required at the time of commencement**

To obtain the certificate of commencement from the Registrar of Companies, the following documents must be submitted.

i. A declaration that the application fee for the shares issued has been received and that the allotment has been made only after receiving the minimum subscription on the issued shares.

ii. A declaration that all the directors have paid the application and allotment money due on their shares in cash, and that the money is in the same proportion as paid by the other subscribers.

iii. A declaration that the company is not liable to pay any money to any applicant today or in the future.

iv. A declaration signed by the directors or the secretary of the company that the company has successfully completed all the requirements mentioned above.

#### ❖ **Effect of Certificate of Commencement of Business**

The following are the effects of the certificate of commencement of business.

**a.** Acts as definite proof that the company has the legal right to do business.

**b.** Completes the formation of a public company.

The following points highlight the **usefulness of the certificate of commencement of**

**business:**

- i. Provides **conclusive evidence that the company is entitled to do business.**
- ii. Completes the formation of a public company and **legally allows the commencement of business.**

❖ **Some important terms**

➤ **Minimum subscription**

- 'Minimum subscription' refers to the **minimum amount that must be subscribed** by the public so that the company can allot shares to the applicants.
- As per the Companies Act of 1956, the minimum subscription of shares cannot be less than 90 per cent of the issued amount.
- If the minimum subscription is not received, the company shall immediately refund the entire application amount received from the applicants.

➤ **Return of allotment**

'Return of allotment' refers to the **statement that contains such information as the name and addresses of the shareholders and the number of shares allotted to them.**

➤ **Preliminary contract/pre-incorporation contract**

- The terms refer to the **contract signed by the promoters of a company with the third parties** during the promotion of the company.
- These contracts are non-binding in nature and cannot be ratified by the signatories.
- The contracts are not enforceable unless fresh contracts are created on the same terms and conditions after the company comes into existence.

➤ **Provisional contracts**

- 'Provisional contracts' refer to the **contracts that are signed after the incorporation of a company and before the commencement of business.**
- These contracts are enforceable automatically once the company obtains the certificate of commencement of business.

➤ **Prospectus**

- The prospectus basically **refers to an advertisement or invitation from a company to the general public to subscribe to, or purchase, the shares or debentures issued by the company.**
- It is also known as an Initial Public Offering (IPO)
- By launching an IPO, a private company transforms itself into a public company.