

BUSINESS STUDIES NOTES

FORM 2 SIMPLIFIED VERSION

QUICK REVISION NOTES

*An Updated Well-Organized Detailed Revision Notes for the
Current Form 2 Syllabus.*

SERIES 1

THIS IS A FREE SAMPLE OF THE
ORIGINAL NOTES

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TOPIC: FORMS OF BUSINESS UNITS

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INTRODUCTION

Forms of business units refers to types of business ownership which includes the following:

- ✓ Sole proprietor
- ✓ Partnerships
- ✓ Co-operatives
- ✓ Limited liability companies
- ✓ Public corporations
- ✓ Parastatals

Business units can further be classified on the basis of their legal status into two, namely:

- a) Unincorporated business organisations
- b) Incorporated business organizations

a) Unincorporated business organizations

This are those business units which the law has no or little control over their formation, ownership and operations. There is no formal certificate of registration required to form these business units. They may include partnerships and sole proprietorships.

b) Incorporated business units

These are business units where there is legal control over their formation, ownership and operation. These business are allowed to start operations after complying with all legal requirements.

Examples are limited liability companies, co-operative societies and public corporations

Differences between incorporated and unincorporated business organisations

Unincorporated business organisations	Incorporated business organisations
There are no legal procedures to be followed during their formation	Legal procedures have to be followed during their formation
The business is not a separate legal entity	The business is a separate legal entity
All transactions are conducted in the name of the owner(s)	All transactions are conducted in the name of the business
The owners have unlimited liabilities	The owners have limited liabilities
They lack perpetual existence	They have perpetual existence
The business tends to be small in size due to limited capital	The business tends to be large in size due to the ability to raise more capital

SOLE PROPRIETORSHIP

Ownership

- ✓ This is a form of business unit which is owned by one person. This person is known as a sole trader or a sole proprietor.
- ✓ Sole proprietorships are the most common forms of business units. They mostly operate in retail and wholesale trade.

Formation

- ✓ Formation of a sole proprietor is very simple since it requires very few legal formalities.
- ✓ In Kenya, one only is required to apply to the local authority and if the application is approved, he is issued with a trade license after paying the trade license fee. The trade licence gives him the permission start his business

Management

- ✓ Management of a sole proprietorship is done by the owner. The owner may however get assistance from his family members or employ other people to assist him in managing the business.
- ✓ The sole proprietor remains responsible for the success and failure of the business

Capital

The amount of capital required to start a sole proprietorship is relatively small compared to other forms of business units.

The owner can raise capital through the following sources:

- Owners' savings (main source)
- Inheritance
- Grants and donations from friends and relatives
- Buying on credit
- Ploughing back profits
- Leasing and renting of property
- Borrowing from friends, banks and other financial institutions.

NOTE: *The amount of capital borrowed depends on the following factors:*

- Whether the lender has funds to loan out
- The amount of interest to be charged on borrowed capital
- Ability of the borrower to repay the loan together with interest
- Whether the amount of money borrowed will serve the intended purpose

Advantages of sole proprietorship

- a) Requires fewer legal formalities to start hence reducing formation costs
- b) Decision making is faster since the sole proprietor does not consult anybody
- c) The owner exercises direct control over the business at all time
- d) The owner enjoys close contact with his customers enabling him cater for their individual needs
- e) Direct contact with customers enables the owner to assess the credit worthiness of his/her customers in order to know whom to allow credit so as to avoid losing money through bad debts
- f) The trader is accountable to himself
- g) The sole trader is able to keep the top secrets of his/her business
- h) The trader enjoys profits alone
- i) The trader can get assistance from family members to run the business
- j) Requires less amount of capital to start
- k) The owner works to his level best because he is accountable to him/herself
- l) The business is flexible i.e. it can switch from one line of trade to another

Disadvantages of sole proprietorship

- a) The business has limited liabilities. This means that in case business assets are not enough to pay business debts, personal property of the owner may be sold to repay the debts
- b) Expansion of the business may be limited due to scarcity of capital
- c) The sole trader may overwork himself leaving him/her with little time for leisure
- d) The owner suffers all losses and risks alone
- e) Lack of specialisation leads to poor performance. This is because one person may not manage all the aspects of the business effectively
- f) Death of the owner may lead to the collapse or poor performance of the business
- g) The owner may not enjoy benefits enjoyed by large scale business such as easy access to loans
- h) Lack of consultation may lead poor decision making

Dissolution

Dissolution refers to bringing a business to an end.

A sole proprietorship may be dissolved under the following circumstances

- If the owner decides to dissolve the business
- In case of death, insanity or bankruptcy of the owner
- In case the intended purpose is accomplished
- If the court orders the business to dissolve

Features of a sole proprietorship

- a) It is owned and managed by one person
- b) The owner is responsible for all the debts of the business
- c) The owner provides capital to start the business
- d) The business lacks a separate legal entity status i.e. the owner and the business are regarded as one
- e) The owner has unlimited liabilities
- f) The owner enjoys all profits
- g) The owner makes all decisions affecting his/her business
- h) The owner bears all losses alone
- i) Mostly, the business is smaller in size

Circumstances under which sole proprietorship is appropriate

- a) When the investor has limited capital
- b) When the size of the market is small
- c) When there is need to retain control over the business
- d) When the investor would like to give personalized services

Role of a sole proprietorship in the economy

- a) Creates employment to oneself and to others
- b) Enables the utilisation of local natural resources
- c) Provides revenue to the government in form of taxes
- d) Helps in bringing goods and services closer to the people

PARTNERSHIP

Ownership

A partnership is a business unit which is owned by more than one person. The people who own a partnership are known as partners.

A partnership is owned by a minimum of 2 partners and a maximum of 20, except for partnerships which provide professional services such as law, medicine, auditing, banking etc. which have a maximum of 50 partners.

Classification of partnerships

Partnerships may be categorised in either of the following ways:

- According to the type of partners
- According to the period of operation

a) According to the type of partners

When classified according to the type of partners, partnerships can either be general or limited.

General partnership: in a general partnership, all members have unlimited liabilities. This means if partners are unable to repay all business debts from the available business assets, personal property of the partners will be sold to repay the debts

Limited partnership: in a limited partnership, partners have limited liabilities. This means that if partners are unable to repay business debts from the available business assets, partners only lose the capital they contributed to the business but not their personal property.

NOTE: in a limited partnership, there must be one partner whose liabilities are unlimited

b) According to period of operation

When classified according to the period of operation, partners can either be temporary or permanent.

Temporary partnership: these are partnerships which are formed to accomplish a specific objective after which they are dissolved. These partnerships are also known as joint ventures.

Permanent partnerships: these are partnerships which are formed to operate indefinitely

Types of partners

Partners may be classified according to the role they play, their liabilities, their age and their capital contribution as discussed below

a) Role played by the partners

Partner can either be active or dormant. An active partner is the one who plays an active role in the running of the business while a dormant partner does not play an active role in the running of the business

A dormant partner is also known as a sleeping, passive or silent partner

b) Liabilities of the partners

When classified according to their liabilities, partners can either be general or limited. Limited partners have limited liabilities while general partners have unlimited liabilities.

c) Age of partners

According to their ages, partners can either be minor or major. A minor partner is the one who is below 18 years. A minor partner only takes part in the sharing of profits but cannot participate in the day to day running of the business until he/she attains the majority age (18 years and above). A major partner is the one who is above 18 years.

d) Capital contributions

- ✓ When classified according to their capital contributions, partners can be real or nominal. A real partner is the one who has contributed capital to the business while a nominal partner is the one who does not contribute capital to the business but allows the business to use his/her name for prestige in order to attract customers.
- ✓ A nominal partner may also be a person who retired from the partnership but left his/her in the business in form of a loan which earns him interest from the partnership at an agreed rate.
- ✓ A nominal does not take part in the sharing of profits.
- ✓ A nominal partner is also known as a quasi-partner.

Formation

- ✓ When forming the partnership, partners have to agree on how the business will be operated in order to avoid misunderstanding amongst themselves. The agreement among partners is known as a partnership agreement.
- ✓ The partnership agreement can either be oral or in writing. When it is in writing, the partnership agreement is known as a partnership deed.

The partnership deed contains the following:

- Name of the partnership
- Address of the head office
- Location and area of operation of the partnership
- The term of the partnership (whether temporary or permanent)
- The objectives of the business
- Amount of capital contributed by each partner
- Rate of interest on capital
- Drawings by partners and the rate of interest on drawings
- Salaries and commissions to partners
- Rate of interest on loans from partners to the business
- Procedures of dissolving the partnership
- Profit/loss sharing ratio
- Means of solving conflicts between partners

- Methods of valuing goodwill on the admission or retirement of a partner

Once the partnership agreement is ready, the business can be registered by the registrar of companies upon payment of the registration fee.

The name of the partnership should be different from the surnames of the individual partners.

NOTE: in case the partnership deed has not been drawn or is ambiguous, the contents of the partnership act of 1963 will apply.

These contents are:

- All partners should contribute equal amount of capital
- No salary is to be paid to any partner
- No interest is to be allowed on capital
- No interest is to be charged on drawings
- All profits and losses are to shared equally
- Every partner has the right to inspect the books of account
- Every partner has a right to take part in decision making
- Interest must be paid on all loans advanced to partners
- When the partnership is dissolving, external debts are paid first, followed by loans from partners and lastly partners' capital
- No partner should carry out competing business
- Any major change in the business such as the admission of a new partner must be agreed upon by all the partners
- Partners should be compensated for the losses they incur while executing duties of the business

Management

All partners share the responsibility of managing the business. This is done by assigning different areas of management to partners based on their specialities. Partners may also employ specialized personnel to manage the business on their behalf especially when the business is too large or when the partners are ignorant on how the business should be managed. Partners who take play an active role in the management of the business are major, real and general partners. Minor, quasi and limited partners do not play an active role in the management of the business. They are however allowed to access the books of account and to offer advice to active partners

Sources of capital

- Contributions by partners
- Loans from banks and other financial institutions
- Buying on hire purchase
- Buying goods on credit
- Ploughing back profits
- Leasing and renting property

Advantages of partnerships

- a) Capital raised is higher
- b) Workload is reduced since work is distributed among partners
- c) Losses and risks are shared
- d) Requires fewer legal formalities to start compared to companies
- e) Consultation in decision making results in good decisions
- f) Combining of different talents in management results in efficient management

Disadvantages of partnerships

- a) A mistake made by one partner results in losses that are shared by all partners
- b) The liability of some partners is unlimited
- c) Continued disagreements among partners may lead to dissolution
- d) Decision making process may be slow since all partners have to be consulted
- e) Actions taken by any partner in good faith on behalf of the business are binding to all other partners
- f) Retirement or death of a partner may adversely affect the partnership in case the business heavily relied on that partner
- g) Compared to limited companies, partnerships have limited access to major sources of capital
- h) Lack of a variety of managerial skills especially when partners manage the business alone
- i) A hard working partner may not be rewarded for his/her hard work due to the fact that profits realised from efforts are shared

Dissolution

A partnership may come to an end under the following circumstances

- a) If the partners mutually agree to dissolve
- b) In case of death, insanity or bankruptcy of the main partner(s)
- c) In case of the completion of the intended purpose or end of the agreed time
- d) If the court orders the business to dissolve
- e) When one of the partners requests for a dissolution in writing
- f) If the business engages in unlawful activities or in activities that have been rendered illegal by a change in law
- g) In case of retirement or admission of a new partner, the partnership may be dissolved temporarily or permanently
- h) In case of continued disagreements among partners

Features of a partnership

- a) Formed and owned by 2-20 people in the case of ordinary partnerships and 2-50 people in the case of partnerships offering professional services
- b) Capital is mostly contributed by partners
- c) The business is managed by partners
- d) The business lacks legal entity status.
- e) Partners have unlimited liabilities
- f) Profits are shared
- g) Losses are shared
- h) Each partner can act as an agent of the business
- i) Business decisions are made jointly

CO-OPERATIVES

- ✓ A co-operative society is a group of people who come together mainly to provide convenient and efficient services to members.
- ✓ Co-operatives are also formed in order to eliminate middlemen so that all profits go to members.
- ✓ Co-operatives are formed by people who have common interests and problems.

- ✓ The idea behind the formation of co-operatives is the need to pool together individuals' scarce resources so as to achieve common goals more efficiently.

Ownership

- ✓ Co-operative societies are owned by more than 10 adults who register as members upon payment of a non-refundable membership fee
- ✓ Members are further expected to buy shares in the co-operative. The value of each should not be less than Ksh 20.
- ✓ No single member should own more than 5% of the co-operative's shares capital. This is to ensure that the co-operative is not controlled by a single member.
- ✓ Membership to a co-operative is open and voluntary. This means that any member of the public can join the society provided he shares the common objective as that of the society. The member can also leave the society at will.
- ✓ Members also have limited liabilities

Formation

- ✓ Co-operative societies are formed by people who are above 18 years irrespective of their social, economic or political background.
- ✓ The number of members required to form a co-operative should not be less than 10.
- ✓ The at least 10 members will draft rules and regulations to govern the operations of the co-operative. These rules and regulations are known as by-laws. The by-laws are submitted to the commissioner of co-operatives for approval. Upon approval, the commissioner registers the co-operative and issues it with the certificate of registration to enable it commence its operations.
- ✓ **NOTE:** in case of failure by members to draft their own by-laws, the co-operative societies' act of 1996 can be adopted in part or whole.

Management

- ✓ A co-operative society is managed by a committee elected by members in a general meeting. The committee consists of nine members.
- ✓ The management committee then elects the executive committee members i.e. the chairman, treasurer and the secretary amongst themselves.

- ✓ The committee acts on behalf of members i.e. it can enter into contracts, borrow money etc. on behalf of the society. The committee also educates the members on their responsibilities by organising seminars.
- ✓ The committee holds regular meetings to discuss matters affecting the co-operative society.
- ✓ The co-operative society can also hire professionals to assist in managing the society.
- ✓ The management committee members are not paid salaries for their services to the society. Instead they are allowed sitting allowances and honoraria in accordance with the guidelines of the commissioner of co-operatives.
- ✓ Where the committee fails to perform as expected, it can be voted out by members in a general meeting or be dismissed by the commissioner of co-operatives

Sources of capital

- a) Membership contributions in the form of registration fee and share capital contribution
- b) Retained profit (earnings)
- c) Interest on loans to members
- d) Investment income
- e) Acquiring property on credit or hire purchase

Dissolution

A co-operative society may be dissolved under the following circumstances:

- a) In case of a court order
- b) In case of an order from the commissioner
- c) In case of a decision by members to dissolve the society
- d) In case of withdrawal of members from the society leaving less than ten members
- e) In case the society is declared bankrupt

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PRINCIPLES OF CO-OPERATIVES

These are rules and regulations which govern the operations of co-operative societies. These principles are discussed below:

a) Principle of open and voluntary membership

Membership to a co-operative society is open to any member of the public provided he shares the same objectives as the other members of the society.

b) Principle of democratic administration

A co-operative society is managed on the basis of one man one vote. This ensures that all members have an equal say in the running of the co-operative

c) Principle of limited interest on share capital

Members earn interest or dividends on their share capital and savings. These interest or dividends calculated on a percentage which is determined by the income earned by the society for the year.

d) Principle of co-operation with other co-operatives

A co-operative society is required to co-operate with other co-operatives of the same level so as to learn from one another

e) Principle of education to members

A co-operative society should continuously educate their members on their rights and responsibilities. This is done through organised seminars.

f) Principle of provision of dividends to members

Co-operatives are required to pay members dividends on their share capital at a given rate.

TYPES OF CO-OPERATIVE SOCIETIES IN KENYA

In Kenya, co-operative societies are classified according to the nature of their activities or according to the levels of operation

Classification according to the nature of their activities

When classified according to the nature of their activities, co-operative societies can be categorised into:

- a) Producer co-operatives
- b) Consumer co-operatives
- c) Savings and credit co-operative societies

a) Producer co-operative societies

A producer co-operative society is an association of producers who have come together to improve the production and marketing of their products.

Functions (advantages) of producer co-operative societies

- Obtaining better prices for members' products
- Providing better storage facilities for members' products
- Providing affordable means of transporting members' products to the market
- Providing loans to members
- Grading, packing and processing products for members
- Providing farm inputs on credit to members
- Educating members on better production methods

Examples of producer co-operative societies in Kenya are:

- Kenya co-operative creameries (KCC)
- Kenya planters co-operative union (KGGCU)
- Kenya grain growers co-operative union (KGGCU)

b) Consumer co-operative societies

- ✓ These are formed by a group of consumers who come together and set up shops from where they can buy goods of better quality more conveniently.
- ✓ These co-operatives buy goods directly thereby eliminating middlemen i.e. retailers and whole salers. As such they are able to sell goods to members at relatively lower prices.
- ✓ These co-operatives mostly deal in goods of general consumption e.g. milk, grocery etc.
- ✓ Members of the public are also allowed to buy from the society at normal prices hence enabling the society make more profit.
- ✓ Profit made by these co-operatives is shared by members in the ratio of their purchases from the society

Examples of consumer co-operative societies in the Kenya are:

- Nairobi consumer co-operative union
- Railways co-operative society etc.

Advantages of consumer co-operative societies

- a) They sell goods of high quality to members
- b) They sell goods to members at lower prices
- c) They sell goods to the public at normal prices thereby making more profit
- d) They give credit facilities to members
- e) They buy goods directly from producers hence eliminating middlemen. This enables them make more profit
- f) They may pay interest on members' capital
- g) They avail a variety of goods to members
- h) They ensure constant supply of goods to members
- i) They protect members against exploitation by traders

Disadvantages of consumer co-operative societies

- a) They face stiff competition from large scale retailers who buy goods directly from producers and sell them directly to consumers at lower prices
- b) They may not afford to employ qualified staff
- c) They may not raise adequate capital due to the fact that majority of its members are low income earners.
- d) Subsistence production, makes them unpopular
- e) Consumer shops may be mismanaged

c) Savings and credit co-operative societies (SACCOs)

These are co-operative societies which are formed with the objective of enabling their members save money and access loans.

They are mostly attached to the employer i.e. the employer deducts part of the employee's earnings on a monthly basis (check off system) and remits the money to the society.

SACCOs have become very popular in Kenya especially due to the check off system and due to the fact that they offer loans at lower interest rates

Examples of SACCOs in Kenya include:

- Mwalimu SACCO
- Stima SACCO
- Mhasibu SACCO etc.

Advantages of SACCOs

- a)** Profits made by SACCOs are distributed to members in form of dividends
- b)** They enable members to save
- c)** Enable members access loans at lower interest rates
- d)** In case a member dies, the outstanding loan is written off
- e)** They offer variety of loans to members e.g. school fees loans, development loans, emergency loans etc.
- f)** In case a member dies, the beneficiaries are entitled double his share contribution
- g)** Easy access to loans since it requires few formalities
- h)** They offer education to members on co-operative activities, their rights and obligations
- i)** They may offer banking services through their front offices
- j)** Members are paid dividends on their share contributions
- k)** They insure members' contributions and loans
- l)** They pay interest to members on their savings

Disadvantages of SACCOs

- a)** They may not have enough finances at their disposal to cater for the needs of all their members
- b)** Continued default on loan repayment may cripple the society financially
- c)** They face stiff competition from well-established financial institutions
- d)** They may be mismanaged
- e)** They may be subjected to misappropriation of funds

Reasons for the popularity of SACCOS

- a)** They provide easy access to loans since very few formalities are required
- b)** They offer loans at relatively lower interest rates
- c)** They offer a variety of loans to their members
- d)** In case a member dies, the outstanding loan is written off
- e)** In case a member dies, his/her beneficiaries are entitled to double the amount of his capital contribution
- f)** Channelling members' share capital contributions through a check off system

Classification according to level of operation

When classified according to the level of operation, co-operatives may be categorised into two, namely:

- Primary co-operative societies
- Secondary co-operative societies

a) Primary co-operative societies

These are co-operative societies which are composed of individuals who are either actual producers, consumers or people who come together to save and obtain loans more conveniently

Most primary co-operative societies operate at village and district levels though a few of them operate at national level

Most consumer co-operatives societies and most SACCOs are primary co-operative societies since their membership is composed of individuals.

b) Secondary co-operative societies

These are co-operative societies which are composed of primary co-operative societies as their members.

They are also known as unions.

They are found either at district or national level.

NOTE: all co-operative societies in Kenya are under the Kenya federation of co-operatives

Advantages of co-operative societies

- a) They serve the interests of members more effectively
- b) They provide services to members more cheaply
- c) Profits made by the society are shared among members in form of dividends or interest
- d) Management is democratic.
- e) They enable members increase their incomes and their living standard by giving them loans
- f) They continuously educate their members on their rights, responsibilities and the investment opportunities available
- g) They offer credit facilities to their members e.g. in the form of farm inputs
- h) Membership is open and voluntary

- i) Members have limited liabilities
- j) They eliminate exploitation of members by middlemen. This is done by buying directly from the producer and selling to their members.
- k) The government through the ministry of co-operatives may step in to assist them whenever they are in financial crisis
- l) They offer loans to members at lower interest rates
- m) Any member can be elected to the management committee.

Disadvantages of co-operatives

- a) Some co-operatives have lesser capital hence they cannot benefit from economies of scale
- b) They may be poorly managed due to lack of trained personnel
- c) Withdrawal of members from the society may create financial problems since their capital contributions are refunded
- d) They may suffer from political interference
- e) They may be subjected to corruption and embezzlement of funds
- f) Some members may not be keen on the management of the society since their capital contribution is small.

Problems facing co-operative societies

- a) Poor management
- b) Financial problems
- c) Low interest on members' deposits discourages their participation
- d) Low share capital
- e) Lack of co-operative education and awareness among potential members
- f) Political interference

Features of co-operative societies

- a) They separate legal entities
- b) Members have limited liabilities
- c) They can sell shares to the public
- d) Membership is free and voluntary
- e) All members are equal i.e. all have one vote irrespective of the number of shares one owns

- f)** One member cannot own more than 5% of the society's shares
- g)** Managed by an elected committee
- h)** Profits are shared amongst members in the form of dividends
- i)** Formed a minimum of 10 people and maximum

LIMITED LIABILITIES COMPANIES

- ✓ A company is an association of persons who contribute capital in order to carry out business with the aim of making profit.
- ✓ A company is viewed by law as a separate legal entity separate from the members who form it, therefore death, insanity, bankruptcy or retirement of some of its members does not affect its continuity.
- ✓ The members (owners) of a company are known as shareholders.
- ✓ A company is regarded by the law as an artificial person, hence just like natural persons, it can own property, enter into contracts, sue and be sued in a court of law in its own name.
- ✓ A company unlike natural persons can only engage in those activities which it is authorised to engage in by terms of its registration (acting intra vires). E.g. a company registered to offer transport services cannot offer banking services. A company which engages in activities which it is registered to engage is said to be acting against the law (ultra vires)

Formation

The people who come together to form a company are known as promoters.

When forming the company, promoters are expected to come up with the following documents

- The memorandum of association
- Articles of association

a) MEMORANDUM OF ASSOCIATION

This is a document which defines the relationship between the company and the outsiders.

Contents of the memorandum of association

Information contained in the memorandum of association is divided into subsections known as clauses. These are discussed below

a) Name clauses

It contains the name of the company. This name must end with the word limited (Ltd) which indicates that the liabilities of the company are limited.

Some companies have their names ending with the initials PLC which stands for public limited company. This indicates that it is a public company and not a private company.

b) The objects clause

The objects clause stipulates the activities the company should engage in. the company is therefore not authorised to engage in any other activity other than the one indicated in its objects clause.

The objects clause serves as a warning to the public that the company is only authorised to engage in the stated activities only.

c) Situation clause

The situation clause indicates the location of the registered office of the company where official communication can be sent to or received from.

d) Liability clause

This is clause which informs members of the public that the liabilities of the members of the company are limited.

e) Capital clause

This clause indicates the amount of capital the company is required to raise and the subdivision of this capital into smaller units of equal value known as shares.

The amount of capital indicated in the capital clause is known as the authorised share capital, registered capital or nominal share capital.

This clause also specifies the types of shares and the value of each share

f) Declaration clause

This is a declaration which is signed by the promoters stating that they wish to form the company and buy shares in the company.

The declaration should be signed by a minimum of seven promoters in the case of a public limited company and a minimum of two in the case of a private company.

NOTE: the memorandum also contains the names of the promoters, their addresses, occupations and the number of shares they intend to buy. Each promoter must sign against his/her details.

b) ARTICLES OF ASSOCIATION

This is a document which governs the internal operations of the company. It contains rules which govern the conduct of shareholders in relation to each other and to the company.

Contents of the articles of association

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