Considerations and criteria for forming business entity

1. Nature of business activity

This is an important factor having a direct bearing on the choice of a form of ownership. In small trading businesses, professions, and personal service trades, sole-proprietorship is predominant. Examples are beauty parlors, repair shops, consulting agencies, small retail stores, medicine, dentist accounting concerns, boarding-house, restaurants, specialty ships, jobbing builders, painters, decorators, bakers, confectioners, tailoring shops, small scale shoe repairers and manufactures, etc. The partnership is suitable in all those cases where sole proprietorship is suitable, provided the business is to be carried on a slightly bigger scale.
Besides, partnership is also advantageous in case of manufacturing activities on a modest scale. The finance, insurance, and real estate industries seem to be suited to partnership form of organization. Some of the financial businesses that find this form advantageous are tax, accounting, and stockbrokerage firms, and consulting agencies.
Service enterprises like hotels and lodging places; trading enterprises, such as wholesale trade, large scale retail houses; manufacturing enterprises, such as small drug manufacturers, etc. can be undertaken in the form of partnership.
Manufacturing contains the highest percentage of companies among all industries. Similarly large chain stores, multiple shops, super-bazaars, engineering companies are in the form of companies.

2. Scale of Operations

The second factor that affects the form of ownership organization is the scale of operations. If the scale of operations of business activities is small, sole proprietorship is suitable; if this scale of operations is modest — neither too small nor too large — partnership is preferable; whereas, in case of large scale of operations, the company form is advantageous. The scale of business operations depends upon the size of the market area served, which, in turn, depends upon the size of demand for goods and services. If the market area is small, local, sole-proprietorship or partnership is opted. If the demand originates from a large area, partnership or company may be adopted.

3. **Capital Requirements**

Capital is one of the most crucial factors affecting the choice of a particular form of ownership organization. Requirement of capital is closely related to the type of business and scale of operations. Enterprises requiring heavy investment (like iron and steel plants, medicinal plants, etc.) should be organized as joint stock companies. Enterprises requiring small investment (like retail business stores, personal service enterprises, etc.) can be best organized as sole proprietorships. Apart from the initial capital required to start a business, the future capital requirements—to meet modernization, expansion, and diversification plans —also affect the choice of form of ownership organization.

In sole proprietorship, the owner may raise additional capital by borrowing, by purchasing on credit, and by investing additional amounts himself. Banks and suppliers, however, will look closely at the proprietor's individual financial resources before sanctioning loans or advances.

Partnerships can often raise funds with greater ease, since the resources and credit of all partners are combined in a single enterprise. Companies are usually best able to attract capital because investors are assured that their liability will be limited.

4. **Degree of control and management**

The degree of control and management that an entrepreneur desires to have over business affects the choice of ownership organization. In sole proprietorship, ownership, management, and control are completely fused, and therefore, the entrepreneur has complete control over business. In partnership, management and control of business is jointly shared by partners. They have equal voice in the management of partnership business except to the extent that they agree to divide among themselves the business responsibilities.

Even then, they are legally accountable to each other. In a company, however, there is divorce between ownership and management. The management and control of company business is entrusted to the elected representatives of shareholders.

Thus, a person wishing to have complete and direct control of business prefers proprietary organization rather than partnership or company. If he is prepared to share it with others, he will choose partnership. But, if he is just not bothered about it, he will go in for company.

5. **Degree of risk and liability**

The size of risk and the willingness of owners to bear it is an important consideration in the selection of a legal form of ownership organization. The amount of risk involved in a business depends, among other, on the nature and size of business. Smaller the size of business, smaller the amount of risk. Thus, a sole proprietary business carries small amount of risk with it as compared to partnership or company. However, the sole proprietor is personally liable for all the debts of the business to the extent of his entire property. Likewise, in partnership, partners are individually and jointly responsible for the liabilities of the partnership firm.

Companies have a real advantage, as far as the risk goes, over other forms of ownership. Creditors can force payment on their claims only to the limit of the company's assets. Thus, while a shareholder may lose the entire money he put into the company, he cannot be forced to contribute additional funds out of his own pocket to satisfy business debts.

6. Stability of business

Stability of business is yet another factor that governs the choice of an ownership organization. A stable business is preferred by the owners insofar as it helps him in attracting suppliers of capital who look for safety of investment and regular return, and also helps in getting competent workers and managers who look for security of service and opportunities of advancement. From this point of view, sole proprietorships are not stable, although no time limit is placed on them by law. The illness of owner may derange the business and his death cause the demise of the business. Partnerships are also unstable, since they are terminated by the death, insolvency, insanity, or withdrawal of one of the partners. Companies have the most permanent legal structure. The life of the company is not dependent upon the life of this member. Members may come, members may go, but the company goes on forever.

7. Flexibility of administration

As far as possible, the form of organization chosen should allow flexibility of administration. The flexibility of administration is closely related to the internal organization of a business, i.e., the manner in which organizational activities are structured into departments, sections, and units with a clear definition of authority and responsibility. The internal organization of a sole proprietary business, for instance, is very simple, and therefore, any change in its administration can be effected with least inconvenience and loss. To a large extent, the same is true of a partnership business also. In a company organization, however, administration is not that flexible because its activities are conducted on a large scale and they are quite rigidly structured. Any substantial change in the existing line of business activity — say from cotton textiles to sugar manufacturing — may not be permitted by law if such a provision is not made in the 'objects clause' of the Memorandum of Association of the company.

Even when it is permitted by the Memorandum, it might have to be endorsed by the shareholders at the general meeting of the company. Thus, from flexibility point of view, sole proprietorship has a distinct edge over other forms.

8. **Division of Profit**

Profit is the guiding force of private business and it has a tremendous influence on the selection of a particular form of ownership organization. An entrepreneur desiring to pocket all the profits of business will naturally prefer sole proprietorship. Of course, in sole proprietorship, the personal liability is also unlimited. But, if he is willing to share the profits partnership is best. In company organization, however, the profits (whenever the Board of Directors decides) are distributed among shareholders in proportion to their shareholding, but the liability is also limited. The rate of dividend is generally quite low.

9. **Costs, procedure and government regulation**

This is also an important factor that should be taken into account while choosing a particular form of organization. Different forms of organization involve different procedure for establishment, and are governed by different laws which affect the immediate and long-term functioning of a business enterprise. From this point of view, sole proprietorships are the easiest and cheapest to get started. There is no government regulation. What is necessary is the technical competence and the business acumen of the owner. Partnerships are also quite simple initiated. Even a written document is not necessarily a prerequisite, since an oral agreement can be equally effective. Company form of ownership is more complicated to from.

It can be created by law, dissolved by law, and operate under the complicated provisions of the law. In the formation of a company, a large number of legal formalities is to be gone through which entails, at times, quite a substantial amount of expenditure.

For example, the cost incurred on the drafting of the Memorandum of Association, the Articles of Association, the Prospectus, issuing of share capital, etc. This cost is however, small in case of private companies. Besides, companies are subjected to a large number of anti-monopoly and other economic laws so that they do not hamper the public interest.

The consideration of the various factors listed above clearly shows that:

(a) These factors do not exist in isolation, but are interdependent, and they are all important in their own right. Nevertheless, the factors of nature of business and scale of operations are the most basic ones in the selection of a form of ownership.

All other factors are dependent on these basic considerations. For instance, the financial requirements of a business will depend on the nature of business and the scale of operations planned. To take an example, if a business wants to set up a trading enterprise (say, a retail store) on a small scale, his financial requirements will be small.

(b) The various factors listed above are only major factors, and in no case they constitute an exhaustive list. Depending upon the requirements of the business and the demands of the situation and sometimes even the personal preference of the owner, the choice of a form of ownership is made.

(c) The problem in choosing the best form of ownership is one of analyzing and weighing relative advantages and disadvantages to find the one that will yield the highest net advantage. And for that, weights may be assigned to different factors depending upon their importance in each form of organization, and the organization that obtains the maximum weights may be ultimately selected.