UNIT 1 NATURE AND SCOPE OF BUSINESS

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1.0 OBJECTIVES

After studying this unit, you should be able to :

- identify broad categories of human activities
- describe what is business
- list the features and objectives of business
- classify business activities
- explain the nature of business organisation

1.1 INTRODUCTION

In our day-to-day life, we use words like business, commerce, trade. industry, etc. quite often. These words have a definite meaning in 'Business Organisation'. In this introductory unit, you will learn the exact connotation of such terms. You will also learn the distinction between economic and non-economic activities, objectives of business, the classification of business activities, importance of 'organisation and the role of entrepreneur in business.

1.2 HUMAN ACTIVITIES

All of us participate in various kinds of works from the time we get up from bed in the morning till the time we go to sleep at night. We get up from bed in the morning; brush our teeth, take bath and get breakfast. Then children go to school or college to study, elders go to office or factory or shop or field to work, and housewives work at home. In the evening all of us come back home, take food and sleep. All the activities in which we, thus, participate from morning till night are called 'human activities'..

If you closely examine the human activities, you will find that some of these produce economic benefits e.g., working in a factory or in an office or at the farm,. Some other activities like brushing teeth, taking breakfast, going to school, playing, cooking food for the family, etc., do not produce any direct economic benefits. Thus, we can classify the human activities into two groups: (1) non-economic activities, and (2) economic activities. .

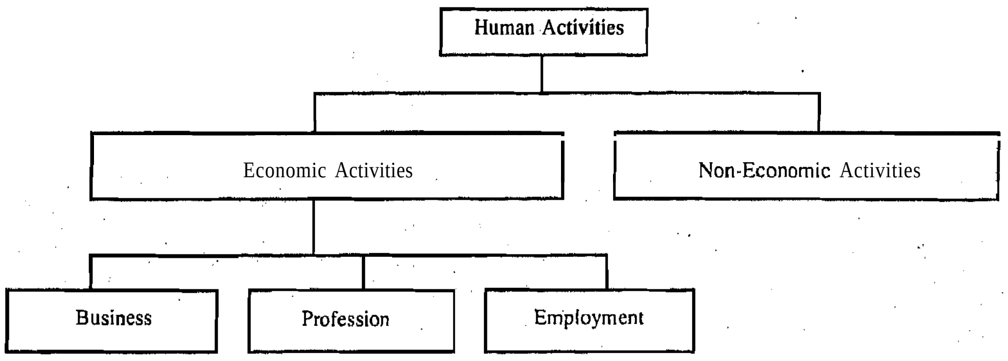
1 Non-economic Activities: These are the activities which are conducted by the human beings due to love and affection, social obligation, religious obligation, physical requirement, patriotism, etc.. but not for earning money. The housewife cooking for the

family, children going to school and playing games, people going to a temple or a mosque for prayer, a social worker working for the uplift of the poor, etc., are some such examples. Persons who participate in such activities do not get any direct economic benefit.

2 Economic Activities: These are activities which are undertaken by human beings for earning money or livelihood. These economic activities are concerned with production, exchange. and distribution of goods and services. For example, a doctor working in the hospital, a teacher working in a school, an employee going to his office, a farmer working in the field, etc. They are all doing this to earn his or her livelihood or to acquire wealth.

We can further classify these economic activities into three groups: (a) business, (b) profession, and (c) employment. Look at Figure 1.1 for classification of human activities.

Figure 1.1
Classification of Human Activities



a) Business: Any activity carried primarily with the object of earning profit can be called a business activity. This objective of earning profit is achieved by production and/or exchange of want satisfying goods and services. Therefore, we can define business as "any activity concerned with the production and/or exchange of want satisfying goods and services carried with a view of eaming profit". Production of soaps, sale of eggs, production of TV sets, transport, etc., are some examples of business. A person who is engaged in business is called a businessman or entrepreneur. Similarly, a firm formed for the purpose of carrying a business activity is called a business enterprise or a business firm. You will Iearn in detail about business later in this unit.

b) Profession: An activity which involves the rendering of personalised services of a specialised nature, based on professional knowledge, education and training is called a profession. Services rendered by doctors, lawyers, chartered accountants, etc., come under this category. Generally, for each category of profession, there would be a professional body. For example, Bar Council of India is the professional body of lawyers which guides and regulates the law profession in India. The professional body prescribes the nature and type of educational qualifications and training required to practice the concerned profession. A professional should become the member of concerned professional body and follow the code of conduct prescribed by such body. Professionals charge some fee for the professional service they render.

c) **Employment:** Any activity assigned to a person by the employer under an agreement or rules of service comes under the category of employment. A person who undertakes such activity is called employee. For performing such activity, the employee receives remuneration from the employer in the form of wage or salary, allowance, bonus, etc. The employment is also called 'service'. Working in a factory, office, hotel, college, etc., are a few examples of employment. Even professionally qualified persons also work as employees in various organisations. For example, doctors employed in government/ private hospitals, engineers employed in a factory, etc.

Although business, profession and employment are distinguished from each other, they are also inter-dependent. Business enterprises provide employment to a large number of people in the,country. Similarly, professionals like engineers, chartered accountants, cost accountants, management consultants, legal experts, doctors, etc., work with the business firms for tackling complicated technical problems. Thus, business enterprises provide 'employment opportunities.to professionals and general public. At the same time the success of the business is dependent on its employees and professionals working with it.

X3 BUSINESS

You have learnt that the entire range of economic activities of the human beings could be classified into business, profession and employment. Among these three categories, profession and employment, though important, are outside the scope of this course. We are primarily concerned with business. So, let us discuss about business in more detail.

1.3.1 Essential Features of Business

You have learnt that business refers to the human activities engaged in production and/or exchange of want satisfying goods and services carried with the intention of earning profits. Now let us study the important characteristics of business. We can list the following five broad features of business.

1 Dealings in goods and services: Business deals with goods and services. The goods may be consumer goods such as sweets, bread, cloth, shoes, etc: They may be producer's goods such as machinery, equipment, etc., which are used to produce further goods for consumption. Business also deals with services such as transport, warehousing, banking, insurance, etc., which are intangible and invisible goods.

2 Production and/or exchange: You can call an economic activity a 'business' only when there is production or transfer or exchange or sale of goods or services for value. If goods are produced for self-consumption or presentation as gift, such activities shall not be treated as business. In a business activity, there must be two parties i.e., a buyer and a seller. Such activity should concern with the transfer of goods or exchange of goods between a buyer and a seller. The goods may be bartered or exchanged for money.

3 Continuity and regularity in dealings: A single transaction shall not be treated as business. An activity is treated as business only whon it is undertaken continually or at least recurrently. For example, if a person sells his residential house, it is not considered as business. If he repeatedly buys houses and sells to others, such activity comes under business. But how frequently the transaction should occur depends on the nature of the activity. For example, a ship building company takes a long time to manufacture and sell a ship. At the same time, a vegetable vendor purchases vegetables from the market in the morning and sells out to his customers by evening. But both these activities are treated as business.

4 Profit motive: Earning profit is the primary motive of business. This is not to undermine the importance of the element of service in business activity. In fact a business will flourish only when it is able to serve its customers to their satisfaction. Profits are essential to enable the business to survive, to grow, expand, and to get recognition.

5 Element of risk: In every business, there is a possibility of incurring loss. This possibility of incurring loss is termed as risk. The element of risk exists due to a variety of factors which are outside the control of the business enterprise. There are two kinds of risks. (1) Risks whose probability can be calculated and can be insured. Losses due to fire, floods, theft, etc., are some examples. (2) Risks whose probability cannot be calculated and which cannot be insured against, e.g., changing technology, fall in demand, changing fashions, short supply of raw materials, etc. These risks are to be completely born by the enterprise.

1.3.2 Objectives of Business

You have learnt that the primary objective of business is to earn profit. Although profit plays an important role as a criterion of success, business may not exist for long with the sole objective of earning profit. As stated by Henry Ford, "business is not mere money chasing but it also should aim at serving the community". According to Urwick, "profit can no more be the objective of a business than eating is the objective of living". Thus, serving the community is regarded as another important objective of business. In fact, some authors regard 'service to community' as the major objective of business and state that this provides the main justification for the existence of business as an important human activily. Therefore, while profit is necessary for the businessman to stay in business, he ought to aim at something more for its survival and growth.

The objectives of business could be listed under three broad headings: (1) economic objectives, (2) social objectives, and (3) human objectives.

Economic Objectives: Basically being an economic activity, primary objectives of business are economic. Some of the main economic objectives are :

I Earning of satisfactory profits.

2 Exploring new markets and creation of more customers.

3 Growth and expansion of business operations of the firm.

4 Making innovations and improvements in goods and services so that customers get improved and more economic goods and services.

Social Objectives: Business, being a part of the society, has obligations towards the society also. Some major social objectives are :

I Providing more and more employment opportunities to the people in the country.

2 Supply of quality goods to the community.

3 Providing goods at reasonable prices.

4 Ensure fair returns to investors.

5 ıvoidance of profiteering and unfair practices.

6 Production of goods in accordance with national interests and priorities.

Human Objectives: Business activity is, generally, carried out through employees who are human beings. In fact, the efficiency and the success of the business enterprise depends on the motivation and ability of its employees. Therefore, business must also have some human objectives to safeguard the interests of its employees. Some of the major human objectives are :

1 Fair deal to employees in terms of wages and incentives.

2 Providing better working conditions and environment to the employees.

3 Provide job satisfaction.

4 Provide the employees more and more' promotional/growth opportunities.

1.3.3 Business Distinguished from Profession and Employment

You have learnt about the essential characteristics of business. Keeping in mind these characteristics, let us now analyse how business is different from profession and employment.

Read Table 1.1 carefully. You will find the distinct features of business. profession and employment.

Table 1.1
Characteristics of Business, Profession and Employment

Features	Business	Profession	Employment
1 Establishment	An individual or a group' of individuals decides to start business. Legal formalities like registration, etc.. are to be fulfilled.	Acquire required qualifications, training, etc. Become the member of concerned professional body.	Enter into service contract with the employer.
2 Qualifications	Specific qualifications are not required.	Professional knowledge and training in the Specific field is necessary.	In some cases specific qualifications required and in some other cases not required.
3 Investment	Capital is required. Actual amount depends on the nature of business.	Some amount of capital required for equipment and establishment of office.	Capital not required.
4 Nature of work	Production and/or exchange of goods and services.	Renders personalised services of a specialised nature to the clients.	Performing the work assigned by the employer under the service contract.

5 Motive	Mainly profit motive.	Although fee is charged. service is the main motive.	No specific motive. Mainly to earn livelihood.
6 Reward	Profit.	Professional fee	Wage or salary.
7 Transferability of ownership interest	By following required legal formalities, business can be transferred to others.	Not possible to transfer:	Not possible to transfer.
8 Risk	There is risk of loss	Possibility of not getting enough fee to meet the expenditure on establishment.	No risk. Employee gets wage or salary regularly so long as the firm continues in operation

1.3.4 Classification of Business

You just recollect what we have stated about business. We stated that business is concerned with production and/or exchange of goods and services with the intention of earning profit. It states that business is concerned with two aspects i.e. production and exchange. Based on this, we may classify business activities into two categories. In the first category we can group all the business activities relating to production. Similarly, all the activities relating to exchange may be grouped under the second category. The first category is known as 'industry', while the second category is called 'commerce'.

Check Your Progress A

1 What is the main distinction between the economic activity and non-economic activity?

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2 What is business?

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3 What is profession?

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4 What is employment?

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5 Classify the following activities into business, profession and employment.

Activity	Classification
i) Selling vegetables.	....
ii) A person working in a medical shop as salesman.	....
iii) A doctor working in a government hospital.	....
iv) A chartered accountant started private practice.	....
v) Manufacture of biscuits.	....

vi) Lawyer siarted private practice. ....

vii) Transporting of goods. ....

6 State whether the following statements are True or False.

i) The sole objective of business is earning profit. ....

ii) Profession is a non-economic activity. ....

iii) Employment is an economic activity. ....

iv) There is no element of risk in business. ....

v) Business is concerned only with the exchange of goods and services. ....

vi) Industry is a part of business activity. ....

vii) Industry and commerce together constitute business activity.

viii) An activity is treated as business when it is undertaken continually or recurrently. ....

ix) In case of profession, ownership interest can be transferred to others. ....

x) Activities taken up for earning money or livelihood are called economic activities. ....

xi) Father teaching his daughter is an economic activity. ....

1.4 INDUSTRY

As you have learnt, industry refers to that part of business activities which is concerned with the production of want satisfying goods through utilisation of available material resources. Industry utilises the natural resources and brings them into the form useful for final consumption or further use. It means that the industrial activity aims at ensuring the supply of goods in that form which suits the objects, needs and convenience of the persons expected to use them. Thus, industry creates form utility to goods. For example, farms, factories, mines, etc., make available a wide range of goods. These goods cater to the needs and convenience of the people. In a nut shell, the activities of human beings engaged in extraction, production, processing, construction and fabrication of products come under industry.

There is another explanation for industry. Under this second explanation, industry means a group of factories usually specialising in a particular product line. For example, all the factories which produce fertilizer are collectively called fertiliser industry. Similarly, all automobile factories together constitute automobile industry. But, in the present context, this approach is not relevant. We adopt the first approach.

1.4.1 Classification of Industry

There are various approaches of classifying industries. All these approaches are listed below.

1 On the basis of the nature of activity

a) Extractive industries

b) Genetic industries

c) Manufacturing industries

d) Construction industries

2 On the basis of the nature of goods produced

a) Consumer goods industries

b) Producer goods industries

3 On the basis of the level of investment

a) Heavy industries

b) Light industries

4 On the basis of size of the activity
   a) Small scale industries
   b) Large scale industries

5 On the basis of area of operations
   a) Regional industries
   b) National industries
   c) Multinational industries

Since the theme of the discussion in this unit is centred around human activity, the classification based on the nature of activity is more appropriate for us. So, let us discuss about the first classification in detail.

a) Extractive Industries: Activities engaged in the discovery and extraction of natural resources like minerals, animals, plants, trees, etc., from the surface or beneath the surface of the earth or air or water come under this category. Extractive industries are also called exhaustive industries because with every attempt there is a depletion of resources and this wealth exhausts. Mining, farming, quarrying, hunting, fishing, etc., come under this category.

b) Genetic Industries: Activities which are concerned with reproducing and multiplying plants and animals with the objective of earning profit from their sale come under this category. Examples are nurseries which multiply and sell plants, poultry farms, cattle breeding farms, fish culture, etc.

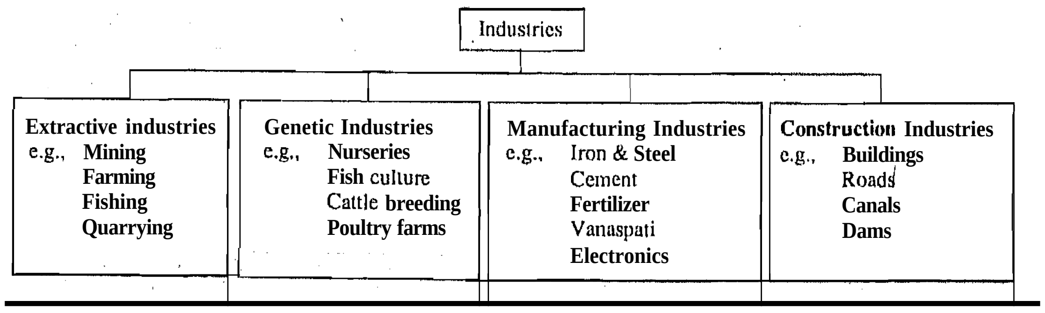
There is one important difference between an extractive i.:dustry and a generic industry. In the case of extractive industry, man cannot add to the wealth which he withdraws from the earth; sea, and air. However, in the case of genetic industry, man not only adds to the growth but also reproduces the nature made goods.

c) Manufacturing Industries: These types of industries are engaged in the conversion or transformation of raw-materials and semi-finished materials into finished products. Generally, the products of extractive industries become raw-materials for manufacturing industries. In other words, manufacturing industries create **'form utility'** to the products of extractive industries. Cement industry, sugar industry, cotton textile industry, iron and steel industry, fertilizer industry, etc., are some examples for manufacturing industries.

d) Construction Industries: These industries are engaged in the construction activities like the construction of buildings, bridges, dams, roads, canals, railway lines, etc. These industries consume the products of manufacturing industries (e.g., bricks, cement, iron and steel) and extractive industries (e.g., quarries, wood). The products of construction industries are immovable. They are erected, built or fabricated at a fixed site.

Look at Figure 1.2 for classification of industries with some examples.

Figure 1.2
Classification of Industries Based on the Nature of the Activity



Check Your Progress B

1 Distinguish between business and industry.

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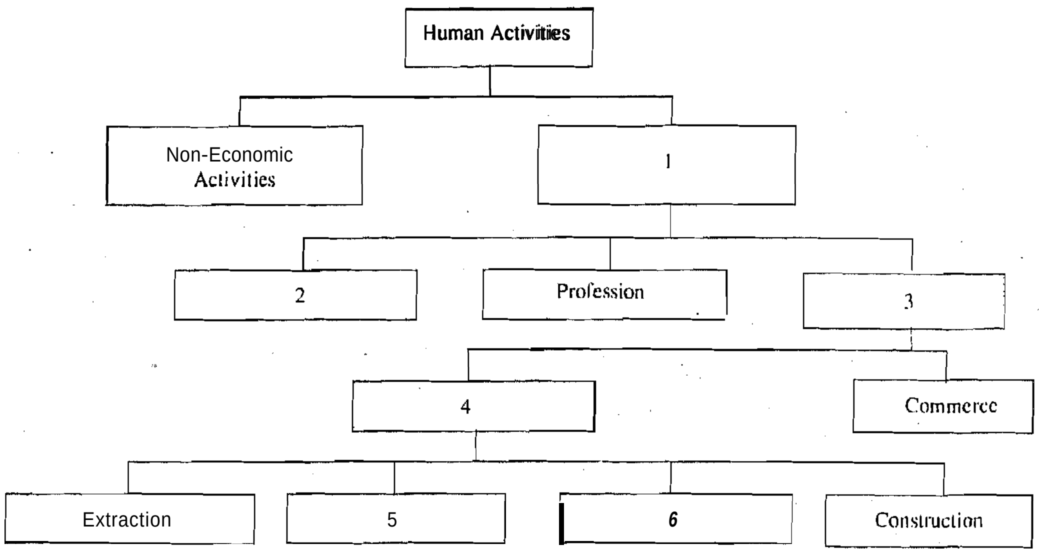
2 Fill in the blank columns.



3 To which category of industry the following activities belong.

Activities — Category of Industry

i) Fishing in the sea. ....

ii) Raising coal from a mine. ....

iii) Weaving of cloth. ....

'iv) Construction of a dam. ....

'v) Preparation of wooden furniture. ....

vi) Cattle breeding. ....

vii) Development of railway track. ....

viii) Producing rail engine. ....

1.5 COMMERCE

You have learnt that the business activities are classified into: 1) industry, and 2) commerce. You also learnt that the industrial activities are concerned with the production of want satisfying goods and services. Unless these goods and services are made available to those . who need them, they may not fulfil their objectives i.e., satisfying human wants. Therefore, the goods produced by the industries should be made available to the consumers at right place, right time, right quantity, right price and in right manner. Here comes the activity of commerce to fulfil all these requirements. **All the activities which establish link between the producers of goods and consumers of these goods, and maintain a smooth and uninterrupted flow of goods between them come under commerce.**

A smooth and uninterrupted flow of goods and services from producer to consumer is beset with many barriers and hindrances. For instance, goods produced by one may be consumed by another. In such a case, unless the producer and consumer identify each other, there is no scope for exchange of goods between them. This is the **hindrance of person.** Similarly, for buying a product, consumers should have the knowledge about the existence of that product, its features, etc. Therefore, there is a need to provide such information to the consumers. This is the **hindrance of knowledge.** The **hindrance of time** arises out of the time gap between the time of production and the time of consumption. In many cases goods are produced at one place while they are consumed at another place. So, the goods should be carried from the place of production to the place of consumption. This gives rise for the **hindrance of place.** Commerce eliminates all these hindrances and facilitates the exchange of goods between producers and consumers. Later, in this section, you will learn in detail how these hindrances are eliminated through various business activities which form part of commerce.

In a nutshell, commerce is mainly concerned with the purchase and sale of gpods, and also embraces all those functions which are essential for maintaining smooth and uninterrupted flow of goods and services between the buyers and sellers. Thus, there are two main aspects in commerce: i) purchase and sale of goods, and ii) activities essential for the smooth and uninterrupted flow of goods. Therefore, we can classify the whole range of commerce activities into two categories :

1) Trade — activities of purchase and sale.
2) Aids to Trade — activities which facilitate the smooth and uninterrupted flow of goods.

1.5.1 Trade

You have already learnt that the human activities engaged in buying and selling of goods and services come under trade. Therefore, trade includes sale, transfer or exchange of goods and services with the intention of earning profit. The objective of trade is to make goods available to those persons who need them and are willing to pay for them. Thus, trade plays 'a major role in establishing contact between the producers and the consumers and eliminates the hindrance of person.

A person who is engaged in trade is called 'trader' or 'middleman'. Various traders operate in between producers and consumers and remove the hindrance of person. We can classify trade into two broad categories: 1) internal trade, and 2) external trade.

1 **Internal Trade:** When the trade takes place within the boundaries of the country, you can call it 'internal trade'. It means that both buying and selling should take place within the country. Payment for the same is generally made in national currency. This internal trade is also termed as inland trade or national trade or homc trade or domestic trade.

On the basis of the scale of operations, we can classify internal trade into: a) Wholesale trade, and b) retail trade.

a) **Wholesale Trade:** Buying and selling in relatively larger quantities is called wholesale trade. A person who is involved in wholesale trade is called wholesaler.

b) **Retail Trade:** This refers to buying and selling in relatively smaller quantities. A person engaged in retail trade is called a retailer.

Let us now discuss in some detail how these wholesalers and retailers operate and eliminate the hindrance of person. A wholesale trader buys goods in large quantities from the manufacturers and sells in relatively smaller quantities to the retailers. Thus, the wholesale traders constitute a link between the producers on the one hand and the retailers on the other hand. Retailers who buy goods from the wholesalers, scll them in smaller quantities to the consumers. Thus, retail traders establish link between wholesale traders on the one hand and consumers on the other. Thus, the wholesalers and retnilers establish a link between the producers and consumers and eliminate the hindrance of person. However, sometimes producers may take the services of only either wholesalers or retailers, or may establish a direct link with the consumers. The whole chain of traders/middlemen operating in between producer and consumer is referred to as 'channel of distribution' about which you will learn in detail in Units 10 and 11 in this course.

2 **External Trade:** This is also called 'foreign trade' or 'international trade'. When the trade takes place across the boundaries of a country, you can call such trade as external trade. In other words, external trade refers to the trade between nations. This trade could be in the form of exchange of one commodity for another or for money.

We can classify foreign trade into three categories: a) import trade, b) export trade, and c) re-export trade.

a) **Import Trade:** when a country buys goods from another country, it is called 'import trade'. For example, India bought machinery from the USA. This is an import trade for India.

b) **Export Trade:** When a country sells goods to another country, it is called 'Export Trade'. For example, India sells leather goods to USSR, and tea to USA. For India such selling of goods shall be termed as 'cxport trade'.

c) **Re-export Trade:** This is also called 'entrepot trade', When the goods are imported from one country and the same are exported to another country, such trade is called 're-export trade'. Re-export is done by those countries which have ports that are conveniently situated to serve as distributing points for neighbouring countries. Such countries import large quantities of goods and re-export the same to the neighbouring countries.

1.5.2 Aids to Trade

Activities which facilitates the trade are called 'aids to trade'. Thus, all human activities which eliminate the hindrances and facilitate the flow of goods from producers to consumers come under aids to trade. They are also called 'auxiliaries to trade'. The whole range of activities coming under aids to trade may be classified into five categories: I) transportation, 2) warehousing, 3) insurance, 4) advertising, and 5) banking.

1 **Transportation:** Generally, all the goods are not consumed at the same place where they are produced. Therefore, goods are to be moved from the place of production to the place where they are demanded. The activity which is concerned with such movement of goods is called 'transportation'. Thus, transportation eliminates the hindrance of place and creates place utility to goods.

   Transportation can be of three types:

   a) Land transportation — road, rail

   b) Air transportation — aeroplane

   c) Water transportation — boat, ship

2 **Warehousing:** Goods may not be consumed immediately after production. Normally there will be time gap between production and consumption. This is the hindrance of time. Therefore, goods once produced should be preserved properly till they are consumed. Particularly, perishable goods like milk, meat, vegetables, flowers, etc., should be preserved very carefully. Otherwise, they get spoiled and become useless. For this reason warehousing is recognised as yet another aid to trade. Warehousing refers to preservation of goods to make them available as and when needed by consumers. Thus, warehousing eliminates the hindrance of time and provides time utility to goods.

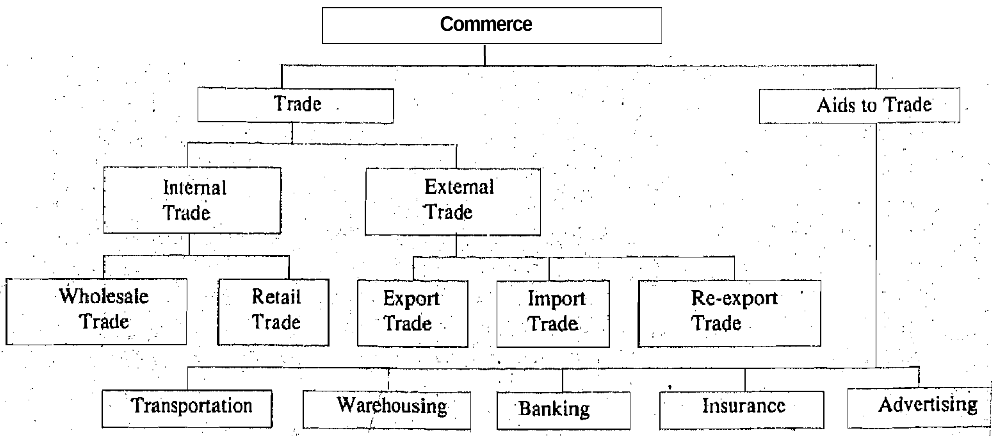
3 **Insurance:** The goods may be destroyed while in production process, or in transit due to accidents, or in storage due to fire or theft, etc. The businessmen would like to cover these risks. Insurance companies come to their rescue in this regard. They undertake to compensate the loss suffered due to such risks. For this purpose, the business has to take an 'insurance policy' and pay a certain amount regularly, called 'premium'. Thus, insurance eliminates the hindrance of risk.

4 **Advertising:** Exchange of goods is possible only when the consumers have the knowledge about the existence of a product. This is the hindrance of knowledge. This hindrance is eliminated through advertising. Through advertisement, producers communicate all inforination about their goods to the prospective consuiners'and create in them a strong desire to buy the product. Thus, advertising facilitates the flow of goods between producers and consumers by bringing the knowledge about the products to the consumers. Advertising is done through TV, radio, newspapers, magazines, hoardings, wallposters, etc.

5 **Banking:** Banking facilitates the flaw of goods by removing the hindrance of finance and credit. Now-a-days we cannot think of business without banks. To start the business or to run it smoothly we require money. Banks supply money. A bank is an organisation which accepts deposits of money from the public, withdrawal on demand or otherwise, and lends the same to those who need it. Banks also provide many services required for the business activity.

Look at Figure 1.3 for classification and sub-classification of commerce.

Figure 1.3
Classification of Commerce



Check Your Progress C

I What is the difference between commerce and industry?

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2 What is the difference between internal trade and external trade?

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3 How is trade different from commerce?

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4 A list of hindrances are given below. State the names of the business activities which eliminate them.

Hindrance	Name of the Business Activity
i) Hindrance of distance	....
ii) Hindrance of time	....
iii) Hindrance of risk	....
iv) Hindrance of finance	....
v) Hindrance of knowledge	....
vi) Hindrance of person	....

5 State whether the following statements are True or False.

i) Trade is concerned with buying and selling of goods. □ True □ False

ii) A person who buys and sells in smaller quantities is called wholesaler. □ True □ False

iii) When goods are sold in another country, it is called export trade. □ True □ False

iv) Activities which facilitate buying and selling come under aids to trade. □ True □ False

v) Import trade refers to buying goods in one country and selling the same in another country. □ True □ False

vi) Internal trade refers to buying and selling within the national boundaries. □ True □ False

vii) Retailer establishes link between wholesaler and consumer. □ True □ False

viii) External trade is also called home trade. □ True □ False

1.6 ORGANISATION

You have learnt what is a business activity and various types of business activities like industry, trade, transportation, banking; etc. Whatever business activity you may take up, you have to bring together various resources like capital, machinery; raw-materials, labour, technicians, etc. Mere presence or availability of these resources is not enough. Such resources are to be put in action in a systematic way to achieve its objective.

For example, take the case of textile production. First you get some land and construct buildings, buy machinery and instal them in the buildings, employ labour and technicians to work on the machinery, buy raw-materials (cotton, dyes, etc.), and process the raw-materials in the factory and produce the cloth. Once cloth is produced it is to be sold to consumers through wholesale and retail dealers. Thus, to produce cloth you have to assemble resources such as factory, cotton, dyes; labour, wholesalers, retailers, etc. But simple presence of these resources may not achieve the purpose. We have to put these resources together in action very systematically and coordinate their activities. Then only it is possible to produce the cloth, distribute it to consumers, and get profits. This is true with any business activity.

A business activity becomes a reality only when efforts are made to bring the required resources together, put them at work systematically, and coordinate their activities properly. This is referred to as business organisation.

In the opinion of J.W. Shulze, "organisation is a combination of necessary beings, materials, tools, equipment, working space apparatus and finance brought together in a systematic and effective correlation to accomplish some desired objective".

Oliver Sheldon defined it as ·· the process of combining the work which individuals and groups have to perform with the facilities necessary for its execution so that they provide the best channels for efficient, systematic, positive and coordinated application of the available effort".

As viewed by F.J. Wright, "organisation is the arranging or combining of resources to achieve an economic aim--either with the resources available to achieve the maximum result or profit, or to achieve a given aim with the least possible expenditure of resources".

Thus, business organisation means bringing together various components of business such as workforce, raw-materials, machines, capital, energy, etc., putting them on work systematically, and coordinating and controlling'their activities effectively to achieve the objective of earning profit.

Forms of Business Organisation: Business may be owned and managed by a single man, or a group of persons forming a partnership firm or as a joint stock company or even as a cooperative society.

Thus, on the basis of ownership and management, we can classify'business organisation into four groups.

1 Sole proprietorship
2 Partnership firm
3 Company
4 Cooperative society

The first two categories (sole proprietorship and partnership forms) may be called non-corporate forms of organisations. The remaining two categories (company form and cooperative society) may be called as corporate forms of organisations. About these forms of organisations, you will study in detail in Units 2 and 3.

Entrepreneur: You know that the business is carried with the primary objective of earning profits. You also know that setting up of the business to achieve this objective requires bringing together various resources, coordinating them and controlling all activities. This has to be done by soinebody who may conceive the idea of doing a particular type of business, mobilise the resources and bring the organisation into existence. Such a person who does all this is called an entrepreneur. He is the one who also bears the risk of the business. You know that although each enterprise is started with the objective of earning profit but the possibility of loss cannot be ruled out. Thus, the entrepreneur is the person who conceives the business idea., brings the organisation into existence and carry on the business activity, and prepared to bear'the risk of loss. You will learn in detail about the entrepreneur in Unit 4.

1.7 LET US SUM UP

The whole range of human activities can be classified into: 1) economic activities, and 2) non-economic activities. Economic activities are further divided into: 1) business, 2) profession, and 3) employment. Business is concerned with production and/or exchange. of goods and services carried with the primary objective of earning profits. Activities concerned with the rendering of personalised services of a specialised nature come under profession. Employment refers to the activity assigned to a person by the employer under an agreement or rules of service.

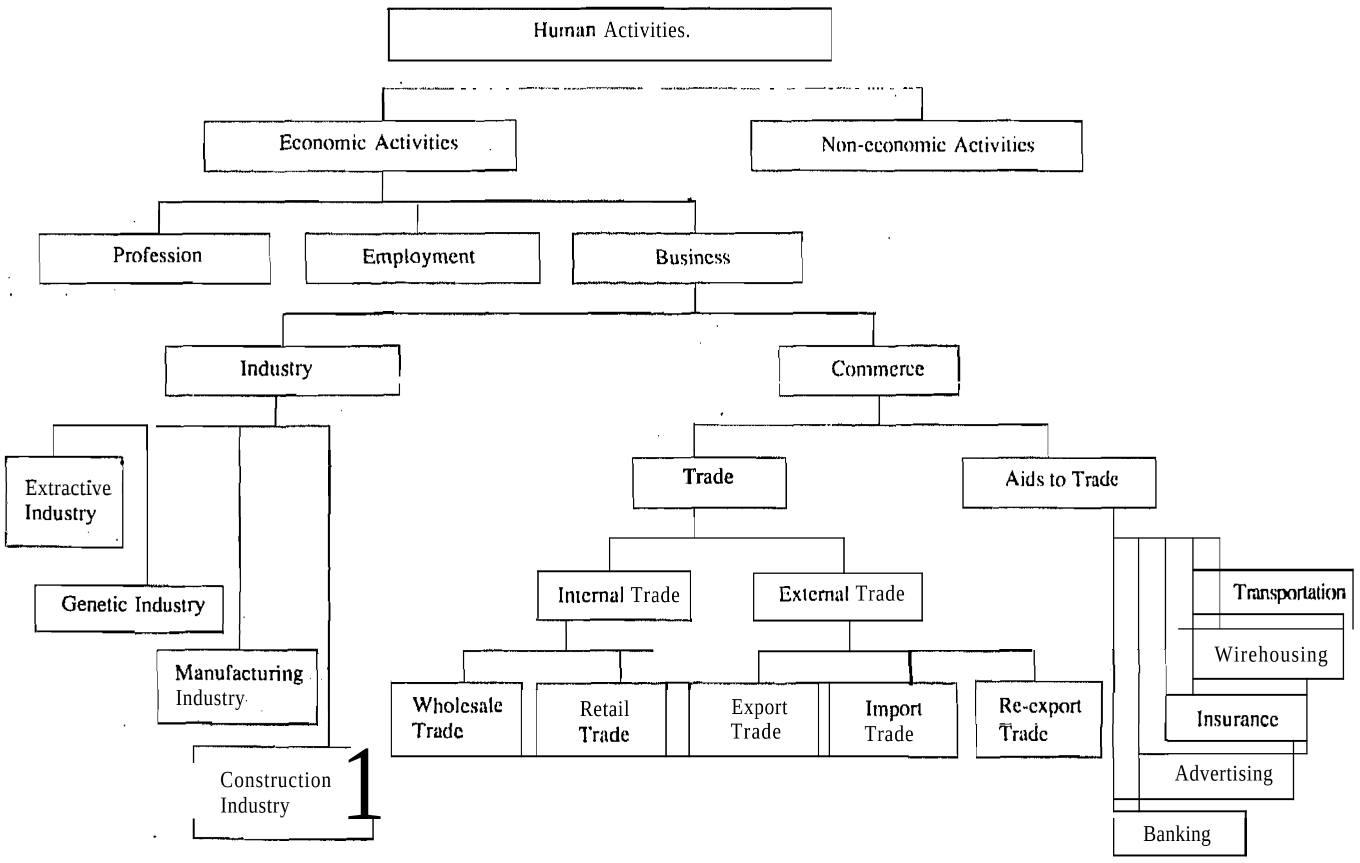
The main features of business activity are: 1) dealings in goods and services, 2) production and/or exchange, 3) regularity in dealings, 4) profit motive, 5) element of risk, and 6) enterprise. Besides earning profit, the business also serves certain economic, social, and human objectives.

Business activities are classified into: 1) industry, and 2) commerce. Industrial activities are classified into four categories: 1) extractive industries, 2) genelic industries, 3) manufacturing industries, and 4) construction industries.

Commerce is classified into: I) trade, and 2) aids to trade. Activities concerned with buying and selling come under trade. Activities which facilitate buying and selling, and maintain smooth flow of goods and services come under aids to trade. These are: 1) transportation, 2) warehousing, 3) banking, 4) insurance, and 5) advertising. Figure 1.4 gives complete classification of human activities.

Organisation makes the business proposition into a reality. It brings together required components, puts them on work systematically, and coordinates and controls their activities effectively to achieve the objective of earning profit. There arc four basic forms of business organisation: 1) sole proprietorship, 2) partnership. 3) company, and 4) cooperative society.

Figure 1.4
Classification of Human Activities


Human Activities.
Economic Activities
Non-economic Activities
Profession
Employment
Business
Industry
Commerce
Extractive Industry
Genetic Industry
Manufacturing Industry
Construction Industry
Trade
Aids to Trade
Internal Trade
External Trade
Wholesale Trade
Retail Trade
Export Trade
Import Trade
Re-export Trade
Transportation
Wirehousing
Insurance
Advertising
Banking

1.8 KEY 'WORDS

Advertising: An activity by which the product and its qualities are made known to the ,'publicfor stimulating demand.

Aids to Trade: Activities which facilitate the smooth and uninterrupted flow of goods and services from producers to consumers.

Banking: An activity of mobilising money deposits from public and giving loans to the needy.

Business: An activity of production and/or exchange of want satisfying goods and services carried with the primary intention of earning profits.

Business Organisation: Bringing together various components of business such as workforce, raw-materials, machines, capital, energy, etc., putting them on work systematically, and coordinating and controlling their activities to achieve the objectives of business.

Commerce: Activities related to purchases and sales of goods, and those concerned with maintaining a smooth and uninterrupted flow of goods and services between buyers and sellers.

Construction Industry: Industry engaged in the construction of buildings, bridges, roads, dams, canals, railway lines, etc.

Economic Activities: Activities which are undertaken by human beings for earning money or livelihood.

Employment: Activity of working with an employer under agreement or rules of service.

Entrepreneur: A person who conceives the business idea, brings the organisation into existence, carries on the business activity, and is prepared to bear the risk of loss.

Export Trade: Selling goods in another country.

External Trade: Purchase and sale of goods and services across the boundaries of a country.

Extractive Industry: Industry engaged in the discovery and extraction of natural resources like minerals, animals, plants, trees, etc.. from the surface or beneath the surface of earth or air or water.

Genetic Industry: Industry engaged in reproduction and multiplication of plants and animals with the objective of earning profit from their sale.

Import Trade: Buying goods from another country.

Industry: Activities engaged in the production of goods and services by utilising available material resources.

Insurance: Covering risk of loss arising from events like fire, accident, etc., by paying certain premium to insurance company.

Internal Trade: Purchase and sale of goods and services within the boundaries of a country.

Manufacturing Industry: Industry concerned with the conversion or transformation of raw-materials and semi-finished goods into finished products.

Non-Economic Activities: Activities which are undertaken by human beings due to love and affection, social obligation, religious obligation, patriotism, physical requirement, etc., but not for earning money.

Profession: Activity which involves the rendering of personalised services of a specialised nature based on professional knowledge, education, and training.

Re-export Trade: Importing goods from one country and exporting the same to another country. It is also called entrepot trade.

Retail Trade: Buying goods from wholesalers in large quantities and selling these in small quantities to consumers.

Trade: Activities concerned with the buying and selling of goods and services.

Transportation: Activities engaged in the moving of goods from one place to another.

Warehousing: Activities engaged in the preservation of goods to make them available as and when needed by consumers.

Wholesale Trade: Buying goods from producers in large quantities and selling them to retailers in smaller quantities.

1.9 SOME USEFUL BOOKS

Bhushan, Y.K., 1987, *Fundamentals of Business Organisation and Management*, Sultan Chand: New Delhi. (Part One, Chapters I & 2)

Ramesh, M.S., 1985, *Principles and Practice of Modern Business Organisation, Administration & Management*, Kalyani Publishers: New Delhi. (Volume 1, Chapters 1, 2 & 3)

Singh, B.P., and T.N. Chhabra, 1988, *Business Organisation and Management*, Kitab Mahal: Allahabad. (Part One, Chapters 1, 2 & 3).

1.10 ANSWERS TO CHECK YOUR PROGRESS

A 5 (i) Business (ii) Employment (iii) Employment (iv) Profession (v) Business (vi) Profession (vii) Business

6 (i) False (ii) False (iii) True (iv) False (v) False (vi) True (vii) True (viii) True (ix) False (x) True (xi) False

B 2 (1) Economic Activities (2) Employment (3) Business (4) Industry (5) Genetic (6) Manufacturing

3 (i) Extractive (ii) Extractive (iii) Manufacture (iv) Construction (v) Manufacture (vi) Genetic (vii) Construction (viii) Manufacture

C 4 (i) Transportation (ii) Storage (iii) Insurance (iv) Banking (v) Advertising (vi) Trade

5 (i) True (ii) False (iii) True (iv) True (v) False (vi) True (vii) True (viii) False

1.11 TERMINAL QUESTIONS

1 What is business? Explain its features and objectives.

2 Is business different from profession and employment? Discuss.

3 What is industry? Explain its classification with illustrations.

4 What do you understand by commerce? Briefly explain the classificalion of commerce with suitable examples.

5 What do you understand by organisation? What are the basic forms of business organisalion?

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

UNIT 2 FORMS OF BUSINESS ORGANISATION I

Structure

2.0 Objectives
2.1 Introduction
2.2 Sole Trader Organisation
2.2.1 Main Features
2.2.2 Merits and Limitations
2.3 Partnership Form of Organisation
2.3.1 Main Features
2.3.2 Classification of Partners
2.3.3 Partnership Deed
2.3.4 Merits and Limitations
2.3.5 Joint Hindu Family Firm
2.4 Company Form of Organisation
2.4.1 Main Features
2.4.2 Classification of Companies
2.4.3 Merits and Limitations
2.5 Cooperative Form of Organisation
2.5.1 Main Features
2.5.2 Classification of Cooperatives
2.5.3 Merits and Limitations
2.6 Let Us Sum Up
2.7 Key Words
2.8 Some Useful Books
2.9 Answers to Check Your Progress
2.10 Terminal Questions

2.0 OBJECTIVES

After studying this unit, you should be able to :

- describe the various forms of business organisations
- outline the features of each form of business organisation
- explain the merits and limitations of each form of business organisation.

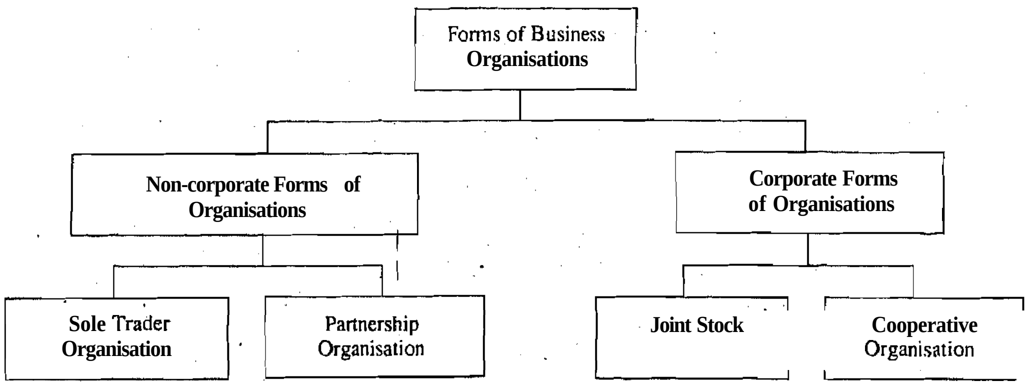
2.1 INTRODUCTION

In the previous unit you learnt that any activity carried with profit motive is called business and that such activity may be an industrial activity, a trading activity or a service activity like banking, insurance, transportation, etc. You have also learnt that bringing various resources together to set up a business and putting them to work systematically is termed as business organisation. The person who takes initiative to set up a business, provides the necessary funds and bears the risk involved is called the owner of the business. When the business is organised on small scale, it may be possible for one person to provide the funds and bear the risk. But when it is large, he may need others to join hands. Thus, business may be owned by an individual or a group of persons. When a business is owned and carried on by one person it is called 'Sole Trader Organisation'. But when it is owned by a group of persons it may take the form of a partnership firm, a company or a cooperative society, In this unit you will study in detail the features, classification, merits and limitations of these different forms of business organisations.

Look at Figure 2.1. It shows various forms of business organisation.

Figure 2.1

Various Forms of Business Organisations


Forms of Business Organisations
Non-corporate Forms of Organisations
Corporate Forms of Organisations
Sole Trader Organisation
Partnership Organisation
Joint Stock
Cooperative Organisation

2.2 SOLE TRADER ORGANISATION

The sole trader organisation (also called proprietorship) is the oldest form of organisation and the most common form of organisation for small business even today. It is the simplest and easiest to form. What is required is that an individual decides about the type of business to be started and arranges the necessary capital. Required capital may be mobilised from his own savings, or may be borrowed from friends and relatives. The business may be carried either in a portion of his own residence or in a rented building. The person generally manages the business on his own. He may also take the help of his family members or employ some persons, if necessary. He can take the advice from others in running the business, but his own will be the final decision. Thus, the sole trader enjoys full control over the affairs of the firm. He enjoys all the profits earned by the business. So in case of loss, naturally, he has to bear the full burnt of it.

Thus, we can now define sole trader organisation as "one man's business in which an individual produces independently with his own capital, skill and intelligence and is entitled to receive all the profits and assumes all the risks of ownership". J.L. Hanson defines it as "a type of business unit where one person is solely responsible for providing the capital for bearing the risk of the enterprise and for the management of the business". Under this form of business organisation, no distinction is made between the business concern and the proprietor. Likewise, the management rests with the same person.

2.2.1 Main Features

Based on the above discussion, we can list the main features of sole trader organisation as follows.

1 One man ownership: The ownership lies with one person only. There are no associates or partners. He invests his own money or borrows from the friends and relatives.

2 No separation of ownership and management: The owner himself manages the business. Therefore, the separation of ownership and management which is quite common in big business is not present in this form of organisation. Since the proprietor himself manages the business, he exercises a high degree of supervision and control in the working of his business.

3 No separate entity: The business does not have an entity separate from the owner. The proprietor and the business enterprise are one and the same.

4 All profits to proprietor: Since there are no partners, all the profits are enjoyed by the sole proprietor.

5 Individual risk: All losses in the business are borne by the proprietor himself.

6 Unlimited liability: The proprietor has an unlimited liability. This means that in caw of loss even the personal property of the owner can be utilised for clearing the business obligations and debts,

7 **Less legal formalities:** To set up sole proprietorship, no legal formalities are required. Of

course, there are some legal restrictions for the setting up of a particular type of business. For example, an individual cannot start a bank or an insurance company. But one can start a fruit stall or a cycle shop without much legal formalities. However, in some cases a licence may be required. For example, to start a restaurant, you need licence from municipal corporation.

2.2.2 Merits and Limitations

You have learnt about the main features of the sole·trade business. In view of these features. this form of organisation has the following merits and limitations.

Merits

1 Easy formation: There are no legal formalities to be observed while starting this form of organisation. Therefore, its formation is very easy and simple. The expenditure involved in the process of formation is also negligible.

2 Direct motivation: As you know, all the profits and gains of the business are solely and exclusively pocketed by the sole proprietor. This motivates the proprietor to work hard and develop the business to get more and more profits. His involvement in the business is, therefore, complete and free.

3 Full control: The proprietor is the monarch of the business he owns. He manages the whole business and takes all decisions himself. In other words, proprietor exercises full control over the functioning and working of the business.

4 Quick decision: The proprietor does not depend on others for decision making. Since there are no partners, he is not required to consult others. This enables the proprietor to take quick decisions on numerous matters concerning his business.

5 Flexibility in operations: Being a small organisation it is easy to bring changes if situation so demands. In a large sized organisation to bring changes is difficult.

6 Secrecy: Since the whole business is handled by the proprietor his business secrets are known to him only. He is not bound to publish his accounts. Therefore, the degree of secrecy is the highest in this form of organisation.

7 Personal touch: When the proprietor handles everything relating to the business himself, it is easy to maintain a personal rapport with the customers. He can easily know their tastes, likes and dislikes and adjust his operations accordingly. Similarly, in this form of organisation, employees, if any, work directly under the proprietor. So, it gives scope for the proprietor to maintain harmonious relations with the employees.

8 Dissolution easy: Since there are no co-owners or partners, there is no scope for the difference of opinion in the case of dissolution of business. The proprietor is free to withdraw from the business or to sell it at any time he wants. Because of ease in formation and withdrawal, proprietorship form is often used to test business ideas.

Limitations

1 Limited resources: The capital and other resources of an individual are always limited. The sole trader has to mainly rely on his own money and earnings, or he can borrow, if necessary, from relatives and friends. Thus, the proprietor has a limited capacity to raise funds. This makes it difficult to plan any large scale expansion.

2 Limited managerial capability: In the modern business, knowledge and skills in various fields like production, finance, marketing, etc., are required. It is not possible for a single individual to possess expertise in all these areas. So, his decisions may not be balanced.

3 Not suitable for large scale operation: Since the resources of the sole trader are limited, it is suitable only for small business and not for large scale operations.

4 Unlimited liability: You know that the proprietor has an unlimited liability. In case of a loss, even his personal property and belongings can be utilised for clearing business obligations. Therefore, he cannot take much risk and is discouraged from expansion of his business.

5 Less stability: The continuity and stability of the business depends solely on one person. When the man dies, there is a likelihood of closure of the business.

6 No check .and control: As the sole trader is the monarch of the business, no outsider can question him on his acts and deals. There are no checks and controls on the sole trader.

7 Less scope for economies of scale: Sole trader usually operates on small scale only. So,

he can not enjoy the benefits of large scale production or buying or selling. This may raise the cost of business operations.

Check Your Progress A

1 Fill in the blanks.

i) The liability of the sole trader is ....

ii) The whole profit of a sole trader organisation is pocketed by the ....

iii) Sole trade business organisation is suitable when the size of business is ....

iv) Number of owners in sole trader organisation is..........................

v) In sole trader business, decision making is solely in the hands of ....

2 State whether the following statements are True or False.

i) Sole proprietorship is most suitable for large scale business. □ True □ False

ii) In sole trader organisation, the proprietor is not distinct from the business concern. □ True □ False

iii) Capital raising capacity of a sole proprietorship is unlimited. □ True □ False

iv) In case of loss, the sole trader has to clear business obligations from his personal property. □ True □ False

v) A sole proprietorship is owned by many persons but is managed by only one person. □ True □ False

2.3 PARTNERSHIP FORM OF ORGANISATION

You have learnt that the sole trader organisations have limited financial resources, limited managerial ability and skills, and unlimited liability. In case of expansion more capital and more managerial skills are required. At the same time, the risk will also increase. A sole proprietor may not be able to fulfil all these requirements. A person who lacks, managerial skills may be having capital. Another person who is a good manager may not be having sufficient capital. This calls for a situation where two or more persons come together, pool their capital and skills, and organise the business. This type of business organisation is called partnership organisation. It grew essentially because of the limitations and failure of the sole proprietorships.

As defined by J.L. Hanson, "a partnership is a form of business organisation in which two or more persons upto a maximum of twenty join together to undertake some form of business activity".

The Indian Partnership Act, 1932 defined partnership as "the relation between persons who have agreed to share the profits of business carried on by all or any of them acting for all".

The Uniform Partnership Act of the USA defines a partnership "as an association of two or more persons to carry on as co-owners a business for profit".

Based on the above definitions, we can state that partnership is an association of two or more persons who have joined together to share the profits of business carried on by **all** or **any** of them acting for **all.**

The persons who own the partnership business are individually called 'partners' and collectively known as the 'firm' or 'partnership firm'. On an agreed basis, partners contribute to capital and share the responsibility of running the business. However, in some cases one partner may provide the whole or major portion of the capital and others contribute technical and managerial skills with or without some capital. All such terms and conditions of partnership are usually mentioned in the partnership agreement.

2.3.1 Main Features

From the above discussion, we can list the main features of partnership form of organisation as follows :

1 **Plurality** of persons; To form a partnership firm, there should-be at least two persons.. The maximum limit on the number of persons is ten for banking business and twenty for other types of business.

2 **Contractual relationship:** Partnership is created by an agreement between persons called 'partners'. In other words, a person can become a partner only on the basis of a contract. This contract could be oral, written or implied.

3 **Profit sharing:** There must be an agreement among the partners to share the profits and losses of the business of the partnership firm. This is one of the basic elements of partnership. If two or more persons jointly own some property and share its income, it is not regarded as partnership.

4 **Existence of business:** The purpose of the agreement among the partners is to do some lawful business and share profits. If the purpose is something other than business, it should not be treated as partnership. For example, if the purpose is to carry some charitable work, it will not be treated as partnership.

5 **Principal-agent relationship:** The business of the firm may be carried on by all or one or more partners acting for all the partners. Every partner is entitled to take part in the operations of the firm. In dealing with other parties, each partner is entitled to represent the firm and other partners in respect of the business of the firm. All partners are bound by his acts done in the ordinary course of business and in firm's name. In this sense a partner is agent of the firm and the other partners.

6 **Unlimited liability:** In respect of business debts, each partner has unlimited liability. This means that if the assets of the firms are not sufficient to meet the obligations of the firm, the partners have to pay from their private assets. The creditors can even realise the whole of their dues from one of the partners. Thus, all the partners are jointly and severally liable for all business debts and obligations.

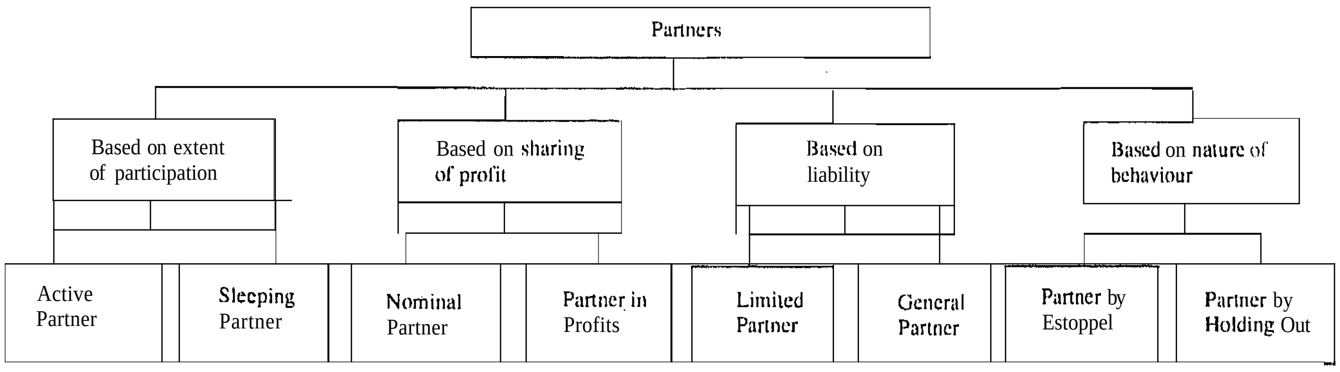
7 **Good faith and honesty: A** partnership agreement rests on good faith among the partners. The partners must be honest to each other and trust each other. They must disclose every information about the business and present true accounts to one another.

8 **Restriction on transfer of share:** A partner cannot transfer his share to an outsider without the consent of all the other partners.

2.3.2 Classification of Partners

You have learnt that different partners play different roles in the operations of the firm. One partner may contribute more capital while another partner may spend more time in managing it. Depending on the role played, we can classify the partners into various categories. Look at Figure 2.2 for the classification of partners.

Fig. 2.2
Classification of Partners



Based on the extent of participation ih the functioning of the business, we can classify partners into: la) active partners, and (b) sleeping partners.

a) **Active partner:** If **a** partner takes an active part in the management of the business, we call him as active partner. He is also known as a 'working partner'.

b) **Sleeping partner: If** the partner is not actively associated with the working of the partnership firm, we call him a sleeping partner. A sleeping business partner simply invests his capital. He does not participate in the functioning of the firm. Such a partner is also known as a 'dormant partner'.

Based on the sharing of profits, partners may be classified into: (a) nominal partners, and (b) partner in profits.

a) **Nominal partner: A** partner who just lends his name to the partnership is known as a nominal partner. He neither invests his capital nor participates in the day-to-day working and management of the firm. Such partners are not entitled to a share of profits, but they are liable to other parties for all the acts of the firm.

b) Partner in profits: A partner who shares the profits of the business without being liable for losses is called a partner in profits. As a rule, he will not take any part in the management of the business. This is applicable to a minor who is admitted to the benefits of the firm.

Based on the behaviour and conduct exhibited, the partners may be divided into: (a) partner by estoppel, and (b) partner by holding out.

a) Partner by estoppel: A person who behaves in the public in such a fashion as to give an impression that he is one of the partners in a partnership finn is called a partner by estoppel. Such partners are not entitled to profits but are fully liable as regards the firms obligations.

b) Partners by holding out: If a particular partner of a firm represents that another person is also a partner of the firm, and if such a person does not disclaim the partnership relationship even after coming to know about it, such person is called a 'partner by holding out'. Such partners are not entitled to profits but are liable as regards the obligations of the firm.

You should note the difference between these two types clearly. In the case of a partner by estoppel, the person's own behaviour and conduct have created a mistaken impression in the third parties mind that he is a partner of the firm. Whereas in the case of a partner by holding out, the other partners have represented the person as a partner, though he is not one, and he does not contradict it. You will learn more about such partners in a separate course.

Based on liabilities also, partners may be classified into two categories: (a) limited partners, and (b) general partners.

a) Limited partner: The liability of such a partner is limited to the extent of the capital contributed by him. He is not entitled to take part in the management of the business, but he can advise the other general members. His acts do not bind the firm. He has right to inspect the books of the firm for his information. Such partners are also called 'special partners'.

b) General partner: He is also called 'unlimited partner'. His liability is unlimited and he is entitled to participate in the management of the business. Every partner who is not a limited partner is treated as a general partner.

As you know in partnership the liability of the partners is unlimited. The limited partners are found only in limited partnership form of organisation which is found only in some European countries and the USA. This is not allowed in India.

2.3.3 Partnership Deed

You know that a partnership is formed by an agreement. Such agreement may be either written or oral. To avoid misunderstanding and unnecessary litigations, it is always desirable to have a written agreement. When the written agreement is duly stamped and registered, it is known as 'Partnership Deed'. After registration, each partner is given a copy of the partnership deed. A partnership deed, generally contains the following particulars.

1 Name of the firm.
2 Nature of the business to be carried out.
3 Names of the partners.
4 The town and the place where business will be carried on.
5 The amount of capital to be contributed by each partner.
6 The profit and loss sharing ratio of each partner.
7 Loans and advances by partners and the interest payable on them.
8 The amount of drawings by each partner and the rate of interest allowed thereon.
9 The rate of interest on capital.
10 Duties, powers, and obligations of partners.
11 Remuneration, if any, payable to the active partner.
12 Maintenance of accounts and arrangements for audit.
13 Settlement in the case of dissolution of partnership.
14 The methods of evaluation of goodwill on admission or death or retirement of a partner.

15 The method of revaluation of assets and liabilities on admission or death or retirement of a partner.

16 The method of retirement of a partner, and the arrangement for the payment of the dues of a retired or deceased partner.

17 Arbitration in case of disputes among partners.

18 Arrangements in case a partner becomes insolvent.

This is not an exhaustive list. Any other clauses, as desired by the partners, could be included in tlie partnership deed. In fact, the Partnership Act defines certain, rights and duties of a partner. But the provisions of the Act come into operation only when there is no agreement amongst the partners.

Registration of the firm: Under the Indian Partnership Act it is not compulsory to register the firm. But there are certain limitations for an unregistered firm. So, it is better to register it. Registration can be done at any time. To register the firm, an application with all particulars about the firm and registration fee have to be sent to the Registrar of Firms.

2.3.4 Merits and Limitations

You have learnt about the main features of partnership. This would help you to identify the merits and limitations of this form of organisation which are as follows.

Merits

1 **Easy formation:** Although the formation of a partnership firm is not as easy as the sole proprietorship, but it is much less difficult as compared to a company. The partners agree to do business together and draw up and sign the partnersliip agreement. After that there are no complex government laws regulating the establishment of the partnership.

2 **More capital available:** Unlike sole proprietorship, there are two or more partners in partnership firms. So. a partnership firm does not have to rely on a single individual as the source of its funds. The added financial strength of the partners increases the borrowing capacity of the firm.

3 **More diverse skills and expertise:** The partnership involves more people in decision making because there are more owners. An ideal partnership brings together partners who complement each other, not partners who have the same background and experience. One partner might be a specialist in manufacturing, another in marketing, and the third partner might be an accountant. Combined judgment of all these partners often leads to better decisions than otherwise.

4 **Flexibility:** Like sole proprietorship, tlie partnership business is also owned and run by the partners themselves. They can easily appreciate and quickly respond to tlie changing conditions.

5 **Secrecy:** In partnership firms, some secrecy can be maintained because there is no obligation to publish accounts of the firm.

6 **Keen interest:** Since partners are liable to losses and risks of a business, they take keen interest in the affairs of the business.

7 **Protection:** Due to the rule of unanimity in fundamental matters, the rights of all partners are fully prolected. If a partner is dissatisfied with the working of the firm, he can ask for dissolution of the firm and withdraw from tlie business.

8 **Checks and controls over careless decisions:** Since the partnership is run on collective basis and all partners participate in major decisions. there is lesser scope for reckless and hasty decisions.

9 **Diffusion of risk:** The losses of the firm will be shared by all the partners. Hence, the share of loss in the case of each partner will bc less than that sustained in sole proprietorship.

Limitations

1 **Limited capital:** Since there is a limit of maximum partners (20 in non-banking firms and 10 in banking firms), the capital raising capacity of the partnership firms is limited as compared to a joint stock compriny.

2 **Unlimited liability:** The most important drawback of a partnership firm is that the liability of the partners is unlimited.

3 **No public confidence:** Since the accounts are not published and publicised, the firm may not be able to command confidence of the public.

4 Non-transferability of interest: No partner can transfer his interest in a firm without the consent of other partners.

5 Uncertainty: The sudden death, lunacy or insolvency of a partner leads to the dissolution of partnership. This breeds uncertainty in the continuity of a partnership firm. However, this could be partly avoided if such matters are specified in the partnership agreement.

6 Conflicts among partners: There is scope for misunderstanding and conflicts among the partners. This may cause delays in decision making and may lead even to dissolution of the firm. To some extent, this problem could be avoided if the partnership agreement is clear and detailed.

7 **Risk** of implied authority: Since each partner acts as an agent of the firm, acts of one partner would bind the firm and all the remaining partners. A dishonest or incompetent partner may lend the firm into difficulties and the other partners may have to pay for it.

2.3.5 Joint Hindu Family Firm

Joint Hindu Family firm is a unique form of business organisation prevailing only in India. This is the firm belonging to joint hindu family and governed by the provisions of the Hindu Law.

In Hindu Law there are two schools :

a) Mitakshara: It is applicable to the whole of India except Bengal and Assam. According to this school, a Hindu inherits property from his father, grand father, and great grand father. Thus, three successive generations in the male line (son, grandson, and great grandson) inherit the ancestral property. They are called coparceners and the senior most member of the family is called 'Karta'. The Hindu Succession Act, 1956 has extended the line of coparcenary interest to female relatives of the deceased coparcener or male relatives claiming through such female relatives.

b) Dayabhaga: It is applicable in Bengal and Assam. According to this, the male heirs become members only on the death of the father.

According to Hindu Law, a business is an inheritable asset. After the death of Hindu, the business will be jointly owned by all the coparceners. The elder person among the coparceners becomes the new Karta and manages the business. If any property is inherited from any other relative, or acquired from personal resources, such property is regarded as personal property and treated as distinct from ancestral property.

Important features of the Joint Hindu Family Firm are :

I) Business is managed by the senior member of the family called Karta. Other members do not have the right to participate in the management of the firm.

2) Other members cannot question the authority of the Karta. Their only remedy is to get the family dissolved by mutual agreement.

3) Karta has the power to borrow funds for the business. The liability of the Karta is unlimited whereas the other coparceners are liable only to the extent of their share in the business.

4) If the Karta has misappropriated the funds of the business, he has to compensate the other coparceners to the extent of their shares in the joint property.

5) The death of any member of the family does not dissolve the business or the family.

6) Through mutual agreement the joint hindu family firm can be dissolved.

You should note the difference between the joint Hindu family firm and the partnership firm. A joint Hindu family firm is the result of the operation of the Hindu Law, No formal agreement is required to convert a business into a joint Hindu family business. The members of the family automatically become coparceners. Only the Karta can participate in the management. The liability of the Karta is unlimited but the liability of the other coparceners is limited to their shares in the business. The rights, duties and liabilities of coparceners are governed by the provisions of the Hindu Law, Partnership is the result of an agreement between the persons who need not be blood relatives. Each partner has the right to participate in the management of the business. The liability of each partner is unlimited. The duties, rights and liabilities of the partners are governed by the Indian Partnership Act, 1932.

Check Your Progress B

1 Fill in the blanks.

i) The maximum number of partners in a partnership firm doing banking business is ....

ii) Liability of partners in a partnership firm is ....

iii) A partner who is not participating in the management of the firm is called .... partner.

iv) The minimum number of members in a partnership firm is ....

v) A registered partnership agreement is called ....

vi) A person's own behaviour has created thk impression that he is one of the partners of a partnership firm. Such partner is called ....

vi) If the liability of the partner is limited to the capital contributed by him, such a partner is called ....

2 State whether the following statements are True or Flase.

i) Partnership agreement must be in writing. □ True □ Flase

ii) There is no maximum limit for membership in a partnership organisation. □ True □ Flase

iii) Members of a partnership firm are called partners. □ True □ Flase

iv) A partner can transfer his share to some other person without the consent of the other partners. □ True □ Flase

v) Every partner is a proprietor of the firm and also an agent of the firm. □ True □ Flase

vi) A sleeping partner actively participates in the working of the firm. □ True □ Flase

vii) A person who is a partner by holding out is entitled to share the profits. □ True □ Flase

viii) The acts of one partner would bind the firm and the remaining partners. □ True □ Flase

2.4 COMPANY FORM OF ORGANISATION

You have learnt that sole proprietorships and partnerships have the disadvantages of limited resources, unlimited liability, limited managerial skills, etc. The life and stability of these organisations also depend on the life and stability of the proprietors/partners. Hence, they are not considered suitable for large scale business,

For large scale business, you require large investment and specialised managerial skills. The element of risk is also very high. This situation led to the emergence of company form of business organisation. In case of joint stock company, capital is contributed by not one or two persons but by a number of persons called shareholders. Thus, it is possible to raise large amount of capital. A joint stock company is an association of persons registered under Companies Act for carrying on some business. It is called an artificial person as it is created by law, with a distinctive name, a common seal and perpetual succession of members. It can sue and be sued in its own name. The most widely quoted definition of a company (called Corporation in USA) is the one given by Chief Justice Marshal. According to him "a corporation is an artificial being, invisible, intangible and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or an incidental to its very existence." Lord Justice Lindley has defined it as "an association of many persons, who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share."

The Indian Companies Act (1956) defines joint stock company as "a company limited by shares having a permanent paid up or nominal share capital of fixed amount divided into shares, also of fixed amount, held and transferable as stock and formed on the principles of having in its members only the holders of those shares or stocks and no other persons." .

2.4.1 Main Features

Based on the above definitions, we can list out the features of the company form of organisation as follows :

1 Incorporation: A company is an incorporated association. It comes into existence only after registration under the Companies Act.

2 Artificial person: A company is regarded as an artificial person as it is created by law and can be effaced only by law. It has no body, no soul, no conscience, still it is in a position to exist. Like any other person it can own property, conduct a lawful business, enter into contracts with others, buy, sell and hold property, all under its own name and its own seal.

3 Separate legal entity: A company has a distinct entity separate from its members. A shareholder of a company can enter into contract with the company and can sue the company and be sued by it. You know that in the case of partnership, every partner is an agent of the firm and also that of the other partners. But the shareholder is not the agent of the company or its shareholders. He can not bind them with his acts.

4 Common seal: As the company is not a natural person, it can not sign the documents. It has a device in the form of common seal on which its name is engraved. This common seal is a substitute of its signatures. It is affixed on all important legal documents and contracts. It is used at the direction of the board of directors and two directors have to sign as witnesses wherever it is affixed on any document.

5 Perpetual succession: A joint stock company has a continuous existence. Its life is not affected by the death, lunacy, insolvency or retirement of its shareholders or directors. Members may come and go, but the company continues its operations until it is legally dissolved. Thus, a company has perpetual succession irrespective of its membership. This feature provides stability to this form of organisation.

6 Separation of ownership and management: The shareholders of a company are widely scattered throughout the country. For the conduct of the business and its management, shareholders elect another set of persons known as directors. The right to manage the company affairs is vested in the directors who are elected representatives of the shareholders. Thus, ownership is separated from management.

7 Number of members: In the case of a public limited company: the minimum number is seven and there is no maximum limit. In the case of a private limited company, minimum number is two and the maximum is fifty.

8 Limited liability: The liability of the members of a company is normally limited by guarantee or by the shares. Members liability is limited to the amount of shares held. Members are not personally liable for the debts of the company. So, personal properties of the members are not liable to be attached for the payment of the company's debts.

For example, the face value of the share of a company is Rs. 10 which the member has already paid. At the time of winding up of the company, the member cannot be asked to pay any money. But if the member had paid only Rs.7, he can at the most be asked Io pay the balance of Rs. 3 (face value Rs.10 minus money paid Rs. 7), and no more.

9 Transferability of shares: The member of a public limited company enjoys a statutory right to sell his shares to others without the consent of other shareholders. But for transferring the shares he has to follow the procedure laid down in the Companies Act. However, there are restrictions for transferring shares in case of a private limited company.

10 Regidity of objects: The scope of the business of a company is limited. The type of business in which the company would participate is mentioned in the 'object clause' of its Memorandum of Association. The company cannot take up any new business without changing the object clause. To change the object clause, the company has to comply with the provisions of the Companies Act,

11 Statutory regulations: A company is governed by the Companies Act and it has to follow various provisions of the Act. It has to submit a number of returns to the Government. Accounts of a company must be audited by a Chartered Accountant. Thus, the company form of organisation has to comply with numerous and varied statutory requirements.

Having studied the features of a joint stock company you can easily make out that the shareholders are the real owners of the company, Their liability is limited. They can also transfer their shares to others. Since the shareholders are very large in number, the company cannot be managed by all. They elect a board of directors to manage the company. The destiny of the company is guided and directed by the directors. These directors employ some people to carry on the day-to-day business of the company.

The company can raise additional funds by issuing debentures (also called bonds). You will learn more about these aspects in Units 5 & 6.

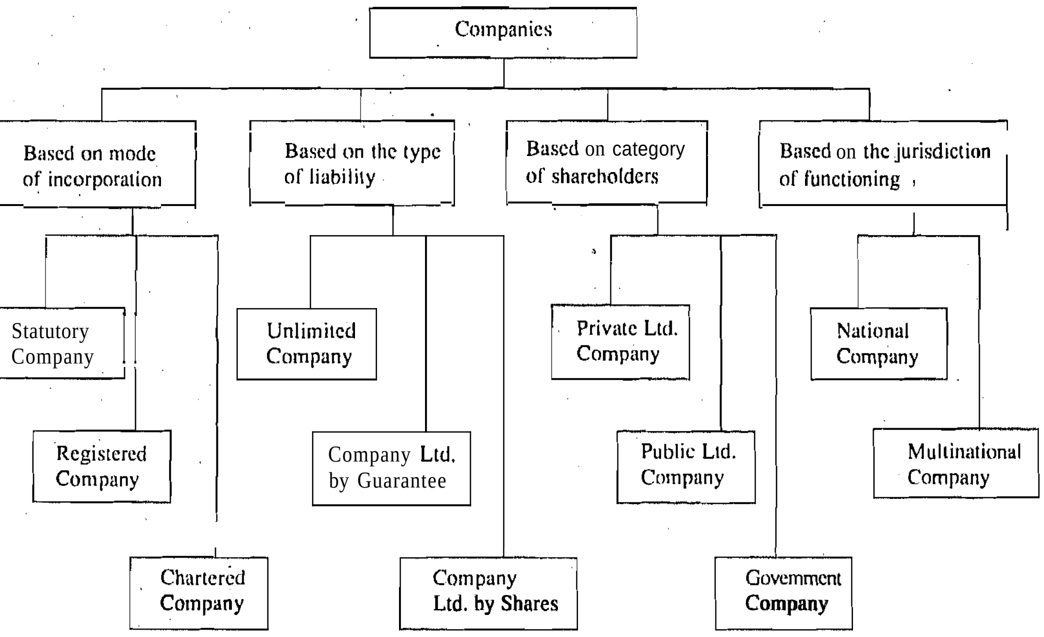
2.4.2 Classification of Companies

We can classify companies on the basis of I) Mode of incorporation, 2) Extent of ltability, 3) Category of shareholders, and 4) Jurisdiction of functioning, Look at Figure 2.3 for the classification of companies.

1 On the basis of the mode of incorporation, we can classify companies into three categories :

a) Statutory Company: A company established by a special Act of the Parliament or State Legislature is called 'Statutory Company'. Such companies are established in special cases when it is necessary to regulate the working of the company for some specific purposes. Examples of such corporations are Reserve Bank of India, Life Insurance Corporation of India, Air India Corporation, Food Corporation of India, etc. These are mostly public sector enterprises.

Figure 2.3
Classification of Companies


Companies
Based on mode of incorporation
Based on the type of liability
Based on category of shareholders
Based on the jurisdiction of functioning
Statutory Company
Registered Company
Chartered Company
Unlimited Company
Company Ltd. by Guarantee
Company Ltd. by Shares
Private Ltd. Company
Public Ltd. Company
Government Company
National Company
Multinational Company

b) Registered Company: A company which is incorporated through registration with the Registrar of Companies under the Companies Act, 1956, is called a 'Registered Company'. This is also called 'In'corporated Company'. All companies established under the private sector belong to this category.

c) Chartered Company: A company which is incorporated under a special Royal Charter granted by the Monarch is called a 'Chartered Company'. It is regulated by the provisions of that charter. Examples are: British East India Company, Bank of England, Hudson's Bay Company, etc. In India this type of companies does not exist now because there is no monarchy.

Based on the type of liability, companies may be classified into three categories :

a) Unlimited **Companies:** A company in which the liability of the members is unlimited, is called 'Unlimited Company'. At the time of winding up of the company shareholders have to pay, if necessary, from their personal assets to clear the company's debts. From this point of view, it is very much like sole proprietorship .and partnership. However, such companies are very rare.

b) Companies Limited **by** Guarantee: In the case of some companies, members give guarantee for the debts of the company up to a certain limit in addition to the amount of shares held by them. The additional amount guaranteed by the members is, generally, laid down in the Memorandum of Association. Such companies are not formed for the purposeof profit. They are formed to promote art, culture, religion. trade, sports, etc. Clubs, Charitable organisations, trade association, etc. come under this category.

c) Companies Limited by Shares: In this case the liability of the members is limited to the amount of the shares held by them. A shareholder can be called upon to pay only the unpaid amount of shares held by him and nothing more. Most of the companies come under this category.

3 On the basis of the ownership, companies may be classified into three categories :

a) Private Limited Company: A private limited company means a company which by its article

i) restricts the right to transfer its shares;

ii) limits the number of its members to fifty; and

iii) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

b) Public Limited Company: A public limited company is one which is not a private limited company. A company having the following characteristics should be called a public limited company.

i) The right of the shareholder to transfer his shares is not restricted.

ii) The minimum number of shareholders is 7 but there is no limit to the maximum number of members.

iii) It can invite public to subscribe for its shares and debentures.

The minimum number of members in the case of a private limited company is two and can be formed more easily as compared to a public company. It is exempted from various regulations of the Companies Act and thus combines the advantages of limited liability and the facilities of a partnership organisation. It is considered suitable for a medium sized business.

c) Government Company: A company in which not less than 51 per cent of the paid up share capital is held by the Central Government, or by any State Government or jointly by Central and/or State Governments.

4 On the basis of the jurisdiction of the functioning, we can classify companies into two categories :

a) National Company: When the operations of a company are confined within the boundaries of the country in which it is registered, such a company is called a national company.

b) Multinational Company: When the operations of a company are extended beyond the boundaries of the country in which it is registered, such a company is called a multinational company. It is also called 'transnational company'.

2.4.3 Merits and Limitations

The company form of organisation has been popular and successful in almost all the countries. This form is suitable where large resources are required and the production has to be carried out on a large scale. The number of joint stock companies has shown a phenomenal increase in the twentieth century. Let us now discuss the merits and limitations of the company form of organisation.

Merits

1 Large capital: Since company form of organisations are allowed to have a large number of shareholders, it is possible to raise capital in large amounts. Whenever new capital is required, it can issue shares and debentures. For this reason, only the company form of organisation is best suited.

2 Limited liability: The liability of shareholders, unless and otherwise stated, is limited to the face value of the shares held by them or guarantee given by them. Their private property is not attachable to recover the dues of the company. Thus, this form of organisation is a great attraction to persons who are not willing to take risk as is inherent in sole proprietorship and partnership.

3 **Stability of existence: A** company has a separate legal entity with perpetual succession. The corporation is not affected by lunacy or insolvency of a shareholder, director or officer. The continuity of the company is desirable in the interest of not only its members but also the society.

4 **Economies of scale:** As companies operate on a large scale, they can take advantage of large scale buying, selling, production, etc. As a result of these economies of large scale operations, companies can provide goods to consumers at a cheaper price.

5 **Scope for expansion:** As there is no limit to the maximum number of shareholders in a public limited company, expansion of business is easy by issuing new shares and debentures. Companies normally keep part of their profits as reserve and use them for expansion.

6 **Public confidence:** Companies are subject to Government controls and regulations. Their accounts are audited by a chartered accountant and are to be published. This creates confidence in the public about the functioning of the company.

7 **Transferability of shares:** The shares of the public limited company can be sold at any time in the stock exchange. Shareholders can sell their shares whenever they want. There is no need to take the consent of other shareholders. Thus, shareholders can convert their shares into cash at any time without much difficulty.

8 **Professional management:** You know that the management of a company is in the hands of the directors who are elected by shareholders. Normally, experienced persons are elected as directors. You also know that day-to-day activities are managed by salaried managers. These managers are the experts in their respective fields. As companies have large scale operations and profits, attracting good professional managers is easy by paying attractive salaries. Thus, company form of organisation gets the services of professionals on the Board of Directors and in various management positions.

9 **Tax benefits:** Companies pay income tax at flat rates. There is no provision for slab system in the taxation of companies. As a result, companies pay lower taxes on higher incomes compared to other forms of organisations. Companies also get some tax concessions if they are established in backward areas.

10 **Risk diffused: As** the membership is very large, the business risk is divided among the several members of the company. This is an advantage for small investors.

Limitations

1 **Difficulty in formation:** Promotion of a company is not as simple as proprietorships and partnerships. A number of persons known as promoters should be ready to associate themselves with it for getting a company incorporated. A lot of legal formalities are to be performed at the time of registratlon. Promotion of a company is expensive as well as complicated.

2 **Lack of secrecy :** The management of companies is usually in the hands of many persons. Everything is discussed in the meetings of Board of Directors. Therefore, compared to sole trader and partnership concerns, maintaining business secrets is relatively difficult in a company form of organisation.

3 **Delay in decision making:** In company form of organisation all important decisions are taken by either the Board of Directors or shareholders in their meetings. Hence. decision making process is time consuming. If a quick decision is needed it will be difficult to arrange meetings all of a sudden. So, some business opportunities may be lost because of delay in decision making.

4 **Neglect of minority interest:** The representatives of the majority group of shareholders become the members in the Board of Directors. The shareholders who are in minority never get representation on the Board of Directors. As a consequence, the interests of the minority members may be neglected and oppressed at the hands of the majority group.

5 **Concentration of economic power:** The company form of organisation gives scope for concentration of economic power in a few hands. Some persons become directors in a number of companies and formulate policies to promote their personal interests. The shares of a number of other companies are purchased to create subsidiary companies.

Establishment of subsidiary companies and interlocking of directorships have facilitated concentration of economic power in the hands of a few business houses.

6 **Lack of personal interest:** In sole proprietorship and partnership firms business is managed by owners themselves. In company form of organisation, day-to-day management is vested with the salaried executives who do not have any personal interest in the company. This may lead to reduced employee motivation and result in inefficiency.

7 **More government restrictions:** The company is subject to many restrictions from which the proprietorships and partnerships are exempted. So, it has to spend considerable time and effort in complying with the various legal requirements.

8 **Fraudulent management:** There is a possibility that some unscrupulous promoters may float a bogus company, issue shares and collect money. Later on, they can get away with the money by putting the company in liquidation. It is also possible that the directors and professional managers may misuse the company resources for their personal benefit and bring losses to the company.

Check Your Progress C

1 Fill in the blanks.

i) The number of members in a public limited company : minimum .... , and maximum..........

i) The number of members in a private limited company: minimum .... and maximum ....

iii) The liability of the shareholders in a joint stock company is usually ....

iv) In a government company .... per cent of shares are held by the government.

v) In the case of unlimited companies, members liability is ....

vi) A company established by a special Act of Parliament is called .... company.

2 State whether the following statements are True or False.

i) In the case of companies, shareholders cannot transfer their shares to others. □ True □ False

ii) A company is a legal person created by law. □ True □ False

iii) A company form of organisation is not suitable for large scale business. □ True □ False

iv) Compared to sole proprietorship and partnership, companies can avail the benefits of economies of large scale. □ True □ False

v) Company can not buy property on its own name. □ True □ False

vi) There are less legal formalities to start a company. □ True □ False

vii) Company is separate from its owners and it has an entity of its own. □ True □ False

viii) A company has to be closed if the majority of the shareholders are dead. □ True □ False

2.5 COOPERATIVE FORM OF ORGANISATION

Cooperative organisations are generally started by the poor and the economically weak sections to promote their common economic interests through business propositions. The basic philosophy of cooperative organisation is self-help and mutual help. The primary objective of any cooperative organisation is to render service to its members. In this respect, it is different from the other three forms of organisations which are primarily meant for making profits. The important features of the cooperative organisation are service in place of profit, mutual help in place of competition, self-help in place of dependence, and moral solidarity in place of unethical business practices.

; defined by International Labour Office "Cooperative organisation is an association of rsons, usually of limited means, who have voluntarily joined together to achieve a mmon economic end through the formation of a democratically controlled business ganisation, making equitable contributions to capital required and accepting a fair share of ks and benefits of the undertaking."

ılvert has defined cooperation as a "a form of organisation wherein persons voluntarily sociate together as human beings on the basis of equality for the promotion of the onomic interests of themselves."

ıe Indian Cooperation Societies Act, 1912, Section 4, defined it as "a society which has as objectives the promotion of economic interests of its members in accordance with operative principles."

ısed on these definitions we can state that the cooperative organisation is a 'voluntary' sociation of persons who are not financially strong and cannot stand on their own legs. ıey come together not with a view to get profits but to overcome destability arising out of want of adequate financial resources. The basic objective of such an organisation is lf-help and mutual help.

ooperative organisations are to be registered with the Registrar of Cooperative Societies of e concerned state in which the society's registered office is situated. There should be inimum of 10 members to form a cooperative. But there is no maximum limit for embership.

ke the company form of organisation, the members of the society are the owners. They ntribute the required capital and get a share in the profits, which is known as dividend. ıe liability of the members is limited.

anagement is vested in the hands of the managing committee which is elected by the embers in the annual general meeting.

.5.1 Main Features

ased on the above discussion we can identify the following distinctive features of ooperative organisations.

Voluntary association: As stated above, persons desirous of pursuing a common objective can form themselves into an association and leave the same as and when one likes. This has two important connotations :

a) Any person can become a member irrespective of his caste, creed, religion, colour, sex, etc.

b) The members come together to form themselves into an association without any coercion or intimidation..

Autonomy and stability: Within the limits set by the constitution, the general law, and its charter, a cooperative society is a self governing organisation. It is self-sufficient, self-renewing, and self-controlling within its jurisdiction. Like a company, a cooperative organisation also enjoys a separate and independent entity distinct from that of its members. As such, it has a perpetual life and is not affected by the entry and exit of members.

Democratic management: The management of cooperative organisation vests in a managing committee elected by members on the basis of 'one member-one vote' irrespective of the number of shares held by any member. It is the general body of the members which lays down the broad framework of policy within which the managing committee has to function. Democracy is, thus, the keynote of the management of a cooperative society.

Capital : The capital is procured from its members in the form of share capital. However, the share capital constitutes only a limited source of business finance. The major part is raised either by way of loan from the government and the apex cooperative institutions, or by way of grants and assistance from the central or state governments.

Government control: In India, all cooperative societies are registered under Cooperative Societies Act, 1919 or other State Cooperative Societies Act. Cooperative societies are subjected to detailed regulation under these Acts.

6 **Service motive:** The primary objective of any cooperative society is to provide service to its members. As you know, in the case of the other three forms of organisations the primary objective is to earn profits.

7 **Limited return on capital:** In cooperative system, profits are distributed among the shareholders for the capital they have contributed. But the rate of dividend paid to the shareholders is limited to 9% as per the Cooperative Societies Act.

8 **Distribution of surplus:** In case of a partnership firm and a company, profits are distributed among the members in the ratio of the capital contributed by each of them. In case of cooperative societies, after giving a limited dividend to shareholders, the surplus profits are distributed in the form of bonus. This bonus is not in the proportion of the share capital, but in the proportion of the business they have done with the society. For example, in case of a consumer cooperative society, bonus is paid in the proportion of the purchases made by the members from the society. Similarly, in case of a producer's society, bonus is paid in the proportion of the goods delivered for sale to the society.

2.5.2 Classification of Cooperatives

Cooperatives were started in different fields to promote the well being of different sections of the society. Therefore there are different types of cooperative societies. The important types are given below.

1 **Consumer cooperatives:** People who want to obtain their day-to-day household goods at reasonable prices form consumer cooperative societies. The main objective of these societies is to protect the members from the evils of unfair trade and the steep rise in prices. These societies purchase goods in bulk from wholesalers or producers and sell them to its members, sometimes also to non-members.

2 **Producer's cooperatives:** These are the societies formed by the small industrial producers and artisans. They are also called industrial cooperatives. The main objective is to protect the small producers and workers from exploitation. They provide credit facility, supply raw-materials, market the products produced by members, and help the members to buy machinery on hire purchase.

3 **Marketing cooperatives:** When the producers form into a cooperative society for the purpose of arranging the sale of their output, it is called marketing cooperative. These societies are started in order to protect producers from exploitation by the middlemen when they market their products.

4 **Housing cooperatives:** These societies mainly operate in urban areas. They are mainly formed to provide housing facility to its members. The housing societies acquire land, plan the lay out and construct houses, and later allot them to the members. Some of them simply develop the land and allot plots to its members who then construct houses on their own. The society helps in arranging loans for them.

5 **Credit cooperatives:** Credit societies are started by persons who are in need of credit. Such societies provide credit to their members at a reasonable rate of interest. These credit societies may be classified into agricultural credit societies and non-agricultural credit societies. Agricultural credit societies are started to provide loans to farmers to meet the expenses in cultivation. These societies may be further classified into two groups: i) societies which provide short term and medium term credit, and ii) societies which are concerned with long term credit.

Non-agricultural credit societies are formed by the employees of industrial units and various institutions. They can also be organised by small traders, artisans and people of low income groups in towns and cities to meet their credit requirements. Under this category there are cooperative urban banks, thrift societies, employees credit societies, industrial cooperative banks, house mortgage banks, etc.

6 **Farming cooperatives:** Economies of large scale operations cannot be derived by small farmers. Therefore, small farmers form into a cooperative society, carry on the work jointly and share the returns. These societies are most helpful to small and marginal farmers and enable them to get the advantages of large scale operations. They may form a cooperative better farming society, a cooperative tenant farming society, a cooperative joint farming society, a cooperative collective farming society, etc.

In addition to the cooperatives described above, there are many other types of cooperatives because the principle of cooperation is extended to a large number of activities and operations. There are cooperatives such as processing cooperatives, construction operatives, transport cooperatives, autorikshaw cooperatives, washermen cooperatives, hery cooperatives, dairy cooperatives, sugarcane growers cooperatives, oilseeds growers operatives, etc. The aim of all these societies is to promote the welfare of their members.

5.3 Merits and Limitations

fferent types of cooperatives have distinct merits and limitations. But there are some mmon merits and limitations which can be traced to all types of cooperative societies.

erits

Easy formation: Formation of a cooperative society is easy as compared to the formation of a company. Cooperative society is a voluntary association and so it does not require long and complicated legal formalities at the time of formation. Any 10 adult persons can voluntarily form themselves into an association and get it registered with the Registrar of Cooperatives.

Limited liability: Like company form of organisation, liability of members is limited in cooperative societies also.

Social services: Cooperatives foster fellow feeling among members and impart moral and educative values in their everyday life which are essential for better living.

State assistance: Cooperatives have been adopted by the government as an instrument of economic policy. So, a number of grants, loans and financial assistance are offered by the government to these societies to make them function effectively.

Open membership: The membership of cooperative societies is open to everybody. Nobody is debarred from joining on the basis of economic position, caste, colour or creed. There is no limit on the maximum number.

Supply of goods at cheaper rates: The societies purchase goods directly from producers and sell them to the members at cheap rates. The middlemen are eliminated from the channel of distribution. The consumer cooperatives supply essential goods to the members at a time when there is scarcity of goods in the market. Even capital goods (like machinery, etc.) are procured directly from producers and are supplied to the members. So cooperative societies ensure regular supply of goods at cheaper rates.

mitations

Lack of business acumen: Members normally do not have business experience. As a consequence, when they become the members of the Board of Directors the society is not conducted efficiently. Unlike companies, cooperatives cannot employ outside talents and trained personnel for improving the management competency. This is because such steps are incompatible with their avowed ends and limited means.

Absence of mutual interest: A cooperative can only succeed when the members are imbued with a spirit of cooperation. Unfortunately, some influential members use the cooperative society as a source of their personal gains.

Lack of interest: Sustained efforts over a period are the prerequisites for success in any business. But such a state of affairs does not exist in many cooperatives. Within a short period of its dramatic start, the cooperative becomes lifeless and inactive in its operation.

Lack of coordination: It cannot be denied that internal dissensions and rivalries among the members sap much of its strength and vigour. The absence of coordinated and joint action is responsible for the collapse of many cooperative associations.

Corruption: One of the most important drawbacks of a cooperative form of organisation is the prevalance of corrupt practices in the management and functioning of the cooperative societies.

Lack of secrecy: The affairs of cooperatives are generally exposed to the members and it becomes quite difficult for them to maintain secrecy in business affairs.

Insufficient motivation: Since the rate of return on capital is low, the members do not feel involved in the affairs of the society.

Check Your Progress D

1 State whether the following statements are True or False.

i) Earning profit is the primary objective of cooperative organisation. □ True □ False

ii) Management of cooperatives is completely in the hands of the government. □ True □ False

iii) Cooperative society is incorporated under the Indian Companies Act, 1956. □ True □ False

iv) In cooperatives, each member is entitled to receive the bonus in the proportion of the business he has done with the society. □ True □ False

v) Women cannot become members of a cooperative society. □ True □ False

2 Fill in the blanks.

i) In cooperative societies, liability of the members is ....

ii) To form a cooperative, there should be at least .... members.

iii) The maximum number in a cooperative society is ....

iv) Primary motive of cooperative is ....

v) Maximum rate of dividend that can be paid to the members on share capital in a cooperative society is ....

2.6 LET US SUM UP

Based on ownership there are four basic forms of business organisation: 1) sole trader organisation, 2) partnership organisation, 3) company organisation, and 4) cooperative organisation.

A business which is owned, financed and controlled by a single person is called sole trader organisation. This is most suitable for small business. There is no distinction between the business concern and the proprietor. This form of organisation has advantages from the point of view of control, secrecy, ease and low cost of formation, ease of dissolution and less government regulations. Disadvantages include the owner's unlimited liability, difficulty in raising capital, limited management expertise, unstable business life and difficulty in attracting qualified employees.

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. Usually there would be a written or oral agreement between partners which specifies the contribution of each partner to the business, the partner's roles, and other major points of agreement. There are various types of partners based on: (a) extent of participation, (b) profit sharing, (c) behaviour and conduct exhibited, and (d) liability shared. Partnership organisations can overcome some of the disadvantages of sole proprietorship organisations. Advantages of partnership include capital, more specialised management, more certainty, greater incentives to key employees, etc. Partnerships suffer from unlimited liability, difficulty in transferring the shares, potential owner conflicts, short length of life, etc.

Limitations of sole proprietorships and partnerships gave rise to company form of organisation. A company is an artificial person created by law, with a distinctive name, a common seal and perpetual succession. Companies may be classified into various types on the basis of: (a) mode of incorporation, (b) extent of shareholders liability, (c) nature of shareholders, and (d) jurisdiction of functioning. Major advantages of company form of organisation include shareholders' limited liability, transferability of shares, stability of existence, ease of obtaining additional capital, more managerial expertise, etc. Major limitations are cost and difficulty of formation, more government regulations, lack of secrecy, less scope for prompt decision making, etc.

Cooperative form of organisation is a voluntary association of persons who are not financially strong and cannot stand on their own legs. They come together not with a view to get profits, but to overcome destability arising out of want of adequate financial resources. The underlying objective is self-help and mutual help. Advantages of cooperative form of organisation include easy formation, limited liability, government assistance, open membership, etc. Disadvantages include lack of business acumen, absence of mutual interest, lack of secrecy, rivalry among members, etc.

2.7 KEY WORDS

Active Partner: A partner who takes an active part in the operations of the partnership business.

Chartered Company: A company which is incorporated under a special Royal Charter granted by the Monarch.

Company: An association of persons registered under the Companies Act. It is an artificial person created by law, with a distinctive name, a common seal and perpetual succession of its members.

Company Limited by Guarantee: A company having the liability of its members limited by its memorandum, to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up.

Company Limited by Shares: A company having the liability of its members limited by the memorandum to the value of shares held by them.

Cooperative Organisation: A voluntary association of persons established under the Cooperative Societies Act.

General Partner: A partner of a partnership organisation whose liability is unlimited and also entitled to participate in the management of the business.

Government Company: A company in which not less than 51% of the paid-up capital is held by the Government.

Limited Partner: A partner whose liability is limited to the extent of the capital contributed by him.

Joint Hindu Family Firm: A business firm owned by a joint Hindu family.

Nominal Partner: A partner who just lends his name to the partnership firm. He neither invests his capital nor participates in the management.

Partner: A person who is the member in a partnership firm.

Partner by Estoppel: A person whose conduct and behaviour creates an impression that he is a partner in the partnership firm.

Partner by Holding Out: If a member of a partnership firm represents that another person is also a member of the firm, and if such a person does not disclaim the partnership relationship even after coming to know about it, such person is called partner by holding out.

Partner in Profits: A partner who shares the profits of the business without being liable for losses.

Partnership Agreement: A written or oral agreement entered into by partners specifying the constitution rules and regulations of the partnership.

Partnership Deed: A written partnership agreement which is duly stamped and registered.

Partnership Organisation: An association of two or more person, who join together to share the profits of business carried on by all or any of them acting for all.

Private Limited Company: A company which by its articles (a) limits the maximum number of its members to 50 excluding its employees, (b) restricts the right to transfer its shares, and (c) prohibits the invitation to the public to subscribe to its shares and debentures.

Public Limited Company: A company which is not a private limited company.

Registered Company: A company which is incorporated under the Companies Act.

Sleeping Partner: A partner in a partnership firm who is not actively associated with the working of the firm.

Sole Trader Organisation: One man business in which an individual produces independently with his own capital, skill and intelligence and is entitled to receive all the profits and assume all risks of ownership.

Statutory Company: A company established by a special Act of the Parliament or State Legislature.

Unlimited Company: A company in which the liability of the members is unlimited.

2.8 SOME USEFUL BOOKS

Bhushan, Y.K. 1987, *Fundamentals of Business Organisation & Management*, Sultan Chand & Sons: New Delhi. (Part Two, Chapters 1, 2 & 3)

Musselman, V.A., and J.H. Jackson, 1985, *Introduction to Modern Business*. Prentice Hall of India: New Delhi. (Chapter 3)

Ramesh, M.S. 1985, *Principles and Practice of Business Organisation, Administration & Management*, Kalyani Publishers: New Delhi. (Volume 1, Chapters 4 to 7)

Singh, B.P., and T.N. Chhabra, 1988, *Business Organisation & Management*, Kitab Mahal: Allahabad, (Part One, Chapters 4 & 5)

2.9 ANSWERS TO CHECK YOUR PROGRESS

A 1 (i) unlimited (ii) proprietor/owner (iii) small (iv) one (v) proprietor/owner

2 (i) False (ii) True (iii) False (iv) True (v) False

B 1 (i) ten (ii) unlimited (iii) sleeping (iv) two (v) partnership deed (vi) partner by estoppel (vii) limited partner

2 (i) False (ii) False (iii) True (iv) False (v) True (vi) False (vii) False (viii) True

C 1 (i) 7, unlimited (ii) 2, 50 (iii) limited (iv) 51 (v) unlimited (vi) statutory

2 (i) False (ii) True (iii) False (iv) True (v) False (vi) False (vii) True (viii) False

D 1 (i) False (ii) False (iii) False (iv) True (v) False

2 (i) limited (ii) ten (iii) unlimited (iv) self-help and mutual help (v) 9%

2.10 TERMINAL QUESTIONS

1 What do you understand by sole trader organisation? State merits and limitations of sole trader organisation?

2 Partnership organisations emerged essentially because of the limitations and failures of the sole proprietorships. Discuss.

3 What is partnership? How does it differ from a joint stock company?

4 What is a joint stock company? Explain how it overcomes the limitations of non-corporate form of organisation

5 Discuss the special features of a cooperative form of organisation. How it is different from a company?

6 What is the main objective of a cooperative form of organisation? Explain its merits and limitations.

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

JNIT 3 FORMS OF BUSINESS ORGANISATION II

tructure

0 Objectives
1 Introduction
2 Requisites of an Ideal Form of Business Organisation
3 Comparison of Various Forms of Organisations
4 Criteria for the Choice of Organisation
3.4.1 Criteria at the Time of Starting a Business
3.4.2 Criteria at the Time of Expansion
5 Choice of Form of Organisation
6 Let Us Sum Up
7 Some Useful Books
8 Answers to Check Your Progress
9 Terminal Questions

.0 OBJECTIVES

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

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

.1 INTRODUCTION

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

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

hen you plan to set up a new business, you have to decide which form of organisation is ore suitable for the proposed business. For this you have to critically analyse the suitability each of the four forms of organisations in the light of the nature of the proposed business. is is a very crucial decision because it determines the power and responsibility of the trepreneur and the division of profits and losses. Once it is chosen, it is very difficult and pensive to change it. In this unit you will learn about the requisites of a good form of ganisation, compare the four forms of organisations, analyse the factors influencing the oice of organisation form, and decide which form is the most suitable in a given situation.

2 REQUISITES OF AN IDEAL FORM OF BUSINESS ORGANISATION

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

2.8 SOME USEFUL BOOKS

Bhushan, Y.K. 1987, ***Fundamentals of Business Organisation & Management,*** Sultan Chand & Sons: New Delhi. (Part Two, Chapters 1, 2 & 3)

Musselman, V.A., and J.H. Jackson, 1985, ***Introduction to Modern Business.*** Prentice Hall of India: New Delhi. (Chapter 3)

Ramesh, M.S. 1985, ***Principles and Practice of Business Organisation, Administration & Management,*** Kalyani Publishers: New Delhi. (Volume 1, Chapters 4 to 7)

Singh, B.P., and T.N. Chhabra, 1988, ***Business Organisation & Management,*** Kitab Mahal: Allababad, (Part One, Chapters 4 & 5)

2.9 ANSWERS TO CHECK YOUR PROGRESS

A 1 (i) unlimited (ii) proprietor/owner (iii) small (iv) one (v) proprietor/owner

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B 1 (i) ten (ii) unlimited (iii) sleeping (iv) two (v) partnership deed (vi) partner by estoppel (vii) limited partner

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C 1 (i) 7, unlimited (ii) 2, 50 (iii) limited (iv) 51 (v) unlimited (vi) statutory

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D 1 (i) False (ii) False (iii) False (iv) True (v) False

2 (i) limited (ii) ten (iii) unlimited (iv) self-help and mutual help (v) 9%

2.10 TERMINAL QUESTIONS

1 What do you understand by sole trader organisation? State merits and limitations of sole trader organisation?

2 Partnership organisations emerged essentially because of the limitations and failures of the sole proprietorships. Discuss.

3 What is partnership? How does it differ from a joint stock company?

4 What is a joint stock company? Explain how it overcomes the limitations of non-corporate form of organisation

5 Discuss the special features of a cooperative form of organisation. How it is different from a company?

6 What is the main objective of a cooperative form of organisation? Explain its merits and limitations.

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

UNIT 3 FORMS OF BUSINESS ORGANISATION 11

Structure

3.0 Objectives
3.1 Introduction
3.2 Requisites of an Ideal Form of Business Organisation
3.3 Comparison of Various Forms of Organisations
3.4 Criteria for the Choice of Organisation
3.4.1 Criteria at the Time of Starting a Business
3.4.2 Criteria at the Time of Expansion
3.5 Choice of Form of Organisation
3.6 Let Us Sum Up
3.7 Some Useful Books
3.8 Answers to Check Your Progress
3.9 Terminal Questions

3.0 OBJECTIVES

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

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

3.1 INTRODUCTION

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

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

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

3.2 REQUISITES OF AN IDEAL FORM OF BUSINESS ORGANISATION

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

1 Ease of formation: An important factor for preferring a particular form of organisation to another is the ease with which a business can be brought into existence. The comparative ease of difficulty in forming a particular form of organisation mainly depends on three factors: (i) formation expenses by way of registration fee, stamp duty, fees of legal experts, charges involved in the drafting of documents, obtaining licenses, etc., (ii) legal formalities, and (iii) procedural delays, etc. Unless it is very essential, it is better to go for an organisation which is easy to form.

2 Scope of raising capital: The choice of organisation mainly depends on the amount of capital required which is determined by the nature of business and the scale of operations. For example, if you want to open a retail shop in groceries, the amount of capital needed will not be much. But if you want to set up a sugar factory, you may require a large amount of capital. Ideal form of organisation is one which provides scope for raising the amount of capital as and when required.

3 Extent of liability: You know that the element of risk and uncertainty is prevalent in each business. In view of this, normally, the businessmen prefer limited liability. Obviously, limited liability is considered as an important feature of a good form of organisation. I-Iowever, a certain amount of risk is also found to be important to provide the needed spur for initiative, drive, and involvement in business. Many times, the absence of such spur leads to weakness, inefficiency and even dishonesty on the part of management personnel.

4 Flexibility of operations: The form of organisation should be very flexible and adaptable to changing business conditions without much difficulty or complication. For example, if you want to expand your business, diversify or modernise the plant and equipment, the organisation should be able to meet all requirements.

5 Stability and continuity: Stability and long life of business is desirable from the point of view of owners, employees, and customers. Employees always prefer a stable and continuous employment. If the business is stable, the owner should be able to formulate plans for the future and to make investments paying for a considerable length of time. From the customers' point of view also, regular supply of goods and services is expected to meet their needs. An ideal form of organisation is one which provides reasonable amount of stability to the business.

6 Effectiveness of management: As you know that the success of any business enterprise depends on the efficiency of management. Managerial efficiency depends on skills, motivation, flexibility, adaptability, etc. It is difficult for an individual to possess all these qualities.

7 Extent of government control and regulations: If the governmental control and regulations are too many, the enterprise may have to divert a lot of time, money and energy for complying with legal formalities and instructions. In some cases there may be too much interference by the government officials in the day-to-day business of the firm. No doubt, the investors, creditors, and customers trust the business enterprises whose activities are properly regulated by the government. But too much government interference is not favoured by the entrepreneurs because it mars their initiative and disrupts the working of their business.

8 Business secrecy: In business, it is important to maintain business secrets without leaking them out to competitors. Therefore, a form of organisation which enables retention of business secrets is preferred to the one wherein business secrets are difficult to preserve.

9 Tax burden: Business taxes like sales tax, excise duty, and customs duty are charged on certain products and services. Hence, such taxes affect all forms alike and they will not affect the choice. But the income tax liability is different from one form of organisation to the other. Naturally, the form of organisation which attrac'ts the minimum amount of this tax liability is considered as an ideal fonn. From this point of view company form of organisation is considered to be best because it enjoys a number of tax reliefs which are not available in case of other forms of organisation.

10 Ownership prerogatives: Some persons have a very strong desire to control the entire business activities themselves and place a great value upon their right of personal leadership. Some persons are desirous of sharing the responsibilities and risks of a business. Some people may want to own a part of the capital without a strong desire to control the affairs of the business. You can also find some persons who are not ready to bear the business risk. An ideal form of organisation takes care of such prerogatives of the owners.

3.3 COMPARISON OF VARIOUS FORMS OF ORGANISATIONS

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

Table 3.1

Comparative Study of Different Forms of Organisation

S. N.	Basis of Comparison	Sole Proprietorship	Partnership	Private Limited Company	Public Limited Company	Cooperative Organisation
1	Formation	Easiest. No legal formalities required	Quite easy: No rigid legal formalities	Difficult due . to legal formalities	Quite difficult due to many legal formalities	Few legal formalities are involved
2	Specific regulation	None	Indian Partnership Act. 1032	Companies Act, 1956	Companies Act, 1956	Cooperalive Societies Act, 1912
3	Legal status	No separate legal status	No separate legal status	Separate legal status	Separate legal status	Separate legal status
3	Membership.	Single owner	Minimum is 2 Maximum is 10 in banking business and 20 in others	Minimum 2 and maximum 50	Minimum 7 and no maximum limit	Minimum 10 and no maximum limit
5	Capital	Very limited capital	Limited capital	Larger capital resources	Any amount of capital can be raised	No substantial resources
6	Management and ownership	Owner management	Owner management	Control, risk and ownership generally go together	Complete separation of management from ownership	Not managed by all members
7	Managerial expertise	Very limited expertise	Limited expertise	Scope for expertise	Very wide scope . for expertise	Scope for expertise
8	Owner's liability	Unlimited	Unlimited	Limited	Limited	Limited subject to By-laws
9	Basis of profit sharing	Fully enjoyed by owner	Shared by partners as per agreement	Shared by owners in the proportion of shares held	Shared by owners in the proportion of shares held	Volume of business by each member
10	Ownership transfer	At will and relatively easy	Restricted and relatively difficult	Restricted and relatively difficult	At will and very easy	Restricted
11	Business stability	Depends upon the life of owner	Depends upon the life, insolvency, retirement of partners	Perpetual existence. Death, insolvency of the members docs not effect the life	Perpetual existence. Death, insolvency of the members docs not effect the life	Death. insolvency of its members does not effect the life
12	Business secrets	Full secrecy	Secrets shared by the partners	Secrets shared by the members	Exposed to public	Exposed to members
13	State regulations	Almost nil	Very little	Considerable regulations	Excessive regulations	Considerable regulations
14	Tax liability	No special income tax	No special income tax	Heavily taxed and income is double taxed	Heavily taxed and income is double taxed	Exemption from income tax
15	Flexibility	It is an elastic. organisation. There is no need of written documents	It can be changed only by the consent of all partners. It requires partnership deed which can be changed by the consent of all the partners	It is an elastic organisation	It is an unelastic organisation. Its Memorandum of Association is difficult to change. It can be changed through the permission of the Govt.	It is an unelastic organisation. Its Memorandum of Association is difficult to change, It can be changed through the permission of Govt.
16	Auditing of Accounts	Not required	Not required	Compulsory	Compulsory	Compulsory
17	Winding up	At will	At will	Under the Act	Under the Act	Under the Act

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

Check Your Progress A

1 List the features of an ideal fonn of business organisation.

....

....

....

....

2 Stale whether the following statements are True or False.

i) An ideal fonn of organisation is one which has complicated legal formalities at the time of formation. ....

ii) Unlimited liability is an important feature of an ideal form of organisation. ....

iii) Organisation should be flexible and adaptable to changing business conditions. ....

iv) Too much governmental control is not ideal. ....

v) An ideal form of organisation should ensure stable and continuous life to the business. ....

vi) Retention of business secrets is one of the essential 'features of a good form of organisation. ....

vii) The form of organisation which attracts more tax burden is desirable. ....

3) Fill in the blanks.

i) .... form is the easiest and .... form is the most difficult in formation.

ii) Membership of owners is the highest in.......... form and the lowest in........ form.

iii) Scope to raise capital is very limited in .... form.

iv) Income is exempted from tax for .... form of organisation.

v) Owners liability is unlimited in ....forms.

vi) Business secrets are maintained in .... forms.

vii) State regulations are the maximum in .... form.

viii) Business secrets are mostly exposed in .... form.

3.4 CRITERIA FOR THE CHOICE OF ORGANISATION

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

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

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

3.4.1 Criteria at the Time of Starting a Business

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

1 **Nature of business:** Choice of a suitable form of organisation is dependent on the nature of the proposed business. The organisational requirements are different for different types of business. For example, a big cement manufacturing activity and a retail cement shop cannot have the same form of organisation. Similarly, the form of organisation suitable for a textile mill is not suitable for a tailoring shop.

2 **Volume of business:** The expected volume of business also influences the decision about the suitable form of organisation. If the volume of business is small, you need small amount of capital and run less risk. In that case sole proprietorship may be quitc suitable. But if the volume of business is large, you need more capital anti run more risk which a single owner may find it difficult to cope with. So, partnership form or a company form would be considered more suitable.

3 **Area of operation:** The area of operation of the business also influences the choice of form of organisation. If the area is limited and confined to a particular locality, the suitable form of organisation may be sole proprietorship. In case the area is widespread, the suitable form may be a joint stock company.

4 **Desire for control:** The extent of control and supervision will also determine the choice of organisation. If it is desired to have a direct control over the business operations, a sole proprietorship or a partnership form of business should be adopted. In case if you feel that there is no need for direct control, the company form of organisation is the best.

5 **Capital requirements:** The form of organisation will also depend on the extent of financial requirements of the business. A business which rcquires a small amount of capital can be organised on sole proprietorship or partnership basis. But if the financial requirements are huge, then the joint stock company form of organisation may be preferred.

6 **Extent of risk and liability:** You know business operations involve risk. If the promoters of a business enterprise are deterred by the risk involved, they will start the business on the basis of a limited liability. That means they can go for a company. In case they have capacily to bear the risk involved, it can he organised on sole proprietorship or partnership basis.

7 **Government regulations:** As you know the governmental controls and regulations are more in company form and cooperative form of organisations compared to the remaining two forms. If you do not want too much government control and regulation, you should choose either sole proprietorship form of partnership form.

3.4.2 Criteria at the Time of Expansion

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

i) Need for larger financial resources.

ii) Need for internal reorganisation and control.

iii) Need for specialised services like communicalion, accounting, marketing, etc.

iv) Increase in governmental controls and regulations.

v) Increase in tax liability.

vi) Increase in the problem'of control and coordination.

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

3.5 CHOICE OF FORM OF ORGANISATJON

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

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

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

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

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

Check Your Progress B

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

....

....

....

....

2 State whether the following statements are True or False.

i) Higher the business'volume, the lower is the capital requirement. ....

ii) Sole trader or partnership forms are desirable when direct control of business is preferred. ....

iii) Nature of the business does not have any influence on the choice of organisation from. ....

iv) If the area of operation is very wide, partnership form is ideal. ....

v) Company form is suitable in case of limited liability is desired. ....

vi) Raising of capital to an unlimited extent is possible through public limited company. ....

vii) Government regulations are more in the case of company form of organisation. ....

3 Put a (✓) mark against correct answer.

i) Suitable form of business organisation for a very small business is sole proprietorship1 company form.

ii) For large scale manufacturing business, suitable form of organisation is partnership/company form.

iii) Suitable form of organisation for medium size retail cloth business is partnership/company form.

iv) To raise small amount of capital, suitable form is sole trade form/cooperative form.

v) If the risk element is very high, suitable form of organisation is partnership/private limited company.

3.6 LET US SUM UP

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

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

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

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

3.7 SOME USEFUL BOOKS

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

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

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

3.8 ANSWERS TO CHECK YOUR PROGRESS

A 2 (i) False (ii) False (iii) True (iv) True (v) True (vi) True (vii) False

3 i) Sole trader, public limited company
ii) public limited company cooperative, sole trader
iii) soletrader
iv) cooperative
v) soletrade and partnership
vi) sole trade and partnership
vii) public limited company
viii) public limited company

B 2 (i) False (ii) True (iii) False (iv) False (v) True (vi) True (vii) True

3 (i) sole proprietorship (ii) company form
(iii) partnership (iv) sole trader form
(v) private limited company

3.9 TERMINAL QUESTIONS

1 Explain the features of an ideal form of business organisation. Which form can be considered to be an ideal'in all respects?

2 None of the four forms of business organisations has all the feature4 of an ideal form of organisation. Discuss.

3 Explain the factors determining the choice of the form of business organisation.

4 You plan to start a business. How would you choose the suitable form of organisation for your business?

5 Company form of organisation is the most ideal form for all types of businesses. Discuss.

6 A partnership firm has decided to expand its business which requires more capital and expertise. Should it take more partners or convert it into a private limited company? Give your advice with suitable arguments.

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

UNIT 4 BUSINESS PROMOTION

Structure

4.0 Objectives
4.1 Introduction
4.2 An Entrepreneur
4.2.1 Entrepreneurship
4.2.2 Characteristics of an Entrepreneur
4.2.3 Functions of an Entrepreneur
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4.3.1 Distinction between Entrepreneur and Promoter
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4.0 OBJECTIVES

After studying this unit, you will be able to:

- explain who is an entrepreneur and what his characteristics are
- describe the functions of an entrepreneur
- distinguish between an entrepreneur and a promoter
- explain the procedure for promoting sole proprietorship, partnership, joint stock company, and cooperative society.

4.1 INTRODUCTION

In the previous units you have learnt about the nature of business activities, the types of business in which individuals and groups of individuals may be engaged, and the different forms in which business activities may be organised. You know in business field a variety of goods and services are dealt with in small shops, large stores, small workshops and large factories. Have you ever enquired how these business activities were started? Who started them and what kind of ideas they had while taking their decision to set up a business? Certainly, some individuals or groups of individuals must have thought of those businesses to start with. If your family is running a business, it is possible that your father or grandfather thought about it and then took steps to set it up. If it is a manufacturing business, a factory building must have been constructed, machinery, supply of raw-materials must have been arranged, workers recruited and availability of power, water, etc., also assured. For all these purposes, those who started the business must have arranged capital to meet the necessary expenditure. In other words, every business is the brain child of someone. That someone is called 'entrepreneur'. In this unit, you will leam who an entrepreneur is, what are the characteristics and functions of an entrepreneur, the role of an entrepreneur in business promotion, difference between entrepreneur and promoter and various types of promoters, You will also leam how various forms of business organisations are promoted and what steps are taken by promoters to set up the business.

3.8 ANSWERS TO CHECK YOUR PROGRESS

A 2 (i) False (ii) False (iii) True (iv) True (v) Truc (vi) True (vii) False

3 i) Sole trader, public limited company
ii) public limited company cooperative, sole trader
iii) sole trader
iv) cooperative
v) sole trade and partnership
vi) sole trade and partnership
vii) public limited company
viii) public limited company

B 2 (i) False (ii) True (iii) False (iv) False (v) Truc (vi) Truc (vii) True

3 (i) sole proprietorship (ii) company form
(iii) partnership (iv) sole trader form
(v) private limited company

3.9 TERMINAL QUESTIONS

1 Explain the features of an ideal form of business organisation. Which form can be considered to be an ideal'in all respects?

2 None of the four forms of business organisations has all the features of an ideal form of organisation. Discuss.

3 Explain the factors determining the choice of the form of business organisation.

4 You plan to start a business. How would you choose the suitable form of organisation for your business?

5 Company form of organisation is the most ideal form for all types of businesses. Discuss.

6 A partnership firm has decided to expand its business which requires more capital and expertise. Should it take more partners or convert it into a private limited company'? Give your advice with suitable arguments.

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4.1 INTRODUCTION

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4.2 AN ENTREPRENEUR

An entrepreneur is one in whose mind the idea of doing business of a particular type first takes shape. He is on the look out for business opportunities and is a good judge of which products will sell. He is imaginative and is guided by a strong sense of achievement. He is not afraid of future uncertainties. He is prepared to take risk and face challenges. Above all, an entrepreneur is one who creates something new, something different. He innovates and combines resources in the form of men, materials and money and brings them together to make the business venture profitable. .

4.2.1 Entrepreneurship

What the entrepreneurs do may be regarded as 'Entrepreneurship'. In other words, entrepreneurship is the act of being an entrepreneur. The word entrepreneurship is actually derived from the French term 'entrepreneur' which means to undertake, to pursue opportunities, to fulfil needs and wants of people through innovation and starting business. The entrepreneur is the person who does all this. He undertakes a venture, organises it, raises capital to finance it and assumes the whole or major part of the risk of business. Thus, 'entrepreneurship is the process of giving birth to a new business'.

Innovation and risk bearing are the two basic elements of entrepreneurship. Hence you must know the exact connotation of these terms.

Innovation: If a business activity does not require anything special to be done, it is not entrepreneurship. In fact a person cannot be called an entrepreneur unless he introduces something new, something different, in his venture. This is known as innovation, thal is, doing something different from others. The entrepreneurs are constantly on the look out for something unique to fulfil the need or want of people. They may or may not be inventors of new products or new methods of production, but they are able to foresee the possibility of making use of the invention for business. Others who come to know about the same invention are not capable of thinking about its practical usefulness in business. Or, they may not have the ambition or self-confidence to take advantage of it.

In a competitive market, an entrepreneur can succeed in his business only through innovation. An innovation need not necessarily be something big or dramatic. A simple adjustment to something old, or giving a service without extra charge while selling a product, or a colourful packaging, or selling a product in packets of different weights, and such types of steps may be profitabie innovations. Of course, if similar things are done by a number of producers and sellers, an entrepreneur has to think of other types of innovations. Thus some innovations may lead to other innovations. No wonder that imagination is sometimes more important than knowledge for innovative thinking. An entrepreneur must have imagination and also the ability to think creatively.

Take the case of fruit juice. Now a days, fruit juice is sold in small cartons instead of bottles so that you can carry it and throw away the container after drinking the juice. This is innovation. Let us take another example. You may have heard of Henry Ford who established the Ford Motor Company in the United States. He did not invent the automobile, but he applied new methods of mass production and turned out passenger cars at low cost so that many people could afford it.

Risk Bearing: Risk bearing is another aspect of entrepreneurship that every entrepreneur has to cope with. One who is an entrepreneur must be a risk taker, not a risk-avoider. In fact. starting a new business always involves risk because money is invested for profits in future. To try anything new is also risky. A new venture may not bring the expected profits or may fail and run into losses. It may happen because of increasing competition, a change in customer preferences, shortage of raw material supply, or sudden unexpected calamities. But an entrepreneur is bold enough to assume the risks. He is prepared to take risks for the reward. Even if he fails in one venture, he persists, and this helps him to succeed.

4.2.2 Characteristics of an Entrepreneur

If you read business history, you will come across the names of many persons who may be called entrepreneurs. Rockfeller and Henry Ford of the United States, Karl Benz and Gottfried Daimler of Germany, Soichiro Honda of Japan, are well-known names of entrepreneurs, who started industrial organisations and made fortunes, In our country, J.N.

Tata, G.D.Birla, Kirloskar and others have set up successful manufacturing industries. Small business firms have often succeeded because of the part played by entrepreneurs. It may be useful to know whether they had anything common as regards their personal characteristics. It has been found that there are certain elements in the character of entrepreneurs which are usually prominent in them.

1 Independence: Many entrepreneurs who started their businesses resisted being pigeonholed or Following routine habits. In fact, entrepreneurs become frustrated when they have to follow someone else's direction. They have to be the boss. They like to be in control. They find it difficult to work under the direction of others.

2 Hard Work: Willingness to work—and work hard—is an outstanding trait of entrepreneurs. You can bet that the successful business owner has paid with tedious, sweat-filled hours, emotional stress, and perseverance. Most likely the business verged on failure many times in the beginning, but the owner simply would not let it die. **A** successful entrepreneur described his early experiences that they worked endless, twelve hour days and sometimes seven days a week. You might say it was his whole life.

3 Desire to Achieve Goals: They have a strong desire to overcome problems and setting up successful business ventures which eventually give adequate profits. They considered profit as a measure of their achievement and performance rather than making money alone.

4 Foresight **and Dynamic Outlook:** Basically, these people have wide knowledge about business environment i.e., market, consumer attitude, technological development, etc. Further, they ore dynamic in forecasting business uncertainties and risks, accordingly, they take quick and sound decisions.

5 Open-mindedness: They are intelligent in predicting changes in business environment. However, they never resist changes because they know that they cannot stop it. Therefore, they are habituated to open-mindedness even though sometimes they lose crores of rupees due to changes in consumer tastes which ultimately forced them to change their technology, etc.

6 Optimistic Outlook: They are generally inclined to believe that present problems are of a temporary nature and conditions will be more favourable in due course. Entrepreneurs are always eager to achieve their goals in the best possible manner, to get outstanding results which they can be proud of.

7 Working **Relationship** : The success of a business mostly depends upon its workers first rind then their links with other business undertakings. Most of the successful business entrepreneurs have had harmonious relationships with others. This builds up their reputation in the market.

8 Good **Organisers** : They are good at bringing together different types of resources needed for starling a business and making it operationally efficient. They can convince people about the prospects of business, get their cooperation, raise funds, procure machinery, arrange supply of materials, select right type of employees and coordinate various activities relating to the business.

9 Innovative Aptitude: Most of the successful entrepreneurs have innovative aptitude. They spend part of their income on research and innovative activities so that they offer suitable products to meet the demands of consumers. Some of our industrialists like Tata, Birla, Kirloskar, etc. have established their own research centres.

4.2.3 Functions of an Entrepreneur

Having read the preceding pages of this unit, you must have started thinking about the functions of an entrepreneur. Essentially, what the entrepreneur does is to recognise the possibility of starting a business which may be profitable. Then, he prepares a plan of action, and steps to be taken to set up the business, and eventually undertakes the operation of the business. Of course, depending upon the nature of business that is in view, the functions will differ. Let us see functions of an entrepreneur who is looking for opportunities to engage in production activity.

1 Develops an idea and explores opportunities: The idea of forming n business unit is first formed in the creative mind of the entrepreneur. On the basis of the idea he

perceives opportunities for profitable investments and explores the prospects of starting a manufacturing enterprise.

2 Product analysis and market survey: He collects data on consumer preferences and needs through market research techniques and to find out the saleability of the proposed product. Further, he collects consumer preferences in respect of design, colour, size, and shape. In addition, the entrepreneur gathers the total demand and the degree of competition for the proposed product.

3 Decides form of organisation: He decides the form of business ownership, i.e. whether it should be a sole proprietorship, a partnership firm, a company or a cooperative society.

4 Decides location: He decides location of the factory at a suitable place taking into account the available facilities of transport, power-supply, fuel, water, labour, supply of raw-materials, nearness of market, etc.

5 Collects necessary capital: He makes available sufficient amount of capital for the initiation and continuation of the business. He gives personal guarantees to the financiers who contribute capital. Otherwise, he promises to invest capital himself or arrange the necessary amounts from friends and relatives. In case of small enterprises, the promoters can provide funds from their own savings. But in case of large enterprises, funds have to be raised from various sources like general public, commercial banks, financial institutions, etc.

6 Places orders for machinery: He places orders for machinery, equipments and other requirements. He takes decision about the installation of equipment and machinery in the process of production.

7 Recruitment of labour: As an entrepreneur he makes an estimale of skilled and unskilled workers of different categories required for various departments. Accordingly, the entrepreneur arranges their recruitment.

8 Designs internal organisation structure: He designs internal organisation structure for his proposed concern. This involves breaking up of the total work of the enterprise into major functions like production, marketing, finance, personnel, purchase, engineering, etc. and the dividing of each of them into sections. He stipulates the functions of different departments and their inter-relationships.

9 Fulfils formalities and launches enterprise: Every type of business has some procedural formalities while starling a new enterprise. The formalities are different for different types of business organisations. Unless you fulfil them you cannot simply launch an enterprise. You will learn about procedural formalities later in this unit.

Thus, the role of an entrepreneur is that of an initiator and promoter. In a sense, the role of an entrepreneur is also that of an expert having knowledge of product, market conditions and of the practical aspects of running a business. He should not be simply an imaginative thinker but also have the ability to judge what kind of business will click. His role is indeed crucial for the eventual success of a business. When an enterprise has been launched and it turns out to be profitable, the entrepreneur may decide to leave it, give up his ownership tights, and hand it over to others to run it. Many entrepreneurs in the past have done so. They have been attracted by new opportunity and more profitable lines of business. But many entrepreneurs have continued to run the business they started taking every opportunity of expanding the original venture, adding new activities, making current operations more efficient, and deriving satisfaction from their achievements.

But you will agree that it is the initial phase which is most important for the success of a venture. It is at this stage that the future of a business is decided. The basic responsibilities of an entrepreneur include the ability to seize an opportunity, to innovate, explore the , prospects of profitable business, and then to complete legal formalities, raise, funds and finally manage the business are the basic responsibilities 'of the entrepreneur. He has to face many obstacles, many problems and difficulties in the course of promoting business. He has . to take decisions which may have long-run implications. An entrepreneur has thus to undertake many things. But the most important of these are: (i) innovation, and (ii) risk- . bearing.

Check Your Progress A

I Indicate whether each of these statements is True or False.

i) An entrepreneur is an imaginative thinker and an innovator. □ True □ False

ii) An entrepreneur is on the Look out for opportunities of profitable ventures □ True □ False

iii) An entrepreneur may not have capital of his own to invest but he is a risk-bearer. □ Ture □ False

iv) Profits earned by the business are regarded as a measure of an entrepreneur's achievement and performance. □ Ture □ False

v) An entrepreneur does not raise initial capital and give personal guarantees to the financers. □ True □ False

vi) An entrepreneur brings together everything required to start a ousiness. □ True □ False

vii) An entrepreneur undertakes activities which are similar to others in the business field. □ True □ False

viii) Entrepreneurs are pessimistic in their outlook. □ True □ False

2 Read the following statements. Find out who is the entrepreneur and who is not.

i) A person sets up a business with an improved quality and usefulness of an existing product or service.

ii) Mr Srikanth is running a spinning mill. He purchased it recently for Rs. 8 crore.

iii) Mr Harish raised finance and started a factory for producing mango juice in paper containers.

iv) Bata Shoe Company opened their showrooms in Andaman and Nicobar Islands in order to sell their products.

v) Ali decides to make alternative raw-materials on production.

4.3 PROMOTION

A business enterprise does not come into existence on its own. It is the result of the efforts of an entrepreneur who conceives the idea based on his knowledge of business opportunities and takes necessary steps to launch the business venture. He is also known as promoter. As a promoter, he assembles the required funds and people, and serves both as a mother and mid-wife to the enterprise. Thus, the promoter is the Kingpin of business as he/she undertakes the risk and gives a concrete shape to business propositions. Promotion may be undertaken for the purpose of setting up a new business, for the expansion of an existing business, or for combing two or more business firms.

4.3.1 Distinction between Entrepreneur and Promoter

Sometimes a distinction is made between 'entrepreneurs' and 'promoters' of business. Those who are innovators and risk-bearers are strictly known as 'entrepreneurs' while those who take steps to set up the business and make it operational are known as 'promoters'. In actual practice, however, this distinction does not hold good. Entrepreneurship (act of entrepreneurs) does not remain confined only to recognition of business opportunities and preparedness to do something new. It does not end with the entrepreneur undertaking to bear the risks of business. It includes planning for the business and taking necessary steps to put it into operation. After all, a business becomes a business only when it gets going. Thus, in a wider sense we cannot make a difference between the role of an entrepreneur and the role of promoter.

4.3.2 Types of Promoters

There are various types of promoters. They are classified as professional promoters, financial promoters, entrepreneurial promoters, institutional promoters and government.

1 **Professional promoters:** These are specialists in forming new business enterprises. After promoting an enterprise they eventually handover the control and management to the shareholders of the company.

2 Financial **promoters:** These promoters float new enterprises during favourable conditions in securities market. They are people who have financial stability and are looking forward to new opportunities for investment.

3 Entrepreneurial promoters: These promoters conceive the idea.of a new business unit, do the necessary preliminary work in setting up the business unit and ultimately control and manage the same. In India most promoters belong to this category.

4 Institutional promoters: There arc some specialised institutions like Industrial Development Bank of India, National Industrial Development Corporation, etc., which are providing technical, managerial and financial assistance for the promotion of new enterprises. These institutions collaborate with other entrepreneurs to launch the enterprises.

5 Government: Since independence, Government of India has emerged as a big promoter of enterprises. It has promoted several enterprises in different fields such as ordnance factories, heavy electricals, shipping, iron & steel, fertilizers and pesticides, oil and natural gas, etc.

4.4 PROMOTION OF DIFFERENT TYPES OF ORGANISATIONS

You have already studied the role of an entrepreneur in setting up a business. The promoter decides the product or service which has a market, and then takes necessary steps for launching a business venture. Before launching the business enterprise, thc promoter takes decision about the form of business ownership. Will it be under single ownership or joint ownership? If it is to be under joint ownership, will it be a partnership organisation or a joint stock company? The steps that he has to take in launching the business will naturally depend upon the form of organisation. The formalities—particularly the legal formalities—necessary to start the business will be different in each case. Let us first see what is required to be done to promote a business venture under single proprietorship and partnership finn.

4.4.1 Proprietory Concern

When a business is decided to be set up under single ownership, there is practically no legal formality involved. Of course, to run certain types of business activities permission has to be obtained from the Government or local authorities. For instance, to open a restaurant, the individual proprietor has to get the pennission from the Health Department of the Municipal Corporation. To start a workshop or factory, the proprietor must get the permission of the Director of Industries through the District Industries Centre.

A business may also be owned by a ***Joint Hindu Family***. In such a business, the head of the family, known as ***Karta*** has full control over the income and expenditure of the business. and controls the business activities just like an individual proprietor. In fact, a joint hindu family business generally comes into existence when the head of the family dies and the members of his family decide to continue the family business through the senior most member of the family. This form of organisation of business also does not require any legal formality.

4.4.2 Partnership Firm

You know that partnership is the relationship between two or more persons who-have agreed to share the profits of a business. The business may be carried on by all or by any of them acting for all. Collectively those persons are known as 'a firm' and individually they are known as 'partners'. The agreement between the partners may be oral or in writing. A partnership business comes into existence as a result of an agreement between two or more persdns. Hence, a partnership firm has no separate existence in the eyes of law. It has no independent legal existence. No legal formality is, thus, required to launch a partnership business and to run it.

However, if the partners desire, a partnership firm can be registered with the Registrar of Firms by filling up a form of application. **A** fee of Rs. **3** is to bc paid for that purpose. Registration of partnership is not compulsory under the law. But it is desirable because an unregistered firm is not permitted to file a law suit or start other legal proceedings against any third party to recover its claims. Moreover, no partner of such a firm can file a suit to enforce his rights against other partners under the partnership agreement, although third parties can,file suits against the firm as well as the partners.

Before starting a partnership business, the partners come to an agreement about their mutual rights and obligations. If it is an oral agreement there is always a possibility of misunderstanding or dispute among the partners as regards their respective rights and liabilities. To avoid any dispute in future, it is advisable that the agreement should be in writing. The written agreement is known as 'partnership deed'. It should be drawn on a stamped paper and signed by all the partners. The partnership deed should contain the nature and place of business, duration of partnership, capital to be contributed and share of profits of each partner, rights, duties and obligations of partners, salary payable to any partner, and all such clauses as may be agreed upon.

Check Your Progress B

State whether the following statements are True or False.

i) Business promotion begins with the conception of an idea and ends with the setting up of the business unit. □ True □ False

ii) Revival of existing sick units is called business promotion. □ True □ False

iii) The Formalities required in proprietory concern are much less as compared to partnership firm. □ True □ False

iv) Registration of partnership is compulsory. □ True □ False

v) The partners cannot file suit against the other partners if the firm is not registered. □ True □ False

vi) The senior member who manages joint Hindu family business is known as 'Karta'. □ True □ False

4.4.3 Joint Stock Company

You have learnt that a company is an association of persons. So, there must be more than one person to start a company. A partnership firm also must have more than one person involved in the business. But legally speaking, a partnership firm has no existence apart from its partners. On the other hand, a company after it is formed acquires a separate legal identity. It is regarded in law as a separate entity distinct'from the members who join it. Because of this feature, the promotion of a company requires a number of legal formalities to be completed before it can be established. One or more promoters can take the responsibility of bringing a company into existence.

The Indian Companies Act, 1956 contains provisions regarding the legal formalities for setting up a company. You know that from the point of view of ownership, mainly two types of companies can be formed under the Companies Act—private company and public company. The promoters have to decide which type of company they would prefer to form. For the purpose of running a business, promoters generally want that the liability of members should be limited to the amount of capital that they agree to contribute. Accordingly, the company decided to be set up may be a private limited company or a public limited company. Whether it is a private limited or a public limited company, it is necessary that the company is duly registered under the Companies Act. The official appointed for the registration of companies is the Registrar of Companies. For each State or group of States in India, there is a Registrar of Companies. For instance, there is a Registrar of Companies for the Union Territory of Delhi and Haryana. His office is in New Delhi. Let us see what the promoters have to do for the registration of a company,

Registration of a Company

Registration of a company is alsa known.as incorporation. A company is said to be incorporated when it receives the certificate of incorporation from the Registrar of Companies. The certificate of incorporation is a conclusive proof of the fact that a company bearing a specific name has been lawfully formed. The promoter has to take the following steps for obtaining the Certificate of Incorporation——

1 Selecting a name for the company

2 Preparation and printing the documents Io be filled

3 Filing the documents with the Registrar of Companies

Let us now take up these aspects one by one.

1 Selecting a name: Every company to be registered should have a name by which it will be known for legal and business purposes. The promoters generally select a few names and ascertain from the Registrar's office whether these names are available. For this purpose an application on a prescribed form is submitted to the Company Law Administration, Government of India, through the Registrar of Companies for approval. The promoter can then adopt any name from the list of approved names. It is also necessary to include the words 'Limited' and 'Private Limited' in case of public limited company and private limited company respectively.

2 Preparation and printing of documents: After the name of the company has been approved and adopted, the promoters have to get the following two documents prepared and printed :

a) Memorandum of Association
b) Articles of Association

Memorandum of Association: It is the most important document of a company as it lays down the constitution of the company and states the relationship of the company with the outside world. It is a public document and each person who deals with the company is supposed to know the provisions contained in the memorandum. The purpose of memorandum is to enable the shareholder, creditors and those who deal with the company to know what is its permitted range of activities. Although the company is a legal 'person' its capacity to do business, unlike that of a real person, is restricted. If a company is engaged in any trade or business which is outside the provisions of the Memorandum of Association, such acts are regarded ultra *vires* of the company and therefore, void and inoperative.

The Memorandum of Association contains the following particulars under different clauses.

i) Name of the company
ii) Name of the state in which the registered office is to be located.
iii) Objects clause—The nature of business activities which the company will undertake is to be stated in this clause.
iv) A declaration that the liability of the members will be limited to the face value of shares subscribed.
v) Capital clause—The total amount of capital with which the company is proposed to be registered and its divisions into different shares of a fixed amount are to be stated under this clause.
vi) A declaration by signatories to the Memorandum that they are desirous of being formed into a company and agree to take the number of shares mentioned against their names.

The Articles of Association: It contains the rules and regulations relating to the management of its internal affairs. They define the rights, powers and duties of the management, the mode and form in which the business of the company is to be carried on and the manner in which changes in the internal regulations of tile company may be made from time to time. Articles lay down the'relations between the company and its members and between the members. A public company limited by shares may register its own Articles of Association or adopt Table A containing the model set of 99 articles given in Schedule I of the Companies Act. Other types of companies must prepare and file their own Articles of Association along with the memorandum at the time of incorporation. The Articles of Association must riot contain anything contrary to the Companies Act, the public policy, the Memorandum of Association and the general law of the land.

3 Filing of documents for registration: After preparing and printing the Memorandum of Association and Articles of Association, the promoters make an application to the Registrar of Companies and file the following documents :

i) A copy of the Memorandum of Association
ii) A copy of the Articles of Association
iii) A-list of persons who have agreed to become director of the company with their names, addresses', age and occupations. In case a separate list of directors is not filed, signatories to the Memorandum of Association will be deemed to be the directors.

iv) Written consent of the directors to act in that capacity, duly signed by each director, along with a written undertaking to take the prescribed qualification shares, if any. A company without share capital and a private company need not file this document.

v) A statutory declaration stating that all the legal requirements with respect to incorporation have been duly complied with, This declaration should be signed by an Advocate of a High Court or of the Supreme Court, or by a practicing chartered accountant or by a person named as director, manager, or secretary of the company.

vi) Notice of the registered office of the company. However, this notice may be filed within 30 days of incorporation.

Along with the above documents, the Memorandum of Association and the Articles of Association must bear stamp duty as per the Indian Stamps Act. The promoters have also arranged payment of registration fees and filing fees at the time of submitting the application. If the Registrar upon scrutiny of the documents finds them to be in order, he issues the certificate of Incorporation in favour of the company. The company becomes a separate entity in law when it gets the Certificate.

Commencement of Business

A private limited company can commence business activities as soon as it is registered. The promoters of such a company raise the amount of capital necessary from their friends and relatives either against shares issued or in the form of loan. The general public cannot be invited to contribute to the capital.

For a public limited company, however, business activities cannot be started immediately after registration. It has to obtain a Certificate of Commencement of Business from the Registrar of Companies for which a number of additional steps have to be taken by the promoters. They are as follows :

1 Preparation and registration of Prospectus or a Statement in lieu of Prospectus: After the company has been incorporated, it is necessary for the directors to raise necessary capital for the company. Generally, shares of fixed amount are decided to be issued to the public to raise the amount of capital required. The document which is prepared to invite the public to subscribe to the shares of the company is known as Prospectus. In fact, the prospectus includes all such information about the company which may be of interest to the people who are likely to subscribe to the capital. The content of the prospectus have been specified in the Companies Act, so that the promoters may not suppress anything or mislead the public. A copy of the prospectus is required to be filed with the Registrar for registration before it is issued to the public.

A private limited company does not have to issue a prospectus to raise its capital since it is not permitted under law to invite the public to subscribe to its shares. However, it is not compulsory even for a public limited company to issue prospectus unless it decides to approach the public for raising its capital. If the promoters decide not to approach the public for raising the necessary capital but to arrange subscription of capital by their friends or relatives or through underwriters, it is not necessary for them to issue a prospectus. In that case, a Statement in lieu pf Prospectus must be filed with the Registrar. The contents of such a statement are virtually the same as those of a Prospectus. The Statement must be signed by all the directors of the company and filed with the Registrar.

2 Subscription and Allotment of Shares: If public offer for sale of shares and debentures exceeds Rs. 1 crore, the company must obtain the permission of the Controller of Capital Issues, New Delhi. After obtaining such permission and the registration of prospectus with the Registrar, the company can invite public to subscribe to its shares. The companies usually appoint brokers through whom they approach the public for subscription. The brokers issue prospectus and application forms to the prospective investors. The company also appoints some banks who receive the applications from the public along with the application money and credit the amount to company's account specially opened for the purpose. After the issue is closed, the Board of Directors decide the basis of allotment in consultation with the stock exchange authorities and pass a formal resolution for allotment. On the basis of the resolution the Secretary of the company issues letters of allotment to the subscribers. If the subscription exceeds the amount of capital to be raised, the excess is refunded to the subscribers involved. After the allotment exercise is over, the Secretary submits a Return of Allotment to the Registrar of Companies.

One of the important conditions to be fulfilled by a public limited company before it can apply for the Certificate of Commencement of Business is that it must have received share applications for the **minimum subscription** as indicated in the prospectus. Minimum subscription is defined as the minimum amount which in the opinion of the directors (or the signatories to the Memorandum), must be raised by issue of shares to meet the following expenses :

i) purchase price of any property bought or to be bought which is to be paid out of the proceeds of the share issue;

ii) preliminary expenses;

iii) repayment of money borrowed in respect of the above matters;

iv) working capital required; and

v) any other payment that may be specified.

If the amount of capital subscribed by the public is less than the minimum subscription or the company could not obtain minimum subscription within 120 days of the issue of prospectus, all money received from the applicants have to be refunded and'no allotment can be done.

3 **Declaration of Compliance:** When all the formalities in respect of the public issue have been completed, the company will have to file a statement with the following declarations with the Registrar :

i) That the shares payable in cash have been allotted up to the amount of minimum subscription as stated in the prospectus.

ii) That every director has paid in cash the application and allotment money on his shares in the same proportion as others.

iii) That no money is liable to become refundable to the applicants by reason of failure to apply for permission for shares and debentures to be dealt in on any recognised stock exchange.

iv) The statutory declaration by the Secretary or one of the directors that the above requirements have been complied with.

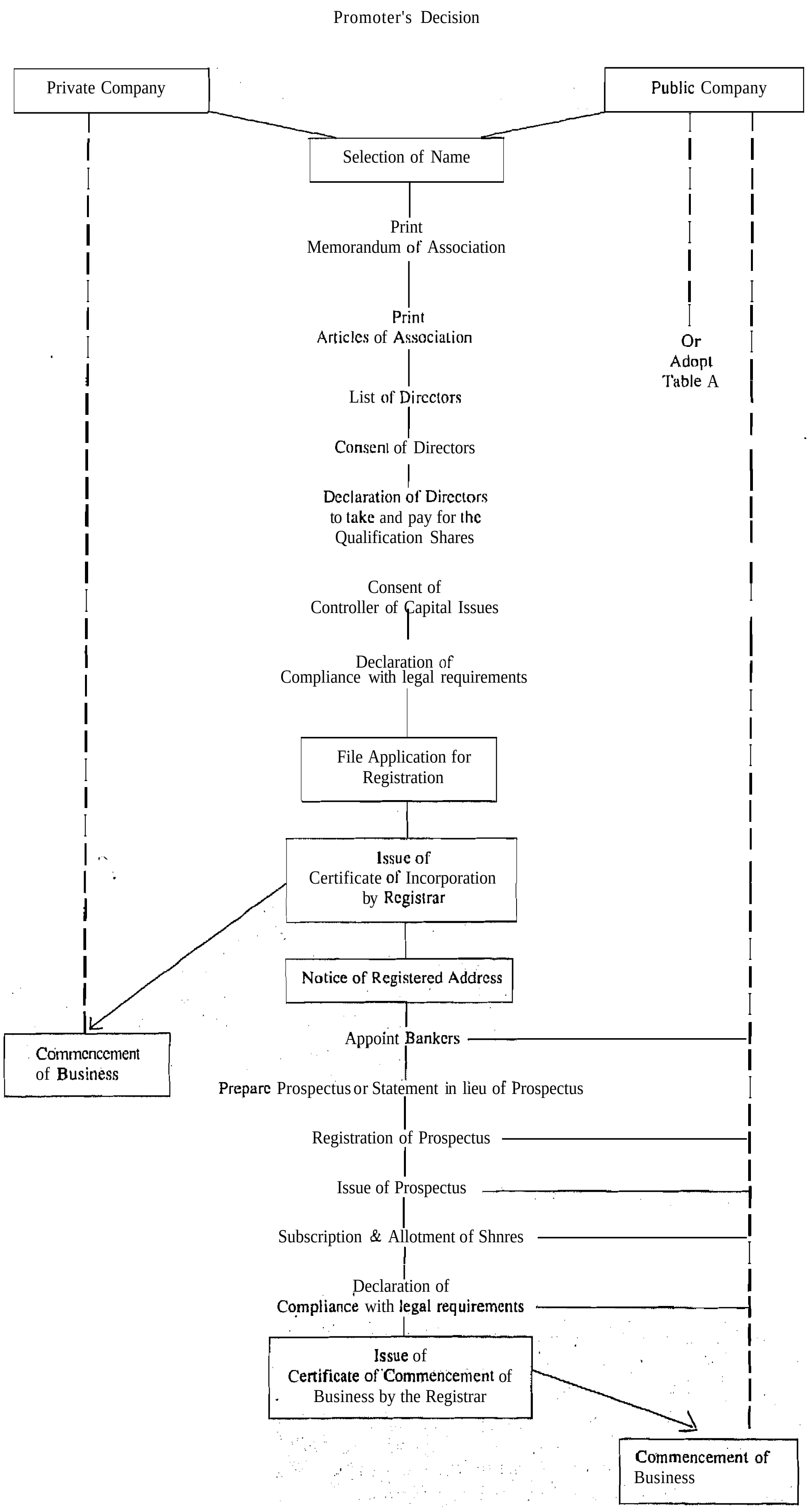
A company which has not issued a prospectus can submit the declaration immediately after the statement in lieu of prospectus has been filed and other conditions have been fulfilled. A private limited company is not required to submit any declaration, as it is permitted to commence business, immediately after incorporation of the company.

The Registrar of companies will scrutinise all these documents and if satisfied, he shall issue a 'Certificate of Commencement of Business'. After this, the company is entitled to commence business and borrow money from the date of issue of the certificate.

Look at Figure 4.1. It gives a bird's eye view of the procedure involved in the formation of private and public limited companies.

Figure 4.1

Stages in **Company** Promotion


Promoter's Decision
Private Company
Public Company
Selection of Name
Print
Memorandum of Association
Print
Articles of Association
Or
Adopt
Table A
List of Directors
Consent of Directors
Declaration of Directors
to take and pay for the
Qualification Shares
Consent of
Controller of Capital Issues
Declaration of
Compliance with legal requirements
File Application for
Registration
Issue of
Certificate of Incorporation
by Registrar
Notice of Registered Address
Commencement
of Business
Appoint Bankers
Prepare Prospectus or Statement in lieu of Prospectus
Registration of Prospectus
Issue of Prospectus
Subscription & Allotment of Shnres
Declaration of
Compliance with legal requirements
Issue of
Certificate of Commencement of
Business by the Registrar
Commencement of
Business

Check Your Progress C

1 Answer the following by putting 'Yes' or 'No' against each question.

i) Does a partnership firm have legal existence apart from its partners? ....

ii) Is registration of firm compulsory? ....

iii) Is any legal formality required to launch a sole proprietory concern? ....

iv) Is it necessary for every public company to prepare its own Articles of Association? ....

v) Can a private limited company commence business after receiving Certificate of Incorporation? ....

vi) Is it necessary for every public limited company to issue a prospectus? ....

2 Fill in the blanks.

i) One or more persons who undertake to bring a company into existence are known as ....

ii) The official appointed by the Government for the registration of companies is known as..........

iii) The Memorandum of Association should mention the .... where the registered office of the company is to be located.

iv) At least.......... persons must subscribe to the Memorandum of Association of a public limited company.

v) The Articles of Association are the rules and regulations for.......... of the company.

vi) The name of a public limited company should end with the word ....

3 List the documents to be filled for registration of a company.

....

....

....

....

4. State whether the following statements are 'True' or 'False'.

i) Prospectus is a document containing an invitation to public to subscribe to the shares or debentures of a company. □ True □ False

ii) It is compulsory for every public limited company to issue a prospectus.
□ True □ False

iii) Prospectus can be issued to the public only after it has been registered.
□ True □ False

iv) The contents of the statement in lieu of prospectus are virtually the same as those of prospectus. □ True □ False

v) If minimum subscription is not received, all application money has to be refunded.
□ True □ False

4.4.4 Cooperative Society

We have so far discussed the promotion of business organisations of three types: proprietory concerns, partnership firms and companies, There is another form of organisation which is quite common these days, i.e. cooperative society. A cooperative society is a form of organisation wherein persons voluntarily associate together on the basis of equality, They pool their resources and work together. They undertake production or distribution of goods and services with the motive of mutual benefit rather than profit.

You know that at least ten persons are required to form a cooperative society. Every cooperative society must register itself with the Registrar of Cooperative Societies, appointed by the Government under the Cooperative Societies Act. The promoters of a Cooperative Society have to take the following steps to get it registered :

I Make an application to the Registrar of Cooperative Societies stating in it the name of the proposed society, its objects, and particulars about its share capital.

2 Prepare the Bye-laws (rules and regulations) of the Society (similar to the Articles of Association of a Company) to be submitted along with the application for registration of the society.

3 The application and the Bye-laws have to be signed by the promoters.

The Registrar scrutinises the objects and bye-laws and, if he is satisfied, issues a 'Certificate of Registration'. The name of the society is entered in the Register of Cooperatives. Thereafter, the society becomes a separate legal entity just like a company. It can acquire assets in its own name, enrol new members, and engage in its business activities.

Thus, the promotion of a cooperative society does not require many legal formalities to be complied with. The promoters can set up a cooperative society with 'Limited' liability of its members. But it can be registered only if its object is to serve the economic interest of its members through mutual help. There is no maximum limit fixed as regards the number of members for the cooperative society. Its shares are not transferable. Since, the policy of Government is to encourage development of cooperative organisations, certain concessions are given to cooperative societies, such as exemption from registration fee and stamp duty, income tax, etc.

4.5 LET US SUM UP

Entrepreneur is a person who undertakes the risk of starting and managing a business by bringing together necessary resources. He conceives the idea of starting an enterprise and explores the prospects of starting a new enterprise. He arranges everything required to set up a business unit i.e., funds, land, people, machinery. The entrepreneur retains strong values of independence and is motivated to work harder than the most people. He is not afraid of future uncertainties. He is always optimistic in outlook and dynamic in taking decisions. He always tries to introduce something different from others in his venture. Innovation and risk-bearing are the two basic elements of entrepreneurship.

Promoters can be divided into professional promoters, financial promoters, entrepreneurial promoters, institutional promoters and Government. Entrepreneur decides the form of business ownership and takes necessary steps in launching the enterprise.

The formalities required to start an enterprise are different for different organisations. The promotion of a sole trading concern does not involve many legal formalities. The same thing is true of a partnership firm. The registration of firm is not compulsory but it is considered desirable because otherwise it suffers from certain disabilities.

Promotion of a joint-stock company involves a number of legal formalities. It must be registered with the Registrar of Companies. After selecting a name for the proposed company and getting it approved by the Government, the promoter has to arrange the preparation and printing of the Memorandum of Association and Articles of Association for the company. Then he files an application submitting these two documents, a list and the consent of directors and a statutory declaration to the effect that all formalities have complied with. He also pays the registration fee. If everything is in order, the Registrar issues a Certificate of Incorporation. A private limited company can commence business as soon as it receives this certificate. But a public limited company cannot start its business until it gets the Certificate of Commencement of Business. For this again the company has to comply with a number of formalities including issue of prospectus, raising the capital, submitting returns of allotment and a statutory declaration that all conditions have been duly satisfied.

A cooperative society is also a corporate body and involves certain legal formalities before it is registered by the Registrar of Cooperative Societies. But as compared with a company the procedure for its registration is much simpler.

4.6 KEY WORDS

Articles of Association: A set of rules and regulations for internal management of the company.

Certificate of Incorporation: Certificate issued by the Registrar of Companies showing that the company has been duly registered. The date mentioned in the certificate will be taken as the date of birth of the company.

Entrepreneur: One who takes the risk of starting and managing business.

Entrepreneurship: The process of giving birth to a new business enterprise.

Innovation: Doing something different or introducing something new from others in the business.

Memorandum **of** Association: A document defining its constitution and objects. It lays down the fundamental conditions upon which the company is allowed to be formed.

Promoter: One who undertakes to form a company with reference to a given project and to get it going, takes the necessary steps to accomplish that purpose.

Promotion: Discovery of business opportunities and subsequent organisation of funds, property and managerial ability into a business concern for the purpose of making profits therefrom.

Prospectus: An invitation issued to the public to subscribe to shares or debentures of the company giving full information about the company.

Statement **in** lieu of **Prospectus:** A document submitted in place of prospectus if the company decides not to approach the public for raising the capital.

4.7 SOME USEFUL BOOKS

Burch, John G., 1986, *Entrepreneurship,* John Wiley & Sons: New York (Part-111, Chapter 5 and Part V, Chapter 12).

Sharma R.A., 1985, *Entrepreneurial Performance in Indian Industry,* Inter-India Publications: New Delhi. (Chapters 1, 2)

Shukla, M.C., 1983, *Business Organisation and Management,* S. Chand & Company: New Delhi. (Chapters 3-5)

Ghosh, Prasanta K., 1986, *Company Secretarial Practice,* Sultan Chand & Sons: New Delhi. (Chapter 3-5)

Bhushan, Y.K. and G.L. Tayal, 1984, *Business Organisation & Management,* Sultan Chand & Sons: New Delhi. (Chapters 6, 8, 10)

4.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 (i) True (ii) True (iii) True (iv) True (v) False (vi) True (vii) False (viii) False

2 (i) Entrepreneur (ii) Not an entrepreneur (iii) Entrepreneur (iv) Entrepreneur (v) Entrepreneur

B (i) True (ii) False (iii) True (iv) False (v) True (vi) True

C 1 (i) No (ii) No (iii) No (iv) No (v) Yes (vi) No

2 (i) Promoters (ii) Registrar of Companies
(iii) Name of state (iv) Seven (v) Internal Management (vi) Limited

4 (i) True (ii) False (iii) True (iv) True (v) True

4.9 TERMINAL QUESTIONS

I What do you understand by the term 'entrepreneurship'? State the important characteristics of an entrepreneur.

2 Explain 'innovation' and 'risk-bearing' in about 100 words each.

3 Briefly describe the role of an entrepreneur in business promotion. How does an entrepreneur differ from a promoter?

4 a) No legal formality is required to launch a sole proprietory concern. Does it mean that the sole proprietor cannot be compelled to pay his business debts?

b) Registration of firms is not compulsory, but it is considered desirable. Why?

5 List the documents which must be filed for the registration of a company. Explain briefly the importance of Memorandum and Articles of Association.

6 Can a public company commence business immediately after its incorporation? If not, what else has to be done before it can commence business.

7 Write notes on the following :

a) Prospectus

b) Statement in lieu of Prospectus

c) Minimum subscription

d) Registration of a cooperative society

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

UNIT 5 METHODS OF RAISING FINANCE

Structure

5.0 Objectives
5.1 Introduction
5.2 Need for and Importance of Finance
5.3 Types of Financial Needs
5.3.1 Fixed Capital and Working Capital
5.3.2 Long-term Capital and Short-term Capital
5.4 Capital Structure
5.4.1 Ownership Capital
5.4.2 Borrowed Capital
5.4.3 What is Capital Structure'?
5.4.4 Factors Determining the Capital Structure
5.5 Methods of Raising Capital
5.5.1 Issue of Shares
5.5.2 Issue of Debentures
5.5.3 Loans from Financial Institutions
5.5.4 Loans from Commercial Banks
5.5.5 Public Deposits
5.5.6 Retention of Profits
5.5.7 Trade Credit
5.5.8 Factoring
5.5.9 Discounting Bills of Exchange
5.5.10 Bank Overdraft and Cash Credit
5.6 Let Us Sum Up
5.7 Key Words
5.8 Some Useful Books
5.9 Answers to Check Your Progress
5.10 Terminal Questions

5.0 'OBJECTIVES

After going through this unit, you will be able to:

- explain the need for finance
- classify types of financial needs
- distinguish between ownership capital and borrowed capital
- explain the concept of capital structure and identify the factors determining it
- describe different methods of raising finance
- evaluate the advantages and limitations of different methods of raising finance

5.1 INTRODUCTION

In Unit 4 you have learnt about various steps taken by promoters before setting up any business venture. One of the important steps is of arrangement of finance for the business. No one can start a business unless adequate capital is available. In this unit you will learn why finance is needed, what the sources of finance are and the methods of raising finance to meet capital requirements of the business.

5.2 NEED FOR AND IMPORTANCE OF FINANCE

We all know that every business activity requires money to run it. Take the case of manufacturers. They must have a place to produce goods. They must buy machinery and raw materials, engage workers and managers, pay for electricity and water supply, and incur expenses for delivery of goods to their customers. Similarly, take the case of traders. They must buy goods and have godown to keep them. They have to arrange for the delivery of the goods to their customers. They must employ people for loading and unloading of goods, for keeping accounts as well as for bill collection. Take another example of goods transportation business, The transporters

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must buy trucks, must engage drivers and helpers, incur expenses on diesel, repairs and servicing of the vehicle, and so on. All these can be undertaken only with the help of finance. Thus, money is required for all types of business activities be it manufacturing or trading or transportation or any other kind. It is true that income is earned by business when goods are sold and services have been rendered. But this takes place afterwards. Goods must be produced or purchased before they can be sold. Arrangement of finance is therefore necessary much before any income can be earned. It costs money to build a factory, to buy machinery and raw materials, to hire a place for the business office, to pay rent, wages and salaries, and to meet to day expenses. So no one can run a business without first raising adequate finance, of course this is done in anticipation of future income, on the assumption that customers will buy the goods and services offered to them.

To run a business, besides finance, we also require men, materials, machinery and management. But finance may be regarded as the most important requirements of business. Men, materials, machinery and managers can be brought together and engaged in business when you have adequate finance. Many business firms are known to have failed mainly due to shortage of finance. The importance of finance has increased in modern times for two reasons. Firstly, the business activities are now undertaken on a much larger scale than in the past. Even if a business is started initially on a small scale, it grows in course of time. There is increasing need for finance with enlargement of business. Secondly, the manufacturing process have become more complex than in the past. Factory production requires expensive machinery, equipment and tools, and many men. It requires large quantities of materials to be procured and kept in stock. The products must be widely advertised. Distribution of the products must be arranged through wholesalers, dealers and salesmen. Thus, with the growth in size and volume of business and with the increasing complexity of production and trade, there is a growing need for finance. In an existing business on the one hand, money must be spent before money is realised from sales. On the other hand, cash realisation on account of sales over a certain period may not be equal to the amount of expenditure incurred during the same period. Finance should, therefore, be available in adequate amount as and when needed. To anticipate what amount of finance will have to be arranged at what point of time is not an easy task. This is because business conditions may change from time to time.

5.3 TYPES OF FINANCIAL NEEDS

Broadly speaking, there are two ways of classifying the financial needs of the business. i) On the basis of the extent of permanence, we can classify the financial needs into: a) fixed capital, and b) working capital. ii) On the basis of the period of use, we can classify the financial needs into: a) long-term capital, and b) short-term capital. Look at Figure 5.1 for the classification of financial needs.

5.3.1 Fixed Capital and Working Capital

Fixed Capital: In every business concern money has to be invested in some fixed or durable assets Iike land, buildings, machinery, equipment, furniture, etc. These assets are required for permanent use, that is, for a long period of time. Funds required to purchase these assets is known as fixed capital or long-term capital.The nature and size of the business generally determines the amount of fixed capital needed. Manufacturing activities, particularly those engaged in heavy engineering, electrical, transport, shipping and ship building, electric supply, iron and steel manufacture, automobiles, etc. require large investments in plant and machinery, equipment, factory buildings, warehouses, etc. On the other hand, trading concerns need relatively lesser investment in fixed assets.

Investment in fixed assets involves a commitment for a longer period of time. These fixed assets continue to generate income and profits over an extended period of time. Moreover, funds which are once invested in fixed assets cannot be withdrawn and put to some other use.

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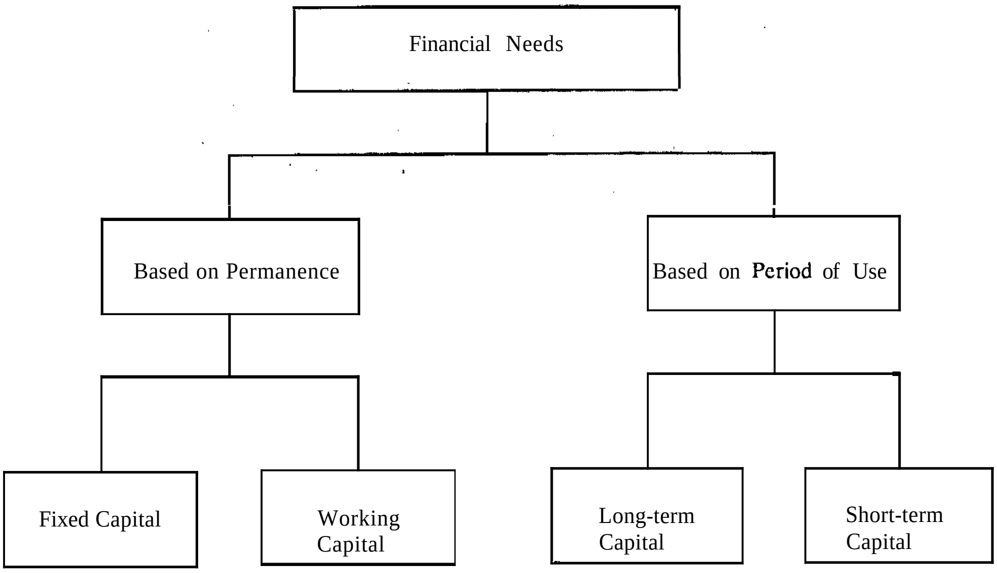
Figure 5.1
Classification of Financial Needs



Working Capital: In business you require finance for purchase of raw material, payment of wages and salaries, rent, fuel, electricity and water, repairs and maintenance of machinery, advertising, etc. Requirements of finance for these purposes arise at short intervals. In course of business activities, it is also necessary to hold stocks of materials, spare parts, and finished goods. This involves investment in short-term assets or current assets in the form of stocks of raw materials, spare parts, stores, finished goods, etc. Besides, sale of goods on credit leads to the holding of debtors balances and bills receivable, which may also be regarded as current assets.

Money invested in current assets like stock of raw materials, finished goods, etc., and book debts (that is debtors balances as well as bills receivable) is known as Working Capital. It is sometimes known as Circulating Capital or Revolving Capital. That is because funds invested in current assets are continuously recovered through realisation of cash, and again reinvested in current assets. The amount keeps on circulating or revolving from cash to current assets and back again to cash. Although this takes place at short intervals, the amount is needed again and again. Hence part of the funds required for this purpose is of a permanent nature. It is known as the 'fixed or permanent' part of the working capital, The permanent part of working capital should accordingly be regarded as long term capital. The other part of working capital may vary due to the rise or fall in the volume of business. Hence it is known as the 'fluctuating' or 'variable' part of the working capital. Therefore, strictly speaking, only the fluctuating part of the working capital is regarded as short-term capital, the funds required are for less than a year. The amount of working capital required depends mainly on the nature of the business, the time rcquircd for completing the manufacturing process, and the terms on which materials are purchased and goods are sold. For instance, trading companies require more working capital than manufacturing companies. This is because the trading business requires large quantities of goods to be held in stock, and also carry large debtors' balances. Construction companies also require relatively larger amounts of working capital than manufacturing concerns. In both these types of business, the value of current assets is about 80% to 90% of the value of total assets. The investment in current assets is relatively smaller in the case of hotels and restaurants because they mostly have cash sales, and only small amounts of debtors balances.

Working capital requirements vary among manufacturing industries because of differences in the time involved in the production process i.e., time that passes 'between the purchase of raw materials and the production of finished goods. Longer' the processing time, the more is the amount of working capital required. For example, heavy engineering industry needs relatively more working capital than a rice mill or a cotton spinning mill or a steel rolling mill.

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Another factor that determines the amount of working capital relates to the terms of credit allowed to customers. For instance, a company may allow only 15 days' credit, while another may allow 90 days' credit. One may extend credit facilities liberally to all customers, while another in the same business may grant credit only to selected reliable customers. The amount of working capital required will 'naturally be more if the credit period is longer and credit facilities are extended to all customers. In both these cases, there will be larger debtors' balance which will demand more working capital. On the other hand, if supplies of materials are available on favourable terms of credit (i.e., payments can be made at longer intervals), working capital needs will be correspondingly smaller.

5.3.2 Long-term Capital and Short-term Capital

As stated earlier fixed assets should be financed with permanent long-term capital. This is mainly because fixed assets are meant for use over a fairly long period of time, generally for five years or more. Long term capital is also required to finance the permanent part of the working capital. On the other hand, to finance current assets and meeting day-to-day expenses, capital is needed generally for a short period i.e., less than a year. This is because stocks of materials and finished goods are normally used for as sold within a year, and dues from customers are usually realised within three to six months. The main difference between long-term capital and short-term capital is that the former is required for a longer pesiod, (five years or more) while the latter is required for a short period (less than a year). Besides these capital needs, business concerns often require funds for a period of 2 to 5 years known as **medium-term capital.** Medium-term capital is required for certain activities like renovation of building, modernisation of machinery, heavy expenditure on advertising, etc.

5.4 CAPITAL STRUCTURE

The funds raised to meet both the long-term and short-term capital requirements may take the form of ownership capital or borrowed capital. Let us first understand these two terms before we talk of capital structure.

5.4.1 Ownership Capital

The amount of capital invested in a business by its owners is known as Ownership **Capital.** It is on the basis of their investment that owners become entitled to the profits of the business. In a business under sole proprietorship, the individual owner normally invests capital from his own savings. In a partnership business, each partner contributes capital as mutually agreed among partners. Companies raise capital by issuing shares. Investors who contribute towards the share capital of a company become its owners by virtue of their share holding. They are entitled to receive dividend out of the profits earned by the company. The owners cannot claim to get any return on their investment unless there is profit. The rate of return on owners investment depends on the level of profits earned. If there is no profit, the owners go without any dividend. The risk of losses and of low rates of return are, thus, associated with ownership capital. Hence it is known as 'risk capital'.

Ownership capital may be used for financing fixed assets as well'as continuous investment in current assets. Ownership capital is generally used as permanent capital or long-term capital. As risk-bearers, owners do not have any assurance whether they will get adequate returns on their investment or not. But they receive high returns if the business is successful. Besides, owners have a right to participate in the management of the business. **A** sole proprietor as also the partners of a business play an active part in running the business. Shareholders of companies do not manage the business directly. They elect members of the Board of Directors who manage the affairs of the company on behalf of the shareholders.

5.4.2 Borrowed Capital

The financial requirements of the business are often met by raising loans. Loans

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carry a certain fixed rate of interest which must be paid at regular intervals, half-yearly or yearly. There is also a commitment that the principal'amount will be repaid in due course. Thus, if loan is raised for a period of 10, 15 or 20 years, its repayment may fall due at the end of that period or after stated intervals according to the tams on which the loan has been raised. Interest on loan is a fixed expense which has to be paid irrespective of the income. Thus, borrowing of money involves fixed obligation to pay interest and repay the principal amount as and when due.

Money may be borrowed for short-term and long-term purposes i.e., to finance fixed assets as well as current assets. In a sole proprietory business the proprietor can borrow money on his persona! security or on the security of his existing assets. A partnership firm can raise loans on the personal security of the individual partners whereby they become jointly and severally liable. Companies can also borrow either by issuing debentures or bonds, or raise direct loans.

If business income is stable and cash is realised from debtors regularly, raising of loan is not difficult. But if conditions are such that payment of interest is not possible as and when due, serious consequences may follow. There is loss of credit worthiness, that is, suppliers may not be prepared any more to supply materials on credit, further loans may not be forthcoming and lender's and creditors may even start legal action to recover their dues. Hence, borrowing money without the ability to meet the obligations of paying interest and repaying the principal is not desirable.

However, there are certain advantages of financing business activities with loans. If the business is profitable, interest being a fixed charge, the return on owners' investment is much higher. Suppose total investment in a business is Rs. 1 lakh out of which owners have contributed Rs. 40,000 and loans have been raised for the balance of Rs. 60,000 at 15% interest per annum. The profit earned during the year is Rs. 30,000. In this case, the total amount of interest payable is Rs. 9,000. So profits after interest payment will amount to Rs. 21,000. Let us assume that tax is payable on profits at the rate of 50%. So, tax to be paid amount to Rs. 10,500. Net .profit after tax will thus be Rs. 10,500. What will be the return on owner's capital? It will be Rs. 10,500 on their investment of Rs. 40,000 that is, 26.25%. Would it be so high if the owners had invested Rs. 1 lakh and there was no borrowings? Obviously not. Let us examine. Since no interest would be payable, tax would amount to Rs. 15,900 (50% of Rs. 30,000). The net profit after tax would amount to Rs. 15,000 (total profit of Rs. 30,000 minus Rs. 15,000 tax). The return on owners' capital would then be Rs. 15,000 on an investment of Rs. 1 lakh which works out to only 15%. You must have realised that owners got a higher rate of return when a part of the total investment was borrowed. If you examine all this carefully, you can notice two effects. Firstly, the amount of tax payable was less (Rs. 10,500 instead of Rs. 15,000). Secondly, the payment on account of interest was fixed. Although loans helped in the expansion of business, nothing more was to be paid to lenders. The remaining profit was entirely for the owners. Use of borrowed capital to derive the benefit of higher rates of return on owners' investment is known as 'Trading on Equity'.

5.4.3 What is Capital Structure?

You have noticed that borrowing is desirable when profits are high. But it may be dangerous to depend on loans when profits decline. Then what should be the amount of borrowing for financing business activities? The general principle is to maintain borrowed capital and owners' capital in proper proportions. For a very successful business in favourable conditions, borrowed capital may be twice or even thrice as large as owners' investment. But for a business which is suffering from declining profits, the proportion of borrowed capital should be as low as possible.

Since borrowing of funds has distinct advantages, you may expect promoters to raise as large an amount as possible through loans. But beyond a certain limit borrowing may be risky. This is because fluctuation in earning and inadequacy of available cash could lead to a situation where it may not be possible for the business to pay interest and repay the amount of loan. In that case, the financial position of the business is sure to be looked upon by suppliers and creditors as unreliable. They may stop extending credit, and in an extreme situation, the business may go bankrupt or insolvent. This danger arises basically on account of the fixed payments to be made

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on borrowed,capital irrespective of the earnings and the shortage of available cash.

The proportion of fixed interest bearing capital in the total capital is known as capital gearing. The capital is, thus, said to be highly geared if borrowed capital is proportionately very high in relation to the ownership capital. Correspondingly, low gearing of capital signifies a smaller proportion of borrowed capital compared with the ownership capital. The composition of the total capital consisting partly of long-term funds with fixed charge and partly of ownership funds is known as the capital structure. Thus, capital structure refers to the relative proportion in which various sources of long-term finance are used to meet the total financial requirements, like debentures and long-term loans, preference share capital, and equity capital (including reserves and surplus).

5.4.4 Factors Determining The Capital Structure

To what extent long-term funds should be raised from different sources so. as to determine the capital structure depends on a variety of factors. Let us now discuss about such factors.

1 Nature of the business: If a company is engaged in business activities in which sales are subject to wide fluctuations, it is desirable to have a smaller proportion of borrowed funds. Companies manufacturing televisions, refrigerators, machine tools and capital goods are normally subject to fluctuations in sales from time to time. If these companies have high debt ratios, they run the risk of facing financial distress during lean business due to their inability to discharge the fixed obligations. On the other hand, companies dealing in essential consumer goods of daily use dr products having inelastic demand generally have stable earnings, and thus may depend to a greater extent on borrowed capital.

Competitiveness among companies is also another aspect of business which may affect the level of earnings. For instance in the ready-made garment industry, competition among the firms is based on styles which are subject to frequent changes and mostly unpredictable. Hence, these firms rely less on borrowed capital and more on equity finance.

2 Characteristics of the company: The size of a company as well as its credit standing also determines the extent to which equity or debt capital should be raised. Small firms have to depend more on owners' funds as it is difficult for them to raise long-term loans. This is because investors consider lending to small firms to be more risky. In contrast, large companies must make use of different sources of raising funds as no single source can meet their total financial requirements. Normally investors prefer to lend money to large companies as they believe that their money is safe and the risk is less with big business firms. Similarly, firms which enjoy high credit standing among investors and lenders are in a better position to raise long-term finance from different sources.

3 Management control: Promoters who had major share holding and control the management of the company take into account the probable effect of raising funds through the issue of equity shares. Equity shareholders having voting rights can influence the policy decisions of the company or the selection of directors. But the persons whd give loans do not have any right to elect directors or to participate in the management of the company. Hence the existing management group, in order to retain their control over management, prefer to raise additional finance through the issue of debentures and preference shares.

4 Cost **of finance:** Since interest paid on borrowings is chargeable to profits before tax calculation, the cost of debt financing is inevitably lower than the expected rate of earnings (i.e. profitability) on equity capital. Hence, it is always beneficial to raise part of the total financial requirement through long-term loans. With lower cost of debt financing, the overall (average) cost of financing is reduced, and the return on equity capital is higher. This is one of the important determinants of the capital structure.

5 **Effect** of debt financing on the earnings per equity **share:** We have already explained how the rate of return on equity share capital increases if borrowed

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capital is used. The effect of debt on the rate of return on equity (or earning per share) is known as 'trading on equity' or 'leverage effect', Thus in business ventures with assured prospect of rising income, there is greater emphasis on debt capital in the capital structure.

6 Expected earning in relation to interest charges: Another factor determining debt-equity ratio is the estimated coverage of interest by profits. If the average earnings of the company are expected to be three to four times the amount of interest payable on borrowed capital, it may be considered safe to raise long-term loans rather than equity capital. Three to four times coverage of interest by earnings is regarded as a reasonable assurance that interest payment would be possible even if profits decline substantially.

7 Availability of cash (cash flow): The ability of a business to discharge its fixed obligations depends essentially on the availability of liquid cash. Profits earned may be adequate to cover the fixed charges arising out of debt, but the firm may not have sufficient cash to pay as the income gets continually invested in the form of more inventory, book debts or even purchase of equipment, particularly, if it is a growing concern. Hence, besides profitability, it is necessary to estimate the cash flows before deciding on the proportion of debt in the capital structure.

8 Flexibility of capital structure: The capital structure decision is usually made by management keeping in view their ability to adjust the sources of funds. The scope of changing the capital structure in future happens to be a basic consideration. For instance, in case additional funds are needed, a firm which is already financed with heavy debt may be forced to issue equity shares with a higher cost of finance involved. Or, again if funds raised are to be refunded on account of declining business, a firm may be unable to do so if it earlier relied heavily on equity capital. Indeed, to preserve operating flexibility, it is desirable that every firm should have unused debt raising capacity for future use. On the other hand, there should be a judicious mix of debt and equity capital so that refund of debt is possible when necessary.

The most suitable capital structure known as optimal capital structure is planned taking into account the effect of alternative sources of financing and the mix of debt and equity capital which will maximise the wealth of the firm.

Check Your Progress A

1 State which of the following statements are True or False.

i) There is ,increasing need for finance in business only because workers always demand higher wages.

ii) No one can run a business without finance.

iii) Fixed capital is required to finance the purchase of raw materials.

iv) Relatively more fixed capital is required by manufacturing companies than trading companies.

v) Long-term investment is required for financing fixed assets as well as current assets.

vi) High gearing of capital indicates more of debt financing.

vii) The permanent part of working capital may be regarded as long-term finance.

viii) Working capital is not required by traders who buy and sell goods on credit.

ix) In a profitable business, the return on owners' capital will be more if part of the total is borrowed,

2 Fill in the blanks with appropriate words,

i) Ownership capital is also known as .... capital.

ii) .... capital is sometimes called revolving or circulating capital.

iii) Funds required for 5 years or more is regarded as .... finance.

iv) Short-term finance is required for a period upto .... years.

v) Medium-term finance is required for a period of .... years.

vi) Trading companies need more working capital than ....,. capital.

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vii) Investment in current assets generally means .... investment.

viii) Loans may be raised for long-term as well as .... purposes.

3 Match the items in Column A with those in Column B.

Column **A**	Column B
1) Fixed capital	i) Current assets
2) Long-term finance	ii) Short-term finance
3) Medium-term finance	iii) Risk capital
4) Capital structure	iv) Durable assets
5) Working capital	v) More than 5 years
6) Ownership capital	vi) Modernisation of machinery
7) Bills receivable	vii) Borrowed capital and equity capital

5.5 METHODS OF RAISING CAPITAL

You have learnt that there are different purposes for which funds have to be raised for periods ranging from very short to fairly long duration. The size and nature **of** business determine the total amount of financial needs. The scope of raising funds depends on the sources from which funds may be available. For a sole proprietor, there are limited opportunities for raising funds. He can finance his business by any of the following means:

1 Investment of own savings

2 Raising loans from friends and relatives

3 Arranging advances from commercial banks

4 Borrowing from finance companies

The same methods of financing are available to partnership firms also. In both these forms of business organisations, long-term capital is generally provided by the owners, i.e., sole proprietor or the partners.

Fixed capital can be raised by way of loans from friends and relatives on the personal security of owners. Generally short-term working capital needs are met partly by trade creditors (suppliers of materials and goods) and loans from finance companies. Another method of securing both long and short-term finance is the reinvestment of profits earned from time to time.

In the case of companies, there are a number of methods of raising finance. To raise long-term and medium-term capital, companies have the following options:

1 Issue of shares

2 Issue of debentures

3 Loans from financial institutions

4 Loans from commercial banks

5 Public deposits

6 Retention of profits

The following methods may be used to finance short-term capital:

I Trade credit

2 Factoring

3 Discounting bills of exchange

4 Bank overdraft and cash credit

5 Public deposits

Look at Figure 5.2 for various methods adopted by companies for raising finance.

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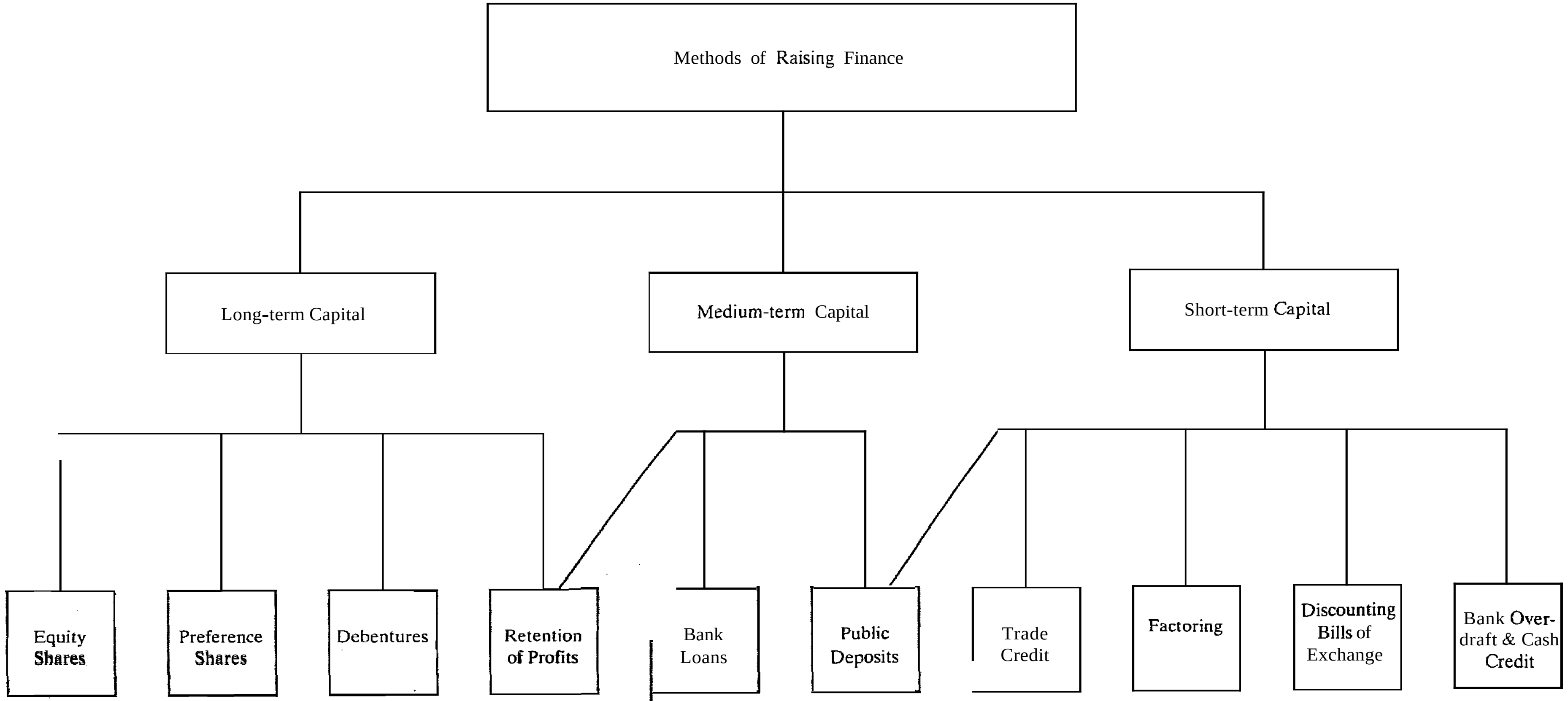
Figure 5.2 Methods of Raising Finance by Companies


Methods of Raising Finance
Long-term Capital
Medium-term Capital
Short-term Capital
Equity Shares
Preference Shares
Debentures
Retention of Profits
Bank Loans
Public Deposits
Trade Credit
Factoring
Discounting Bills of Exchange
Bank Over-draft & Cash Credit

Note: 1. Public deposits could be used for both medium-term as well as short-term purposes.
2. Retention of profits could be used for both Long-term as well as short-term capital purposes.

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5.5.1 Issue of Shares

Issue of shares is the most important method of raising long-term capital for companies. There are two types of shares: i) equity shares and ii) preference shares. In the case of shares, the liability of shareholders is limited to the face value of shares, and also they are easily transferable. For these reasons investors prefer to invest their money in shares. Moreover, shares issued are generally of small face value viz., Rs. 10 or Rs. 100. So investment in shares is within the means of ordinary people. As you know, a private company cannot invite the general public to subscribe for its share capital. Private companies can issue shares to a limited number of persons not exceeding fifty. Also shares of private companies are not freely transferable. But for public limited companies there are no such restrictions.

Equity shares: There are several advantages of issuing equity shares to raise ownership capital. The rate of dividend on these shares depends on profits available and the discretion of directors. There is, therefore, no fixed burden on the company. The shareholders expect high rates of dividend in profitable years. But they also bear the risk associated with uncertainty of earnings of the company. Thus, risk capital is available by issuing these shares. Further, the amount raised by issue of equity shares can be used permanently. It is not required to be paid back so long as the company exists. Moreover, equity shares do not require mortgaging of the company's assets. Additional funds can be raised as loan on the security of assets.

However, excessive issue of equity shares may create problems for the promoters who may like to control the management of the company. Each equity share carries one vote for the holder. So holders of equity shares may form groups and vote against the existing directors of the company. This may not be always in the best interest of the company as a whole. Secondly exclusive dependence on equity share capital may not permit the company to take advantage of trading on equity. Besides, once equity shares are issued the amount become a permanent capital which at times may be more than what the company can use profitably. In that case, there is no way of reducing it unless detailed legal formalities are complied with. Also reduction of share capital damages the image of the company.

Preference shares: Issue of preference shares is another method of raising long-term capital. It has certain merits. Dividend is payable on preference shares at a fixed rate and is payable only if there are profits. Hence, there is no compulsory burden on the company's finances. Secondly, preference shareholders do not have voting right. So they cannot take part in the management of the company and thus are not a threat' to the promotkrs. Another advantage of preference shares is that the company can declare higher rates of dividend for equity shareholders in good years because the rate of preference dividend is fixed. Besides, permanent use of preference share capital is also not essential. **A** company may issue redeemable preference shares and have the flexibility of paying off the amount if necessary and replace it by some other type of capital.

Some investors subscribe to preference shares because of preferential rights as to the payment of dividend'and the return of capital. But others do not prefer it due to the fixed return as well as some risk of non-payment of dividend. Also they do not derive any benefit by way of rise in market price of the shares as is the case with equity shares.

5.5.2 Issue of Debentures

Companies generally have powers to borrow and raise loans by issuing debentures as securities of specified face value. The rate of interest payable on debentures is fixed at the time of issue, and they are recovered by a charge on the property or assets of the company, which provide the necessary security for payment. Debentures are mostly issued to finance the long-term requirements of business. There are certain advantages of issuing debentures.

i) Because of the fixed interest on debentures, companies with stable income can secure higher returns on equity capital by trading on equity.

ii) The rate of interest is usually lower than the expected rate of return on share capital. This is because debenture holders do not bear any risk.

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iii) Debentures do not carry any voting right. Hence management by promoters or existing directors remains unaffected.

However, if the earnings of the company are uncertain or unpredictable, issue of debentures may pose serious problems for the company due to the fixed obligation to pay interest and repay the principal. The company is liable to pay interest even if there is no profit. If there is default in payment of interest or repayment of the principal, assets can be attached by order of the court. Trading companies which generally do not have large fixed assets, cannot provide adequate security for issue of debentures. Even for manufacturing companies the capacity to raise loans is limited by the value of their properties and assets.

5.5.3 Loans from Financial Institutions

Long-term and medium-term loans can be secured by companies from financial institutions like the Industrial Finance Corporatioh of India, Industrial Credit and Investment Corporation, State-level Industrial Development Corporations, etc. You will learn in detail about financial institutions in Unit 6. These financial institutions grant loans for a maximum period of 25 years against approved schemes or projects. Loans agreed to be sanctioned must be covered by securities by way of mortgage of the company's property or hypothecation or assignment of stocks, shares, gold, etc.

Usually the financial institutions nominate one or two directors to have some degree of control over the functioning of the company. These nominee directors may not allow decisions to be made by the Board of Directors affecting the interest of the lending institution. The loan agreement may also provide for conversion of loans into equity capital after a stated period if the lending institution so desires.

The most important advantage of this method of raising finance is that the rate of interest payable is lower than the market rate. But there is a close security of the investment project before loan is sanctioned. Preference is given to companies which submit projects in accordance with the priorities of industrial development laid down in the five year plan. The potential profitability of the project and the potential ability of the company to discharge its interest and repayment obligations are strictly evaluated. Also the companies are required to comply with a number of legal and technical formalities. Hence a long time is taken in the process of negotiating a loan from the financial institutions.

5.5.4 Loans from Commercial Banks

Medium-term loans can be raised by companies from commercial banks against the security of properties and assets. Thus, funds required for modernisation and renovation of assets can be borrowed from banks. Generally 50% to 75% of the value of industrial assets are granted as loan after the bank is satisfied about the earning capacity of the company and its ability to generate sufficient cash flows. The bank does not interfere with the management of the company. Also this method of financing does not require any legal formality except that of creating a mortgage on the assets. Besides, the loan can be repaid in parts and interest saved to that extent. Short-term loans can also be obtained from banks on the personal security of the directors of the company. These are known as **clean advances.**

5.5.5 Public Deposits

Companies often find it convenient and necessary to raise funds by inviting their shareholders, employees and the general public to deposit their savings with the company. The Companies Act permits such deposits to be received for a period up to **3** years at a time. Thus, public deposits can be raised by companies to meet their short-term and medium-term financial needs. It is a simple method of raising finance for which the company has only to advertise in the newspapers giving particulars about its financial position as prescribed by the Companies Act. The deposits are not required to be covered by mortgaging assets or by other securities. Moreover deposits can be invited by offering a higher rate of interest than the interest on bank deposits.

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But companies are not permitted to raise unlimited amounts of fund through public deposits. The aggregate of all outstanding deposits cannot exceed 25% of the paid up capital and free reserves of the company. Interest to be allowed on deposits must also be in accordance with the rate fixed by the Government. Further, it is laid down in the Companies Act that at the beginning of each year, the company must deposit in a bank at least 10% of the deposits maturing during that year, or invest an equivalent amount in Government securities for repayment of deposits. Besides, the company has to file a return or statement every year with the Registrar of Companies giving all information relating to the deposits.

However, small scale industries (i.e. manufacturing companies with investment in plant and machinery not exceeding Rs. 35 lakhs) are exempted from the restrictions as to the maximum limit of deposits if the following conditions are satisfied.

ij The amount of deposit does not exceed Rs. 8 lakhs or the amount of paid up capital whicfiever is less.

ii) The paid up capital does not exceed Rs. 12 lakhs.

iii) The number of depositors is not more than 50%.

iv) There is no invitation to the public for deposits.

5.5.6 Retention of Profits

Profitable companies do not generally distribute the whole amount of profits as dividend. A certain proportion is transferred to reserves and utilised as additional capital. Thus the financial needs of a company can be met by retaining a part of the annual profits. This may be regarded as reinvestment of profits or **'ploughing back of** profits'. Since retained profits actually belong to the shareholders of the company, these are treated as a part of ownership capital, and may be used to meet long, medium and short-term financial needs. The main advantage is that there is no legal formality involved, nor does the company has to depend on external investors to raise capital. Retention of profit is a sort of self financing of business. However, only the on-going profitable companies can make use of this source of finance. For profitable companies transfer upto 10% of current profits is legally permitted. A company may transfer more than 10% of profits to reserves provided it fulfils certain conditions laid down in the rules framed under the Companies Act. In short, more than 10% of current profits can be retained only after declaring a minimum rate of dividend consistent with the dividend distributed in the past.

5.5.7 Trade Credit

Just as companies sell goods on credit, they also buy raw materials, components, stores and spare parts on credit from different suppliers. Hence, outstanding amounts payable to trade creditors as well as bills payable relating to credit purchases are regarded as sources of finance. Generally suppliers grant credit for a period of 3 to 6 months, and thus provi short-term finance to the company. Availability of this type of finance is closely connected with the volume of business. When the production and sale of goods increase, there is automatic increase in the volume of purchases, and more of trade credit is available. On the other hand, if sales decline there-is a corresponding decline in purchases of materials, and consequent decline in trade credit as **a** source of finance. Thus, creditors' balances (accounts payable) and bills payable help companies to finance current assets, i.e., stock of materials and finished goods as well as book debts. However, trade credit also involves loss of cash discount which could be earned if payments were made within 7 to 10 days from the date of purchase. This loss is regarded as the cost of trade credit.

5.5.8 Factoring

The amounts due to a company from customers on account of credit sale generally remain outstanding during the period of credit allowed i.e. till the dues are collected from the debtors. If necessary, book debts may be assigned to a bank and cash realised in advance from the bank. By this arrangement the responsibility of collecting the debtors' balances is taken over by the bank on payment of specified

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charges by the company. This is a method of raising short-term capital and known as **'factoring'.** It helps companies to secure finance against debtors' balances before the debts are due for realisation, and incidentally also helps in saving the effort of collecting the book debts. The bank charges payable for the purpose is treated as the cost of raising funds. Keeping in view the risk of bad debts, the amount to be made available by banks is calculated so as to provide for a margin for non-realisation of debts. The disadvantage of factoring is that customers who are in genuine difficulty do not get the facility of delaying payment which they might have otherwise got from the company.

5.5.9 Discounting Bills of Exchange

This method is widely used by companies for raising short-term finance. When goods are sold on credit, bills of exchange are generally drawn for acceptance by the buyers of goods. The bills so drawn are payable after **3** or 6 months depending on the prevailing practice among traders. Instead of holding the bills till the date of maturity, companies generally prefer to discount them with commercial banks on payment of a charge known as bank discount. Bills are endorsed in favour of the bank so as to enable it to realise the amount of the bill on maturity from concerned parties. The amount of discount is deducted from the value of bills at the time of discounting. The rate of discount to be charged by banks is prescribed by the Reserve Bank of India from lime to time. It really amounts to the interest for the period from the date of discounting to the date of maturity of the bill. If any bill is dishonoured on maturity, the bank returns it to the company which then becomes liable to pay the amount to the bank. The cost of raising finance by this method is the discount charged by the bank.

5.5.10 Bank Overdraft and Cash Credit

Arranging cash credit and overdraft with commercial banks is a common method adopted by companies for meeting short-term financial requirements. Cash credit refers to an arrangement on a continuing basis whereby the commercial bank allows money to be drawn as advance from time to time within a specified limit known as cash credit limit. This facility is granted against the security of goods in stock, or promissory notes bearing a second signature, or other marketable instruments like Government bonds. The company is allowed to draw whatever amount is required at different times within the limit agreed upon. The cash credit limit may bc revised according to the value of securities. The money drawn can be repaid as and when possible. Interest is charged on the actual amount withdrawn.

Overdraft is a temporary arrangement with the bank which permits the company to overdraw from its current deposit account with the bank upto a certain limit. The overdraft facility is also grantecl against securities as in the case of cash credit. Interest is charged only on the amount actually overdrawn.

The rate of interest charged on cash credit and overdraft is relatively much higher than the rate of interest on bank deposits. But this method of financing has the flexibility of allowing funds to be drawn for short-term purposes according to changing needs which depend on business conditions.

Check Your Progress B

1 Six methods of raising finance are mentioned below. Indicate by tick marks the methods which can be used for raising fixed capital.

i) Issue of equity shares
ii) Clean advance from banks
iii) Public deposits
iv) Loans from financial institutions
v) Discounting of bills
vi) Issue of preference shares

2 Which of the following methods can be used by a company for raising short-term finance? Put a tick mark against those methods only.

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i) Issue of debentures

ii) Cash credit

iii) Public deposits

iv) Bank overdraft .

v) Term loans from banks

3 Read the following statements and indicate which of them are True or False.

i) 'Trading on equity' is possible if a company issues preference shares and debentures for raising necessary capital.

ii)' Fixed capital can be raised by issuing preference shares.

iii) Factoring means appointing a bank as collecting agent.

iv) Equity share capital can be used for investment in fixed assets as well as current assets.

v) Bills of exchange can be discounted with a bank on payment of interest in advance.

vi) **Any** amount of public deposits can be raised by a company.

vii) Issue of debentures must be covered by adequate security of assets.

viii) Cash credit is just like clean advance from banks.

ix) Term loans can be raised from commercial banks for long-term purposes.

x) Trade credit helps in financing short-term investments.

4 Fill in the blanks with appropriate words selected from the words given in the brackets.

i) Equity shares are issued for ....(investment in fixed assets, financing operating expenses, modernisation of plants)

ii) Short-term working capital is generally raised from ....(financial institutions, general public, commercial banks)

iii) Cash credit is granted against the security of ....(fixed assets, goods in stock, bank balance)

iv) The cost of trade credit is ....(loss of profit, loss of cash discount, loss of interest)

v) Amount due from customers on account of credit sale requires ....financing. (long-term, medium-term, short-term)

vi) Public deposits can be raised by companies for a maximum period of .... (2 years, 3 years, 4 years)

5.6 LET US SUM UP

Every business firm requires money or finance to run its activities. The importance of finance has increased in modern times for two reasons: (i) business activities are now undertaken on a much larger scale than in the past, and (ii) manufacturing processes have become more complex than before.

Broadly speaking, the financial requirements of a business are of two types: i) fixed capital and ii) working capital. Finance required to purchase fixed assets is known as fixed capital or long-term capital. Finance needed for investment in current assets is known as working capital or circulating capital. The nature of business and size **of** the business unit generally determine that amount of fixed capital needed. On the other hand, the amount of working capital depends upon the nature of business, the time required for completing the manufacturing process, and the terms on which materials are purchased or goods are sold.

Funds raised to meet the financial requirements of a business can be classified as ownership capitaland borrowed capital. The amount of capital invested in a business by its owners (proprietor, partners or shareholders) is known as ownership capital. Borrowed capital may be raised by way of direct loans, or by issue of debentures or bonds in the case of a company. Ownership capital is raised by companies by issuing

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shares. Borrowed capital is often used to derive the benefit of higher rates of return on owners' investment. This is known as 'trading on equity'.

'Capital structure' refers to the relative proportion in which different sources of long-term finance is used to meet the total requirements. The proportion of fixed interest bearing capital in the total capital is known as 'capital gearing'.

The main difference·between long-term finance and short-term finance is that the former is required for use over a longer period, five years or more, while the later is required for a short period of less than a year. Finance required for a period of 2 to 5 years is known as medium-term finance.

Sole proprietorship concerns and partnership firms have limited opportunities of financing their business. They can use one or more of the following methods of raising funds: investment of own savings, raising loans from friends and relatives, advance from commercial banks and borrowings from finance companies, all against personal security or against the security of their own assets and properties.

A company may decide to use one or more of the following methods to meet the needs of long-term and mcdium-term finance: issue of shares, issue of debentures, loans from financial institutions, loans from commercial banks, public deposits and retention of profits.

To raise short-term finance, a company may use trade credits, factoring, discounting bills of exchange, arranging bank overdraft and cash credits, and raising public deposits. Each of these methods have certain advantages as well as disadvantages.

5.7 KEY WORDS

Borrowed Capital: Funds raised by way of loans or issue of debentures, which entitle the investors (i.e. lenders) to claim regular payment of interest and repayment of the loan when due.

Capital Gearing: The proportion of fixed interest-bearing capital in the total capital of a business.

Capital Structure: Proportion in which different sources of long-term finance are used to meet the total funds requirement, like shares, debentures, loans, retained profits, etc.

Factoring: Assignment of book debts to a bank and receiving cash in advance with the responsibility of collecting the debts taken over by the bank on payment of specified charges.

Fixed Capital: Funds required for purchase of fixed assets like land, building, plant and machinery, furniture, etc..

Long-term Finance: Finance required for use over a long period, five years or more, meant for purchase of fixed assets and continuous investment in a part of the current assets.

Mediutn-term Finance: Funds required for use over a period of 2 to 5 years, generally for renovation of building, modernisation of plant and machinery, etc.

Ownership Capital: Funds invested by owners of business for permanent use, which entitle them to decide how the business activities will be managed and what will be their share in the profits.

Public Deposits: Deposits raised from the public for medium or short-term financial needs.

Short-term Finance: Funds required for short periods, less than a year, meant for financing current assets which fluctuate due to changing volume of business.

Trade Credit: Outstanding amounts payable to suppliers of raw materials and consumable items and bills payable relating to credit purchases.

Trading on Equity: Use of borrowed capital to have a higher rate of return on equity capital.

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Working Capital: Funds required for holding current assets like stock of raw materials; finished goods, book debts, bills receivable, etc.

5.8 SOME USEFUL BOOKS

Bhushan, Y.K. 1987. *Fundamentals* of *Business Organisation and Management,* Sultan Chand & Sons: New Delhi. (Part 8, Chapters 1 & 2)

Kuchhal, S.C. *Corporation Finance,* Chaitanya Publishigg House: Allahabad.

Paish, F.W. 1975. *Business Finance,* Pitman: London (Chapters 1-3)

Singh, B.P. and T.N. Chhabra. 1988. *Business Organisation & Management,* Kitab Mahal: Allahabad. (Chapters 16 & 17).

5.9 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) False ii) True iii) False iv) True
v) True vi) True vii) True viii) False
ix) True

2 i) Fixed ii) Working iii) Long-term iv) One
v) 25. vi) Fixed vii) 'short-term viii) Short-term

3 1) iv 2) v 3) vi 4) vii 5) ii 6) iii 7) i

B 1 i, iv, vi

2 ii, iii, iv

3 i) False ii) True iii) False iv) True v) True
vi) False vii) True viii) False ix) False x) True

4 i) investment in fixed assets
ii) commercial banks
iii) goods in stock
iv) loss of cash discount
v) short-term finance
vi) 3 years

5.10 TERMINAL QUESTIONS

1 Discuss briefly the importance of finance in business. Distinguish between fixed capital and working capital.

2 State the purposes for which working capital is required.
Discuss the factors determining working capital needs.

3 What are the advantages of raising capital through borrowings?

4 What is meant by ownership capital? What are its merits and limitations?

5 State the methods of raising fixed capital.

6 What are the methods of raising short-term capital? Discuss.

7 Briefly explain the merits and demerits of issuing debentures. Compare it with equity shares as a method of raising fixed capital.

8 Compare the relative advantages and disadvantages of issuing equity shares and preference shares.

9 What are the advantages of raising finance through public deposits? What are the legal requirements to be fulfilled for raising public deposits?

10 Discuss briefly 'factoring' and 'discounting of bills of exchange' as methods of raising short-term finance.

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11 What do you understand by overdraft and cash credit facilities? Mention the types of securities required for cash credit and overdraft.

12 What is meant by capital structure? What factors should management take into account while deciding on a capital structure?

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

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UNIT 6 SOURCES OF LONG-TERM FINANCE AND UNDERWRITING

Structure

6.0 Objectives
6.1 Introduction
6.2 Nature and Importance of Long-term Finance
6.3 Sources of Long-term Finance
6.3.1 Capital Market
6.3.2 Special Financial institutions
6.3.3 Leasing Companies
6.3.4 Foreign Sources
6.3.5 Retained Profits
6.4 Underwriting
6.5 Let Us Sum Up
6.6 Key Words
6.7 Some Useful Books
6.8 Answers to Check Your Progress
6.9 Terminal Questions

6.0 OBJECTIVES

After going through this Unit you will be able to':

- explain the nature and significance of long-term finance
- identify the various sources of long-term finance
- define underwriting
- explain the importance and limitations of underwriting
- recognise the legal restrictions on underwriting

6.1 INTRODUCTION

In Unit 5 you have learnt about the nature of financial needs of business and various methods of raising finance. You have also noted the distinction between long-term, medium-term and short-term finance. In this unit we shall examine in detail the nature and importance of long-term finance and the sources through which long-term finance may be raised by companies. We shall further discuss what is meant by underwriting, in what way it helps long-term financing, and the role of different agencies which undertake this function.

6.2 NATURE AND IMPORTANCE OF LONG-TERM FINANCE

You know every business unit requires some amount of money for investment in fixed assets besides the money required for day 'to day operations. The types of fixed assets required for business activities depends mainly upon the nature of business. For example, the fixed assets required by manufacturing companies generally include land and buildings, plant and machinery, furniture, etc. A trading company, on the other hand, may require'a godown, office-building, furniture and fixtures, etc. The proportion of capital to be invested in fixed assets is naturally more in the case of manufacturing companies than trading concerns.

Fixed assets are long-lived assets and, therefore, investment can be made only with long-term finance i.e., funds which will not have to be returned within five years. Actually, the useful life of assets like machinery and equipment, furniture and fixtures, etc. maybe 5 to 10 years. It may be as long as 50 years in-the case of steel plant, and more in the case of buildings. Hence, long-term finance is defined as finance required for a period of five years or more. As a result; profits earned on long-term investment in fixed assets invariably extend over a long period in the future. In other words, long-term finance is associated with long-term return on the investment. Since the future is always uncertain, long-term finance must be invested with care and estimation of the future prospects of business. Particularly, investment in plant and machinery requires careful consideration of the possibility of changes in production techniques which may necessitate replacement of the existing plant'. Another implication of long-term investment is that decisions once made cannot be reversed at short intervals. For example, if a company has installed plant and machinery with a production capacity of 10 lakh tonnes of cement per year, it cannot reduce the size of the plant just because there is a decline in the demand for cement. Moreover, it may be economical and profitable to instal plant and machinery with large production capacity involving a correspondingly heavy investment. This is true of certain industries like iron and steel, cement, basic chemicals, engineering goods, etc. Even otherwise, large scale production always leads to lower cost of production per unit.

The importance of long-term finance, therefore, lies in its necessity for investment in fixed assets which is essential particularly for manufacturing activities. At the same time, long-term finance involves long-term commitment of funds which cannot be withdrawn at short notice. And larger the business greater is the need for long-term finance.,

check Your Progress **A**

1. Fill in the blanks.

   i) Long-term finance is required for investment in ....

   ii) The need for long-term finance is relatively more in ,case of .... companies than in .... companies.

   iii) Long-term investment decisions cannot be .... at short notice.

   iv) Funds invested in fixed assets cannot be .... within a short period.

2. Which of the following statements are True and which are False?

   i) Long-term finance isgenerally required for a period of 20 years or more.

   ii) Fixed assets are long-lived assets.

   iii) Plant and machinery once installed must be used continuously till the same are completely worn out.

   iv) Long-term finance is required in all types of business activities — manufacturing, trading as well as transport business.

   v) The amount of long-term investment required depends upon the nature and size of the business-unit.

6.3 SOURCES OF LONG-TERM FINANCE

Funds required for investment in fixed assets'are mainly provided by the promoters in the case of proprietory and partnership business. Friends and relatives of the proprietor or partners may also make long-term investment in the business on the personal security of the promoters. However, if large amounts of funds are required for any business venture, the promoters generally set up a company. This is because in the case of a company, there is greater scope of raising finance from different sources. Generally speaking', long-term finance may be raised by companies from , one or more of the following sources:

1 Capital market which consists of individual investors, financial institutions and investment companies

2 Special financial institutions consisting of development banks and institutional investors

3 Leasing companies

4 Foreign sources

5 Retained profits

Let us examine how long-term finance may be procured from these sources.

6.3.1 Capital Market

The meaning of capital market is not the same as or similar to that of a market place where goods are bought and sold. Capital market actually denotes the arrangements whereby transactions of money capital (not capital goods) are facilitated. In other words, transactions involving procurement of funds and supply of funds which take place among individuals and various organisations may be regarded as the capital market. Thus, the capital market is not located in a particular place. Nor there are fixed categories of investors and dealers in the capital market, that is, those who supply funds and those who procure funds for investment.

You may have heard or read about another type of market in connection with business finance, known as the money market. Money market refers to transactions involving borrowing and lending of money for short periods for which again there is not definite place set aside in a town. Thus, we can say that money market is the market for short-term funds.

Sometimes the term 'money market' is used in a broad sense to include the markets for short-term as well as long-term funds. Strictly speaking, money market refers only to the market for short-term funds. This distinction helps us in understanding the nature of money transactions which take place for financing business activities. But there is a close relation between the capital market and the money market. The same institutions often deal in both the markets. Companies borrow money for capital purposes. Many financial institutions lend money for short periods as also long periods. Apart from having common links, the two markets are mutually interdependent. The relative demand and supply of funds in the two markets are determined by changes in the rates of interest on short-term funds compared to the expected yield on long-term funds. Thus, if there is increase in interest rate in the money market, one expects an increase in demand for funds in the capital market. Or, a rise in the expected yield in the capital market may lead to a rise in demand for funds in the money market.

You have learnt that transactions involving the procurement and supply of long-term funds take place in the capital market. You also know that companies raise funds by issuing shares and debentures of different types. Individuals and institutions which contribute to the share capital of a company become its shareholders. They are also known as members of the company. Share certificates are issued to them by the company bearing the company's seal and indicating the number of shares allotted to the holders of the certificates. Similarly, debentures are issued by companies to raise long-term loans. Debenture bonds are issued to those who subscribe to the loans.

When long-term capital is initially raised by new companies or by existing companies by issuing additional shares or debentures, the transactions are said to have taken place in the market for new capital. Those who deal in newly floated shares or debentures of companies become a part of the capital market known as the market for new capital or **New Issue Market.** 'As you know, shares and debentures issued by public limited companies are freely transferable. Buying and selling of shares and debentures already issued by companies take place in another type of market, known as the **stock exchange,** which is also a part of the capital market. You will learn in detail about stock exchanges in Unit 7.

The New Issue Market for raising capital consists of arrangements which facilitate the procurement of long-term finance by companies issuing shares and debentures. Shares are issued by companies before the commencement of business and, if necessary, subsequently for expansion of business. Before shares are issued, the directors of the company have to decide on the following matters: the amount of capital which is to be raised by issue of shares, the types of shares (preference shares, equity shares, or both) which will be issued, and the time of issuing shares. No company can raise share capital exceeding the amount of authorised capital mentioned in the Memorandum of Association. What part of the authorised capital should'be raised initially or at any other point of time depends upon the purpose for which funds are needed and the alternative sources of raising capital which may be available (like borrowing, for instance). Next, the directors must decide the type or types of shares to be issued. If both equity and preference shares are to be issued, decisions have to be made as to the proportion in which they will be issued, the number and the face value of shares in each category and the rate of dividend on preference shares. The relative attractiveness of equity shares and preference shares is generally taken into account while deciding the above matters. The time of issue is decided by the directors taking into account the likely demand for shares in the capital market, the investors' mood, government policies with regard to money and credit control and taxation, as well as the prevailing business conditions. If it is desired that the shares to be issued should be listed in the stock exchange for official quotation, the directors must fulfil the conditions for that purpose.

Sometimes, the directors of a company along with their friends and relatives agree to take up a certain proportion of the shares. Similarly, the promoters may privately negotiate with Non-Resident Indians (Indians living abroad) and financial institutions to raise a part of the share capital. The arrangement whereby shares are, thus, decided to be allotted is known as private placement of shares. At the same time, the general public may be invited to subscribe to the share capital through advertisement and issue of prospectus. This is known as public issue of shares.

Where a company decides to issue additional shares at any time after two years of its formation or after one year of the first allotment of shares, whichever is earlier, it is required under law that such shares must be first offered to the existing shareholders of the company. If the offer is declined by the existing shareholders, only then the shares can be issued to the public. Such an issue is called **'rights** issue' and these shares are known as 'right shares'.

Besides issuing shares, most companies also raise long-term loans by issuing debentures to the public. **A** public company can simultaneously issue shares and debentures immediately after its incorporation. The company's indebtedness is acknowledged in the debenture bonds issued to the subscribers. The terms and conditions relating to the issue are also specified in the debenture bond. Debentures are usually repayable after a specified period and carry a fixed rate of interest payable at regular intervals. The company creates a mortgage or charge on its assets to secure the issue of debentures. Although debentures are usually repayable after a fixed period, companies may also issue debentures which are convertible into equity shares after a certain period. Such debentures are known as 'convertible debentures'.

The issue of convertible debentures by a company, which has bright prospects, makes it more attractive for investors. The reason is that, investors as debenture holders enjoy a fixed interest income during the initial stage and, later on, as equity shareholders they become entitled to share in the prosperity of the company through high dividend income as well as increase in share prices. However, approval of the Central Government is required where the holders of debentures are given the option to convert or not to convert the debentures into shares. .

Control of **Capital Issues:** 1o ensure that investment made by companies are in accordance with the national development plans, and not used for wasteful . purposes, Government controls the issues of shares and debentures under the Capital Issues (Control) Act, 1947. Let us study the main points in this connection.

I A company making public offer of shares and debentures must obtain the consent of the Controller of Capital Issues if the amount to be raised during a period of 12 months exceeds Rs. one crore. But public limited companies issuing shares (not debentures) are exempt from seeking consent provided the following conditions are Fulfilled:

a) The amount of debt (borrowings) of the company does not exceed twice that of the owners' investment (in the form of share capital and retained profits) i.e. the debt to equity ratio does not exceed 2:1.

b) The amount of equity (owners' investment) is less than three times that of preference share capital i.e. the equity-preference ratio is less than 3:1.

c) The rate of dividend on preference shares and interest on debentures do not exceed the maximum limit fixed from time to time by the Controller.

d) The shares issued to the public are eligible for being officially quoted on a recognised stock exchange.

2 Companies making fresh issue of shares (not debentures) are to file a statement of proposals for capital issue with the Controller at least 30 days before the date of the proposed offer of shares. The companies must also obtain a letter of acknowledgement from the Controller before making the public offer and make a statement to that effect in the prospectus or statement in lieu of prospectus.

3 Loans raised by companies from financial institutions do not require the Controller's approval.

4 Private limited companies are also subject to control over their capital issues if more than 20% of the amount is subscribed by one or more public limited companies, and the amount of capital issue involved exceeds Rs, one crore during a period of 12 months.

5 Companies must seek the consent of the Controller of Capital Issues for issue of debentures to the public.

6 The amount of debenture issue for working capital purposes is not to cxceed 20% of the gross current assets, loans and advances. For long-term investment projects, the amount will he considered on the basis of approval of the scheme of finance by the financial institutions or Government.

7 The debt-equity ratio, including the proposed debenture issue, must not cxceed 2:1. But this requirement may be relaxed in the case of industries like fertilisers, petrochemicals, cement, paper, shipping, etc., which require heavy investments.

8 The debentures shall carry rate of interest not exceeding the rate which may bc prescribed from time to time by the Controller.

Normally debentures shall not be redeemable before the expiry of the period of seven years. A company may have the option of redeeming the debentures from the fifth to the ninth year from the date of issue in such a way that the average period of redemption continues to be seven years. However, investors holding debentures of the face value of Rs. 5,000 or less must be paid in one instalment.

Check Your Progress B

1 Which of the following statements are True and which are False?

i) Companies can raise long-term finance from different sources.

ii) Public limited companies cannot issue shares and debentui es simultaneously.

iii) There is no difference between the money market and capital rnarkct.

iv) The new Issue Market is a part of the capital markct.

v) If additional shares are issued by a company within two years of its formation, the shares must be offered only to the existing shareholders.

vi) All companies offering shares or tlebentures to the public must obtain the consent of the Controller of Capital Issues.

vii) The maximum rate of dividend which may be paid on preference shares is notified from time to time by the Controller.

viii) Debentures are permitted to be issued provided the debt-equity ratio does not exceed 2:1.

2 Fill in the blanks.

i) Loans raised by public limited companies from financial institutions do not require the consent of the ....

ii) .... funds are raised from the money market and .... funds from the capital market.

iii) Debentures are not normally redeemable before the expiry of .... years.

iv) Dehentures which can be exchanged for equity shares after a specified period are known as ....

v) When directors or their relatives and financial institutions agree to subscribe to a part of the share issue before they arc offered to the public, the arrangement is known as .... of shares.

vi) A public company can issue shares and debentures after its ....

3 Match the items in column **A** with those in column B.

Column **A**	Column B
1) New Issue Market	i) Existing shareholders
2) Issue of debentures	ii) 2:1
3) Right shares	iii) Fresh issue of shares and debentures
4) Capital market	iv) 3:1
5) Debt-equity ratio	v) Long-term funds
6) Equity-preference ratio	vi) Mortgage or charge on assets

6.3.2 Special Financial Institutions

After independence a large number of financial institutions have been established in India with the primary objective of providing long-term financial assistance to industrial enterprises. Some of these institutions have been set up on the initiative of the Central Government, while others have been set up in different states on the initiative of the concerned State Governments. Thus there are all-India institutions like Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICT), Industrial Development Bank of India (IDBI), and Industrial Reconstruction Corporation of India (IRCI). They mainly provide long-term finance for large companies. On the other hand, at the state level there are State Financial Corporations (SFCs) and Industrial Development Corporations (SIDCs). These state level institutions mainly provide long-term finance to relatively smaller companies. These institutions (both national level and state level) are known as 'Development Banks' because their main objective is to provide financial assistance to industrial enterprises for investment projects, expansion or modernisation of plants in accordance with the priorities laid down in the Five Year Plans.

Besides the development banks, there are several other institutions known as investment companies or investment trusts which subscribe to the shares and debentures offered to the public by companies. For example, the Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), the Unit Trust of India (UTI), etc., come under this category. A brief account of the functions of some of these institutions is given in a subsequent section.

Now let us discuss about the functions of some of the major development banks and investment companies.

Development Banks

1 Industrial Finance Corporation of India (IFCI): This was set up in 1948 under the Industrial Finance Corporation Act, 1948. Its primary objective is to provide long-term and medium-term finance to large-scale industrial concerns particularly when bank loans were not suitable or funds could not be raised from the capital market by issue of shares. The IFCI deals only with industrial enterprises registered as limited companies or cooperative societies. Non-manufacturing concerns, private limited companies, partnership or sole traders cannot get assistance from this institution. It considers loan applications for amounts in excess of Rs. 30 lakh. It provides financial assistance for long-term investment in new industries or expansion or diversification of existing activities, or moderqisation and renovation of plant and equipment. The IFCI can grant loans or subscribe to debentures issued by companies repayable in not more than 25 years. It can also guarantee loans raised from other sources or debentures issued to the public. Further, companies can secure loans in foreign currency from the IFCI or get such loans guaranteed by the Corporation. IFCI takes up the underwriting of the public issue of shares and debentures by companies. You will learn in detail about 'underwriting' of shares and debentures later in this unit.

2 Industrial Credit and **Investment** Corporation of India **(ICICI):** It was incorporated under the Indian Companies Act in 1955. It provides financial assistance to companies in two ways: i) by providing long-term loans for a period upto 15 years, and ii) by subscribing to the shares and debentures issued by companies. However, proprietory and partnership concerns are also entitled to secure loans

from the ICICI. Loans are granted against proper securities. Like the IFCI, the ICICI also guarantees loans raised by companies from other sources, besides underwriting the issue of shares and debentures by companies. Foreign Currency Loans can also be secured by companies from the ICICI.

3 **Industrial Development Bank of India (IDBI):** This was set up by Government of India in 1964 and is a subsidiary of the Reserve Bank of India. It seeks to cover the gaps left by the various institutions in the field of industrial finance. The IDBI can provide financial assistance to all types of industrial enterprises which are registered under the Companies Act or any other law. There is no restriction on the types of finance and the amount of funds that may bc available from this institution. It has the unique role of not only providing financial assistance directly to industrial units, but also to refinance loans granted by other financial institutions. Further, it is required to coordinatc the functions of all development banks, scheduled commercial banks and state cooperative banks as regards industrial financing. Thus, the functions of thc IDBI include the following:

i) It refinances (a) term-loans to industrial concerns granted by IFCI and other financial institutions repayable between 3 and 25 years; (b) loans repayable between 3 and 10 years given by scheduled banks or state cooperative banks; (c) export credit granted by specified financial institutions maturing between 6 months and 10 years.

ii) It subscribes directly to the issue of shares and debentures made by industrial concerns.

iii) It grants loans and advances to companies repayable between 8 to 10 years.

iv) It guarantees loans raised by industrial concerns from the capital market or scheduled banks.

v) It accepts, discounts and rediscounts commercial bills of exchange and promissory notes of industrial enterprises.

vi) It undertakes underwriting of the public issue of shares and debentures made by companies.

vii) To meet the financial requirements of large enterprises, the IDBI also arranges joint financing by two or more financial institutions, particularly when the amount and the risk involved happen to be too heavy for any single institution to bear alone.

4 **State Financial Corporations (SFCs):** These institutions are set up in different states by the respective state governments under the provisions of the State Financial Corporation Act, 1951. All types of enterprises — proprietory and partnership concerns as well as limited companies — can seek financial assistancc from the SFCs. The primary objective of these corporations is to accelerate the pace of industrial development in their respective states.

SFCs provide finances in the form of long-term loans or advances or through subscription of debenture issues repayable within 20 years. But the maximum amount of loan or advance granted to any single enterprise is not to exceed 10% of the paid up capital of the SFC or Rs. 10 lakhs, whichever is less. Loans raised by industrial concerns from other sources and repayable within 20 years can be guaranteed by the SFCs. SFCs also take up underwriting public issue of shares and debentures made by companies. They cannot directly subscribe to the shares issued by companies. If shares are required to be taken up as a result of the underwriting obligation, the same must be disposed of in the market within 7 years.

Investment Institutions

We have mentioned earlier about another category of institutions known as 'investment corporations' or 'investment trusts' or 'investment companies' which provide long-term finance. These institutions promote the savings habit among individuals and households with an assurance that the amount of savings entrusted to them would be invested in profitable channels and help in earning adequate return for the savers.

Investment Corporations: The most important investment corporations in India are: i) Life Insurance Corporation of India, and ii) General Insurance Corporation of

India. The Life Insurance Corporation of India (LIC) which undertakes life insurance business, guarantees payment of the amount of policy on the death of the insured person or on the expiry of a certain period. The amount of premium received from the policy-holders are invested by the LIC in different types of securities, e.g. Government bonds, shares and debentures of public limited companies, etc. Similarly, the General Insurance Corporation of India (GIC) invests its funds in Government securities, and shares and debentures of companies. As you know, the GIC undertakes general insurance business including fire, marine, accident, burglary and so on. Thus, the LIC and GIC may be regarded as sources of long-term finance for industrial enterprises.

Investment Companies: A number of investment companies registered under the Companies Act have been engaged in financing industrial concerns by subscribing to the shares and debentures of other companies. These investment companies issue their own shares and debentures to individuals, and borrow money from other institutions. The funds so raised are invested in the shares and debentures of other companies. Besides providing long term finance to industrial concerns, the investment companies also underwrite the issue of shares and debentures of other companies. However, financing of industrial companies by the investment companies is regulated by law (the Companies Act). They can invest in the shares of another company upto 10% of the subscribed capital of that other company, and the aggregate of investments made in all other companies should not exceed 30% of the subscribed capital of the investing company. Some of the well-known investment companies in India are: Investment Corporation of India Ltd., Sri Ram Investment Co. Ltd., Eastern Investment Ltd.. Shree Sun Investment and Trading Co. Ltd., Shree Rishav Investment Co. Ltd., etc.

Investment Trusts: Another category of investment institutions which provide long-term finance to companies is investment trusts. Investment trusts specifically refer to those investment companies which are established for the investment of funds obtained from individuals and institutions. The investors receive shares (or units) issued by the investment trusts. These investment trusts are also known as Unit Trusts. The Unit Trust of India (UTI) is the largest organisation of this type in our country. The UTI was set up under the Unit Trust Act of 1962, and started its operation in 1964. Its initial capital was subscribed by the Reserve Bank of India, LIC, State Bank of India and other financial institutions. Let us try to understand the working of the UTI in some more detail.

Briefly speaking, the UTI invests its funds in shares and debentures of different companies. The securities (shares and debentures) are held in trust by the management. Based on the value of the securities, the management offers 'units' to the public. Each unit having a specified face value is a kind of certificate of participation in the 'unit scheme'. Individuals can buy and sell units at any time. The management receives interest and dividend on the debentures and shares held by them. The income so realised is distributed among the unit-holders in proportion to the value of their holdings. Thus, small savers find it convenient to buy units with an assurance that the UTI will invest the savings in profitable companies, and give them a reasonable return by way of dividend on value of units. On the other hand, the investible funds of the UTI are available to industrial enterprises. You will study the working of financial institutions in detail in another course.

6.3.3 Leasing Companies

Manufacturing companies can secure long-term funds from leasing companies. For this purpose a lease agreement is made whereby plant and machinery and fixed assets may be purchased by the leasing company and allowed to be used by the manufacturing concern for a specified period on payment of an annual rental. At the end of the period the manufacturing company (lessee) may have the option of purchasing the asset at a reduced price. The ownership of the asset remains with the leasing company (lessor) during the lease period. To meet its financial requirements, a manufacturing company may also sell its existing fixed assets to a leasing company at the current market price on the condition that the leasing company would lease the assets back to the seller for a specified period. Such an arrangement is known as 'sale and lease back'. The manufacturing company in this case gets the fund immediately without having to part with the physical possession of the assets. It continues to use the assets on payment of periodical rent for the lease. In any type of lease agreement, the lease rent includes an element of interest besides expenses and profits of the leasing company. Actually, the leasing company makes an investment of its own funds and must earn an income as a return on its investment through the lease rents.

6.3.4 Foreign Sources

Funds can also be collected from foreign sources which usually consist of:i) foreign collaborator, ii) international financial institutions, and iii) non-resident Indians (NRIs)

Foreign Collaborators: If approved by the Government of India, large companies may be able to secure long term finance on the basis of collaboration agreements with companies abroad. Foreign collaboration may, thus, enable Indian companies to secure equity capital from abroad through the subscription of foreign collaborator to their share capital, or by way of supply of technical knowledge, patents, drawings and designs of plants or supply of machinery.

International Financial **Institutions:** There are a number of international financial institutions which provide long-term funds for industrial development all over the world. The most important among them are: i) The World Bank, and ii) International Finance Corporation.

The World Bank grants loans for specific industrial projects of high priority included in the national development plan. The loans have to be guaranteed by the Government of India, and may be given directly to an industrial concern, or through a Government agency, or may be given to the IOBI for refinancing to companies.

The International Finance Corporation (IFC) was established in 1956. It is an affiliate of the World Bank. As you know the World Bank grants loans only to governments of member-countries or private enterprises with guarantee of the concerned government and it does not provide risk capital to enterprises in .member-countries. IFC was set up to assist the private undertakings without the guarantee of the member-countries. It also provides them risk capital. IFC grants loans to industrial firms for a period of 8 to 10 years. Such loans do not require Government guarantee. Industrial concerns with investment plans drawn in accordance with the priority laid down under the national development plans can secure long-term loans from the IFC. But the corporation considers loan applications involving large amounts of about $100,000 or more from organisations having total assets of the value of at least $500,000.

Non-resident Indians: Persons of Indian origin and nationality living abroad (Non-resident Indians) are also permitted to subscribe to the shares and debentures issued by companies in India. A non-resident or a company controlled by a non-resident can invest upto a maximum of 5% of the paid up equity capital of an Indian company. New issues of shares or debentures by an industrial company can be subscribed by non-resident Indians to the extent of 40% of the new issue subject to a quantity ceiling of Rs. 40 lakh if the non-resident wants to have the option of repatriating the investment i.e. sell the shares and debentures and get the amount remitted abroad. However, exceptions are allowed in the case of priority industries like industrial machinery, scientific instruments, fertilisers, chemicals, drugs, export industry, hotels, etc.

6.3.5 Retained Profits

An important source of long-term finance for ongoing profitable companies is the amount of profit which is accumulated as general reserve from year to year. To the extent profits are not distributed as dividend to the shareholders, the retained amount can be reinvested for expansion or diversification of business activities. It can also be used for renovation of assets or modernisation of plant and equipment. It may be interpreted that the existing shareholders provide the finance. Hence, the company must decide to reinvest profits only when the rate of return is comparable with that of other similar companies. Moreover, a part of the profits must be distributed as dividend keeping in mind shareholders' expectation and the effect of dividend rate on the market price of shares. Retained profit is an internal source of finance. Hence it does not involve any cost of floatation which has to be incurred to raise finance from external sources. Further, the company does not have to face the uncertainties of external financing. The only drawback of this source of long-term finance is that it depends on the availability of adequate profits for retention.

Look at Figure 6.1. It shows various sources through which companies raise long-term finance.

Check Your Progress **C**

1 Fill in the blanks with appropriate words.

i) IFCI is a .... bank.

ii) Companies can seek loans from the IFCI which are repayable in not more than .... years.

iii) Long-term loans are granted by ICICI for a period upto .... years.

iv) IDBI .... long-term loans granted to companies by other development banks.

v) The maximum amount of loan which a company can obtain from any SFC is Rs. .... lakhs or .... % of the paid up capital of .... whichever is less.

2 Which of the following statements are True and which are False?

i) LIC is an investment trust.

ii) UTI can invest its funds in shares and debentures of companies.

iii) An industrial concern can raise long-term finance from an investment company upto 20% of its subscribed capital.

iv) A partnership firm can get loans sanctioned by the IFCI.

v) SFCs grant loans to companies as well as proprietory and partnership concerns.

vi) Units issued by UTI can be purchased any time by the public at face value.

vii) Development banks are just like commercial banks.

viii) Companies can raise funds by issuing shares to investment companies.

3 Which of the following statements are True or False?

i) 'Sale and lease back' is based on an agreement between leasing company and a manufacturing concern.

ii) Assets which are used for sometime on lease must be invariably returned to the leasing company at the end of the lease period.

iii) Foreign companies can never subscribe to the issue of shares in India.

iv) The World Bank can give Ioans directly to an industrial firm without Government guarantee of its repayment.

v) The International Finance Corporation grants loans for a period of twenty years.

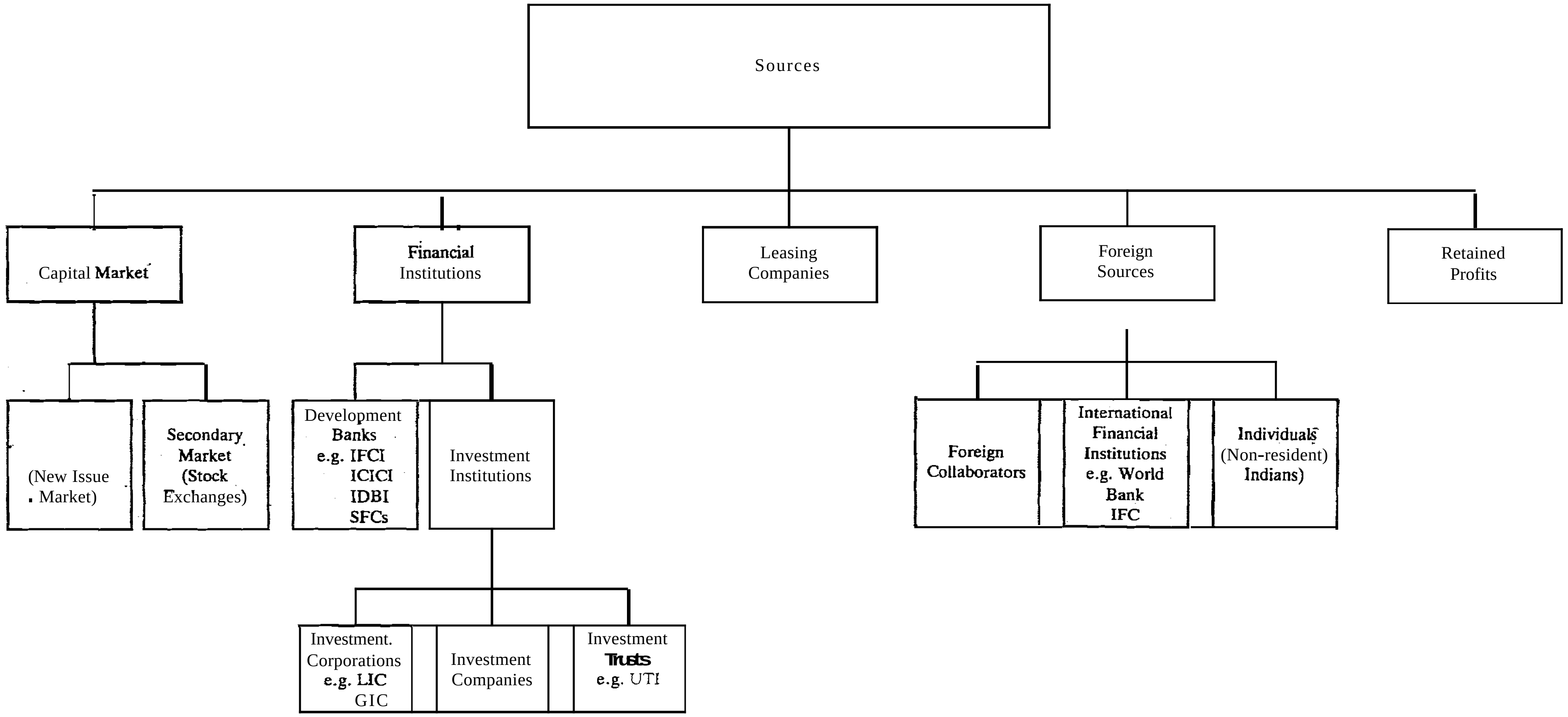
vi) Non-resident Indians can subscribe to the new issue of shares upto a maximum of 10% of the paid up equity capital of a company,

vii) A company need not pay dividend out of profits if the whole amount of profit can be reinvested for the expansion of business to earn higher level of profits.

6.4 UNDERWRITING

We have already mentioned that development banks and financial institutions **underwrite** the issue of shares and debentures of public limited companies. Besides, investment trusts, stock-brokers. issue houses and other similar organisations also underwrite the public issue of shares and debentures. Those who underwrite security issues are known as **Underwriters.** Let us study in detail about underwriting.

Figure 6.1 : Sources of Long-term Finance


Sources
Capital Market
Financial Institutions
Leasing Companies
Foreign Sources
Retained Profits
(New Issue Market)
Secondary Market (Stock Exchanges)
Development Banks e.g. IFCI ICICI IDBI SFCs
Investment Institutions
Foreign Collaborators
International Financial Institutions e.g. World Bank IFC
Individuals (Non-resident) Indians)
Investment. Corporations e.g. LIC GIC
Investment Companies
Investment Trusts e.g. UTI

What is Underwriting?

Before issuing the prospectus inviting public subscription for shares and debentures, the promoters of a company generally make arrangements whereby public response to the issue may be encouraging. Otherwise, the promoters cannot be sure that the shares or debentures would be fully or substantially subscribed by the public and ,necessary finance would be available. Similarly, when any existing company decides to raise additional finance by issuing shares or debentures, it has to be reasonably sure that there is adequate response to the issue.

Underwriting refers to an agreement between the promoters or directors of a company on the one hand, and an individual, firm or institution (known as underwriter) on the other, whereby the latter agrees to take up the whole or part of the shares or debentures issued which may not be subscribed by the public. In consideration of the undertaking given by the underwriter, the company agrees to pay a commission which is known as 'underwriting cornmission'. The commission agreed'upon is generally a percentage of the issue price of the shares or debentures underwritten.

Terms and Conditions of Underwriting

There is a written agreement between the company and the underwriter known as the 'Underwriting Agreement' (or Contract). Usually the following aspects are specified in this agreement.

i) The number of shares or debentures which are agreed to be underwritten.

ii) An undertaking by the underwriters to take up such of the shares or debentures as are not subscribed by the public.

iii) An undertaking by the company that the terms of issue given in the prospectus will not be changed without the consent of underwriters.

iv) Authority of the underwriters to the company to allot them the balance of shares or debentures not taken up by the public.

v) The rate of commission to be paid to the underwriters and the mode of payment.

The commission is payable as a percentage of the issue price of all the shares or debentures even if the issue is fully subscribed by the public.

Sometimes the underwriters want to subscribe to a block of shares or debentures even if the total issue is fully subscribed by the public. This is known as 'firm offer'. A clause to that effect is then included in the underwriting agreement. Thereby the underwriters are assured of allotment of the block of shares or debentures specified for which they have made a firm offer.

Legal Regulations

Regarding payment of underwriting commission, certain legal requirements, as prescribed under the Companies Act, must be fulfilled by the company. First, the payment of the commission must have been authorised by the Articles of Association of the company. Secondly, the commission agreed to be paid must not exceed 5% of the issue price of shares, and in the case of debentures it must not exceed 2.5% of the issue price. The amount or rate of commission agreed to be paid must be disclosed in the prospectus or statement in lieu of prospectus. The commission may be paid out of capital or out of profits.

Advantages and Limitations of Underwriting

To the promoters of a coinpany the most important advantage of underwriting is that the funds required for the enterprise become available whether or not there is adequate public response to the issue of shares and debentures. The underwriters ensure the availability of finance. A new company has to invariably enter into various contracts with different parties for purchase of fixed assets and other arrangements, before the commencement of business. The promoters can confidently prqceed with the preliminary steps after the underwriting agreement. They do not have to wait for the public response and actual subscription to the issue of shares and debentures. Thus, precious time may be saved and business activities started on a sound basis as a result of underwriting.

Another advantage of underwriting is that the company gets the benefit of expert advice from the underwriters. Every underwriter, before entering into an agreement, carefully examines the scheme of financing the business ventures prepared by the company. The underwriter signs the contract only when the scheme is sound. While examining the scheme, the underwriter may suggest improvements in the scheme and thus enable the company to avoid future setbacks. If a reputed firm has underwritten the issue of shares or debentures, it creates confidence in the public and helps the company to raise the necessary amount of finance from the public.

Underwriters usually have working arrangement with brokers and agents who secure public subscription on behalf of the company and earn commission for their services. Thus, public response to the issue of shares and debentures is not restricted to any particular area but secured from different areas. Members of the public who intend to invest their savings are also benefited as a result of underwriting of shares and debentures offered by a company. It is expected that the underwriters must have fully satisfied themselves about the soundness of the issue before underwriting the same. Hence, an investor runs much less risk when he subscribes to the issue which has been underwritten than otherwise.

The only disadvantage of underwriting is that it adds to the cost of raising finance. Thus, the rate of return on investment proposed to be made with the funds raised must be sufficiently high so as to absorb the additional cost of floating shares and debentures. But the significance of underwriting arrangement is such that even well-established profitable companies cannot avoid it while issuing additional shares or deberitures to the public. Smaller companies often find the cost involved quite heavy.

Underwriting Agencies and Institutions

We have stated before that any individual, partnership firm, company or financial institution may become an underwriter. They may be regarded as underwriting agencies or institutions. In India, the development banks, commercial banks, investment companies, investment trusts and stock brokers (share brokers) engage in underwriting business. Some of the well-known underwriting agencies in India are given below.

1	Development banks	IFCI, IDBI, ICICI, SFCs
2	Investment Institutions	LIC, GIC, UTI and Investment Companies
3	Commercial Banks	State Bank of India, Central Bank, Bank of India, Bank of Baroda, etc.
4	Others	Stock brokers and financiers like the Firm of Place, Siddens and Gough, etc.

Check Your Progress D

Put a tick mark against the appropriate answer.

a) Underwriting means

i) promise to buy shares.

ii) promise to buy debentures.

iii) assuring public subscription to the issue of shares.

iv) undertaking to subscribe to shares or debentures if public subscription is not adequate.

b) Underwriting commission is payable as a percentage of

i) the face value of shares.

ii) the market price of shares.

iii) value of shares subscribcd by the public.

iv) issue price of all the shares offered to the public.

c) A company can pay underwriting commission upto a maximum rate of

i) 2% on shares underwritten,

ii) 4% on shares underwritten.

iii) 5% on shares underwritten,

iv) 7.5% on shares underwritten.

d) Payment of underwriting commission must be authorised by

i) Board of Directors.
ii) Articles of Association.
iiif Memorandum of Association.
iv) Managing Director of the Company.

6.5 LET US SUM UP

Investment in fixed assets can be made only with long-term finance. The need for long-term finance is more in the case of manufacturing concerns. Public limited companies can raise long-term funds on a much larger scale than other forms of organisation. Companies can procure long-term finance from capital market, special financial institutions, leasing companies, foreign sources as also through retention of profits.

Capital market denotes transactions involving procurement and supply of long-term funds which take place among individuals and institutions.

Long-term capital which is raised by companies by issue of shares and debentures also involves transactions. Dealings in such newly floated shares and debentures of companies form a section of the capital market known as 'new issue market'. The arrangement whereby shares or debentures are decided to be allotted to friends and relatives of directors or promoters, or through private negotiation with investors is known as 'private placement'.

A company making public offer of shares and debentures must obtain prior consent of the Controller of Capital Issues if the amount to be raised during one year exceeds Rs. one crore. But public limited companies issuing shares are exempt from seeking consent provided certain conditions are satisfied. But companies must seek the consent of the Controller for issue of debentures to the public. Loans raised from financial institutions do not require the Controller's approval.

There are a number of special financial institutions at national level and state level — IFCI, ICICI, IDBI, IRCI — which provide long-term financial assistance to business enterprises. These institutions are known as development banks. Several other types of institutions known as 'investment companies' or 'investment trusts' also subscribe to the shares and debentures issued by companies. These development banks and investment institutions, besides giving loans to industrial enterprises, also guarantee loans and underwrite shares and debentures issued by such companies.

Assets may be acquired by companies for use under 'lease agreement' with any leasing company. Leasing companies invest funds in assets and charges rental from the user companies. Long-term finance is sometimes available to large industrial concerns through collaboration with foreign companies or from the World Bank or International Finance Corporation, subject to the approval of the Government of India. Non-resident Indians can also subscribe to the shares and debentures issued by companies in India subject to certain restrictions. To the extent profits are not distributed as dividends, the retained amount becomes a source of long-term finance for companies.

Underwriting of securities refers to an agreement between the promoters or directors of a company and another party (the underwriter) whereby the latter agree to take up the whole or part of the shares or debentures issued which may not be subscribed by the public. The company agrees to pay commission at an agreed rate to the underwriter subject to the maximum rate laid down in the Companies Act.

Companies are assured of the availability of finance by virtue of the underwriting agreement. Companies sometimes get the benefit of expert advice from the underwriters. Since the underwriters fully satisfy themselves about the soundness of the company which'is raising the capital, investors run less risk when they subscribe to the issues which have been underwritten. The disadvantage of underwriting is that it adds to the cost of raising finance. In India, the development banks, commercial banks, investment companies as well as stock-brokers (share brokers) engage in underwriting business.

6.6 KEY WORDS

Capital Market: The transactions through which long-term funds are procured by companies and supplied by investors. This is the market for long-term capital.

Convertible Debentures: Debentures issued initially to raise loans but subsequently convertible into equity shares.

Development Banks: Financial institutions which provide long and medium-term finance to entrepreneurs and organisations so that funds are invested in industrial ventures which are in conformity with national development plans,

Investment Institutions: Financial institutions which promote the saving habits of people with an assurance that the savings entrusted to them would be invested in profitable channels and help in earning adequate return for the saving public.

Investment Trust: Investment company which raises funds from the public for investment in profitable securities against which its own shares (or units) are issued to the public which can be encashed at any time at their underlying asset value.

Money Market: Market for short-term capital involving borrowing and lending of money for short periods.

New Issue Market: Arrangements which facilitate issue of shares and debentures by companies.

Private Placement: Shares and debentures decided to be allotted through private negotiation before offering them for public subscription.

Retained Profits: Amount of profits which is not distributed as dividend to shareholders.

Special Financial Institutions: Financial institutions set up for long-term financial assistance to industrial enterprises.

Underwriting: Agreement whereby the underwriter agrees to take up the shares or debentures issued by a company to the extent they are not subscribed by the public on payment of a commission known as 'underwriting commission'.

6.7 SOME USEFUL BOOKS

Bhushan Y.K. ,1987. ***Fundamentals of Business Organisation & Management,*** Sultan Chand & Sons: New Delhi. (Part Eight, chapters 2 & 3)

Musselman, Vernon A., and John H. Jackson, 1985. ***Introduction to Modern Business,*** Prentice-Hall of India: New Delhi. (chapter 14)

Ramesh M.S., 1985. ***Principles and Practice of Business Organisation, Administration & Management,*** Kalyani Publishers: New Delhi. (Volume III chapters 15–17)

Singh, B.P., and T.N. Chhabra, 1988. ***Business Organisation and Management,*** Kitab Mahal: Allahabad. (Section Five, chapters 17–19).

6.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) fixed assets ii) public, private
iii) reversed iv) withdrawn

2 i) False ii) True iii) False iv) True v) True

B 1 i) True ii) False iii) False iv) True v) False
vi) False vii) True viii) True

2 i) Controller of Capital Issues
ii) Short-term, long-term
iii) seven
iv) convertible debentures
v) private placement
vi) incorporation

3 i) iii ii) vi iii) i iv) v
v) ii vi) iv

C 1 i) development ii) 25 iii) 15 iv) refinances v) 10, 10, SFC

2 i) False ii) True iii) False iv) False
v) True vi) True vii) False viii) True

3 i) True ii) False iii) False iv) False
v) False vi) False vii) False

D a) iv b) iv c) iii d) ii

6.9 TERMINAL QUESTIONS

1 Briefly explain the meaning of: (a) Money Market, (b) Capital Market. and (c) New Issue Market.

2 Mention the sources from which companies may raise long-term finance. Distinguish between investment companies and investment trusts as sources of long-term finance.

3 What is meant by private placement of shares? Is private placement possible for debentures also?

4 Is it compulsory to seek the consent of the Controller of Capital Issues before offering shares and debentures to the public? What are the conditions to be fulfilled if a company wants to issue debentures to the public?

5 What do you understand by the term development bank? State the functions of two all-India development banks.

6 State briefly the functions of the Unit Trust of India.

7 What is a leasing company? How can a company secure long-term finance through a leasing company? What do you undetstand by 'sale and lease back'?

8 Write explanatory notes on the following;

a) Retained profits as a source of long-term finance.

b) Foreign sources of long-term finance.

c) Restrictions on investment in shares by non-resident Indians,

9 What is meant by 'Underwriting' of shares and debentures? How does it help companies in raising Iong-term finance? Discuss briefly the terms and conditions relating to underwriting of shares and debentures.

10 A public company issuing debentures and shares has entered into an underwriting agreement with IFCI. The agreement covers the issue of 1,00,000 equity shares of Rs. 10 each and 50,000 debentures of Rs. 100 each. Underwriting commission is payable at the maximum rate allowed under the ,Companies Act, Public Subscription has been secured for 70,000 shares and 40,000 debentures. The balance of shares and debentures are taken up by the underwriters. Calculate the amount of underwriting commission to be paid.

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

UNIT 7 STOCK EXCHANGES

Structure

7.0 Objectives
7.1 Introduction
7.2 What is a Stock Exchange?
7.3 Functions of Stock Exchanges
7.4 Method of Trading on a Stock Exchange
7.5 Types of Dealings in a Stock Exchange
7.6 Some Important Terms
7.7 Listing of Securities on a Stock Exchange
7.8 Speculation and Stock Exchange
7.9 Factors Affecting Prices in a Stock Exchange
7.10 Advantages and Shortcomings
7.10.1 Advantages
7.10.2 Shortcomings
7.11 Regulation and Control of Stock Exchanges
7.12 Let Us Sum Up
7.13 Key Words
7.14 Some Useful Books
7.15 Answers to Check Your Progress
7.16 Terminal Questions

7.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and importance of stock exchange
- state the economic functions of stock exchanges
- explain the method of trading on a stock exchange
- describe the terms used and types of dealings conducted at the stock exchanges
- describe the importance of listing
- explain the meaning of speculation
- identify the factors responsible for fluctuations in the prices of securities at the stock exchanges
- enumerate the advantages and shortcomings of stock exchanges
- appreciate the need to regulate and control stock exchanges
- explain the provisions of the Securities Contracts (Regulation) Act, 1956.

7.1 INTRODUCTION

In Units 5 and 6 you have learnt about the need for capital and the sources of short-term and long-term finance. You also know that companies raise capital by issuing shares or debentures known as corporate securities. Like companies, the central and state governments alsp issue bonds or instruments known as government securities to raise funds from the public. So do various other authorities like Port Trusts, Municipalities and public undertakings. Most investors hold securities to earn income by way of interest or dividend. But many of them might decide to sell them either to meet their urgent financial needs or to reinvest those funds in some other securities with a promise of better income. Similarly, people with accumulated savings or the institutions having surplus funds may also like to invest their funds in various securites.

If some investor wants to sell securities, he has to find another person who is interested to buy. But it is not easy to find ready buyers. Even if he finds one, the .buyer may take advantage of the seller's urgency to sell and offer a lower price. A 'similar problem may be faced by a buyer also. Buyer may not be able to find a ready seller. Even if he finds, the seller may quote a high price knowing the buyer's eagerness to invest. Thus, both buyers and sellers have problems of identifying each

2 i) Controller of Capital Issues
ii) Short-terra, long-term
iii) seven
iv) convertible debentures
v) private placement
vi) incofporation

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7.1 INTRODUCTION

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If some investor wants to sell securities, he has to find another person who is interested to buy. But it is not easy to find ready buyers. Even if he finds one, the buyer may take advantage of the seller's urgency to sell and offer a lower price. A 'similar problem may be faced by a buyer also. Buyer may not be able to find a ready seller. Even if he finds, the seller may quote a high price knowing the buyer's eagerness to invest, Thus, both buyers and sellers have problems of identifying each other and arriving at a mutually satisfactory price. It would be very convenient if buyers and sellers could meet at one place to solve their problem. The stock exchange is such a place. Stock exchange is an organisation which provides facilities for the purchase and sale of existing securities.

In this unit you will learn about the meaning of the stock exchange, its importance, the procedure of dealing at stock exchange, and regulation of stock exchanges in India.

7.2 WHAT IS A STOCK EXCHANGE ?

If you break up the expression 'Stock Exchange', you get twa words: one is 'Stock' which means a part or fraction of the capital of a company, and the other is 'Exchange' which means a market for purchasing and selling. Thus, we can describe the stock exchange as a market or a place where different types of securities are bought and sold. It not only deals in shares and debentures but also in various other types of securities issued by central, state and local governments as well as institutions like Unit Trust of India, Steel Authority of India, National Thermal Power Corporation, etc. Therefore, it is also called 'securities market' or 'securities exchange'. It is a secondary market of securities because only the securities already issued are allowed to be dealt with on the floor of a stock exchange.

This market is open only to members, most of whom are brokers acting as agents of the buyers and sellers of shares, debentures and bonds. A stock exchange is generally organised as an association or a society or a company. The membership of the stock exchange is restricted to a certain number, and new members are admitted only when there are vacancies. Every member has to pay the prescribed membership fee.

The Securities Contracts (Regulation) Act, 1956 has defined stock exchange as an 'association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in Securities'.

According to Pyle, 'security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation'.

K.L. Garg has described the stock exchange as 'an association of persons engaged in the buying and selling of stocks, bonds and shares for the public on commission and guided by certain rules and usages'.

Based on the above discussion and definitions, we can identify the characteristics of stock exchange as follows:

1 Stock exchange is an organised market.

2 Securities (shares, debentures, bonds, etc.) issued by central, srate and local governments, municipalities, port trusts, public utility concerns, joint stock companies and public corporations are bought and sold on the floor of a stock exchange.

3 In a stock exchange, transactions take place between members or their authorised agents on behalf of the investors.

4 In a stock exchange all transactions are regulated by the rules and bye-laws of the concerned stock exchange.

There are fourteen stock exchanges in India in different cities and towns viz., Bombay, Calcutta, Madras, Delhi, Ahmedabad, Hyderabad, Indore, Bangalore, Cochin, Kanpur, Pune, Ludhiana, Gauhati and Jaipur. They all function in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956.

Check Your progress A

1 Tick mark the correct answers.

a) Stock Exchange is a market where there is buying and selling of

i) gold, silver and bullion. ( )

ii) commodities. ( )

iii) securities. ( )

iv) all the above. ( )

b) Securities traded in the stock exchanges are issued by

i) joint stock companies. ( )

ii) central government. ( )

iii) public trusts. ( )

iv) all the above. ( )

c) The buyers on a stock exchange are

i) government. ( )

ii) companies. ( )

iii) investors. ( )

iv) none of the above. ( )

2 Explain the meaning of a stock exchange.

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7.3 FUNCTIONS OF STOCK EXCHANGES

Stock exchange, being a part of financial market, plays a very important role in the economic development of the country. Let us now examine the functions of stock exchanges from the economic point of view. These functions may be enumerated as (a) primary functions, and (b) secondary functions,

Primary functions

1 **Marketability and price continuity:** The stock exchange provides for easy marketability of securities as securities can be bought and sold conveniently on the floor of the stock exchange. Since transactions take place regularly, there is continuity in the dealings. Prices quoted are duly recorded and reported in the newspapers for the benefit of investing public. Besides, price fluctuations are also moderated because of the continuity of buying and selling.

2 **Mobilising surplus savings:** Stock exchange is an integral part of the capital market of a country. It is because through stock exchanges the savings from all parts of the country are made available to the industrial and commercial undertakings for meeting their financial requirements.

3 **Barometer of economic and business conditions:** The intensity of buying and selling of securities and the corresponding rise or fall in the prices of securities reflect the investors' assessment of the economic and business conditions. Thus, during periods of economic and business prosperity prices of securities tend to rise. Conversely, prices tend to fall when there is economic stagnation or when business activities slow down as a result of depression in the markets. Indeed, change in security prices are known to be highly sensitive to changing economic, social and .political conditions. In the words of Alfred Marshall, the well known economist. stock exchanges are not merely the chief theatres of business transactions, they are also barometers which indicate the general conditions of the atmosphere of business.

4 **Mobility of capital:** Stock exchanges furnish an open and continuous market for securities. Savings invested in securities are converted into cash for reinvestment in other securities. Thus, stock exchanges provide mobility to capital and facilitate sound investment.

5 **Contribution to capital formation:** Savings are encouraged when people come to

know about the avenues of investment. Stock markets educate investors as regards where and how to invest their savings for a fair return.

6 Shock absorber: Stock exchanges bring about equilibrium in the prices of securities which are bought and sold by speculators. Speculators generally buy securities in anticipation of rise in the prices. As a result of their buying, prices do not decline as low as might have been the case without their buying. Again when prices are high, speculators sell securities in anticipation of decline in the prices. Their selling prevents price rising too high. Thus, speculative activities regulate excessive price fluctuations.

7 Sifting process: Investors generally prefer to invest their savings after proper assessment of the relative risks and returns associated with different securities. The comparative advantages and disadvantages of investment in various types of securities may be grasped by investors from the dealings which take place on the stock exchanges. Hence they can pick and choose from among different securities and make investment decisions on a sound basis.

8 Facilitates resource allocation: As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises. Thus the existence of stock exchange provides for mobility of funds i.e. movement or flow of funds in the economy as a whole. Industries which have potentials of growth are able to attract the savings of people towards their ventures relatively more than those which have no such prospects. Thus, financial resources of the economy are allocated on a reasonable basis. It is said that "without the stock exchange, the savings of the community, the sinews of economic progress and productive efficiency, would be used much less completely and be much more wasteful, than they are now".

Secondary Functions

1 Safety of investment and equity in dealings: The stock exchanges do not allow trading in each and every company's securities. Companies which want their securities to be traded on the floor of a stock exchange have to fulfil certain conditions. The stock exchange satisfies itself about the genuineness and soundness of the company to protect the investors from being cheated. There are a wide variety of securities. The investors have the opportunity to assess the relative advantages of investing in securities of companies dealing in various products (engineering goods, consumer goods, etc.) having wide markets and situated in different parts of the country. Every region or state and every industry gets a fair share of the investor's attention for investment of their savings.

2 Easy liquidity: The investors usually prefer liquidity of their investment i.e.. easy conversion into cash, besides adequate return on their investment. The stock markets provide that assurance to investors. These are markets which facilitate buying and selling of securities. As such the investors readily come forward to subscribe to new issues. Thus, stock exchange assures liquidity of investments which goes to serve the investor's need.

3 Accurate and continuous report regarding sales: All stock exchanges maintain regular record of the securities traded each day and the prices at which deals are finalised. This information is supplied to newspapers and other information media alongwith the prices of important securities which ruled at closing time. The statistics relating to prices at which securities were traded are published in weekly bulletins for the information of the investors. This information helps in ascertaining the trend of price fluctuations and promotes healthy speculation.

4 Full information regarding listed companies: The organised stock exchanges collect information about the companies listed with them and publish the information in the form of "Official Year Book". This proves very useful to the investors in making investment decisions.

5 Helpful in re-investment decisions: The investors sometimes want to switch their investments from one type of securities to others depending on which will be more rewarding. If shares or debentures of a company are in greater demand there is a rise in their market price indicating that the investors have assumed the company's performance and prospects to be better than others. On the other hand, if shares or debentures are offered for sale by many, the price tends to fall indicating that

investors are not satisfied with the earnings and future prospects of the company. Thus, changes in the prices of securities provide a fair index of demand and supply of securities of particular companies. The investors can make their investment decisions accordingly.

6 Safeguards to investors: Every stock exchange has its own rules and regulations for the control of operations of the exchange. Only members are allowed to deal in securities and make transactions. As the members have to transact their business strictly according to the rules, the investors' interests are safeguarded against dishonesty or malpractices.

7.4 METHOD OF TRADING ON A STOCK EXCHANGE

All the securities issued by companies and other bodies are not permitted to be quoted on a recognised stock exchange. Only the listed securities are permitted to be traded. You will study about listing of securities in detail later in this unit. Only members of the stock exchange or their authorised agents can buy or sell securities on the floor of the stock exchange. Suppose you want to buy or sell securities you have to contact a stock broker who is a member of the stock exchange.

When you wish to buy somc shares you have to place an order with the broker for the purchase of those shares. You can also depend upon the broker for selecting the type of securities you should buy. After taking the decision about the securities you are to buy, you have to deposit the estimated cost of the securities with the broker.

The broker usually entrusts the task to his authorised clerk in the hall of the stock exchange who announces his requirement by 'shouting in the hall' during the time allotted for dealings in the particular class of securities. He will announce the particulars of the securities, the quantity required as also the price which he offers. Some other broker shall respond to your broker's call. He will either accept the offer made by your broker or may make a counter call/offer. Through such process the bargain/deal is struck,

Each broker has a note book, known as sauda bahi, on which he obtains the signature of the broker from whom he has bought the securities. The signature is obtained as a confirmation of the transaction by the other party. At the end of the day, every broker submits his copy of the transactions recorded in his book to the stock exchange. This is done to reconcile all purchase transactions with those of sales. On the settlement day, the broker takes the delivcry of the securities and makes the necessary payment.

You have to pay to your broker the cost of securities purchased and thc commission. This commission is a fixed percentage as per the schedule fixed by thc stock exchange. The broker prepares a contract note in favour of the client and forwards it to him. The contract note mentions the quantity and the description of the securities bought and the price (inclusive of his commission) at which they are bought.

A similar procedure is followed when some security is to be sold. Look at figure 7.1 which depicts the process of purchase and sale of securities in the stock exchange.

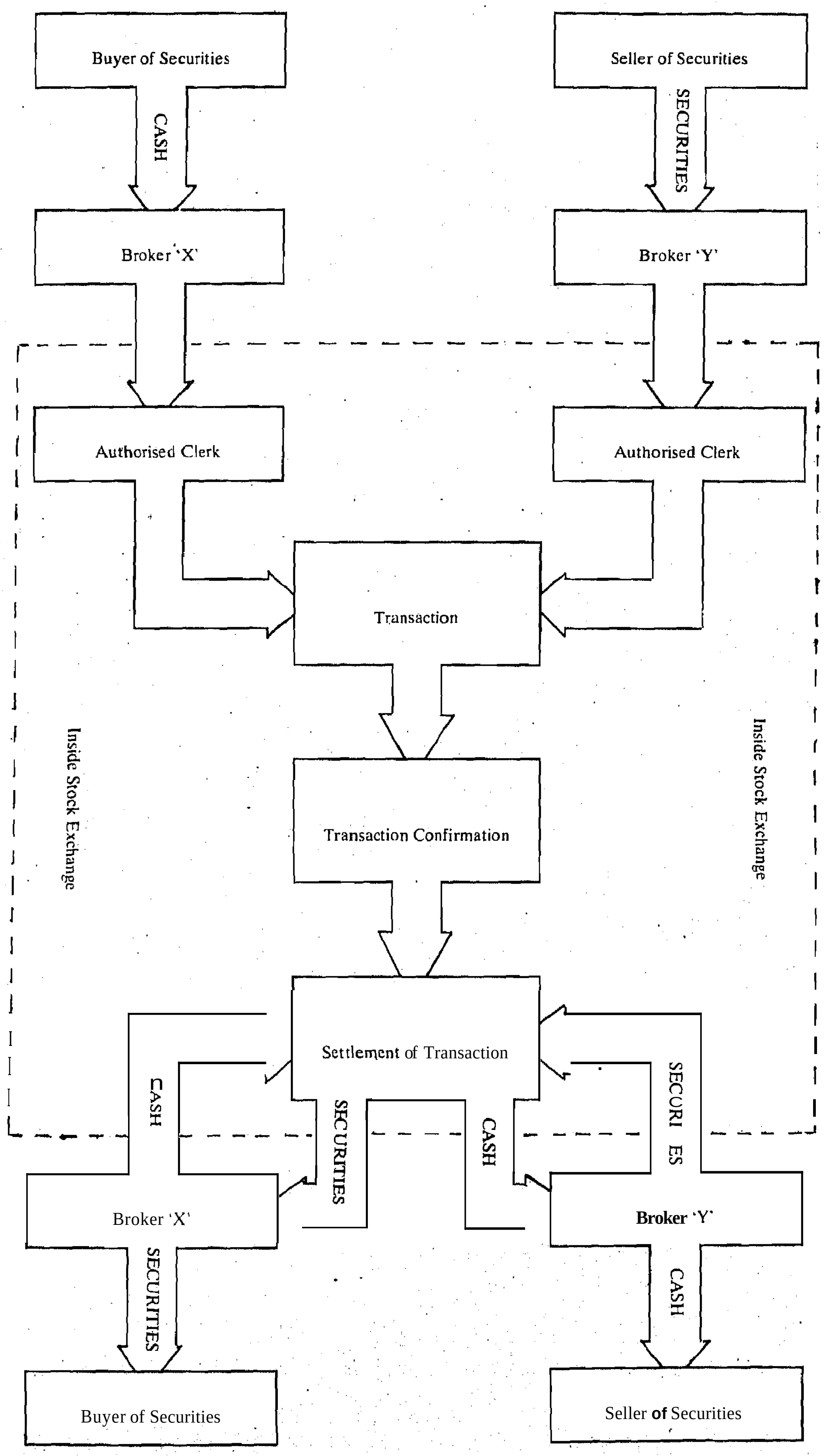
7.5 TYPES OF DEALINGS IN A STOCK EXCHANGE

There are various types of dealings in stock exchanges. Let us now discuss about them briefly.

1 Spot delivery contracts: Such contracts are settled on the spot i.e., the delivery and payment are made on the day of the transaction itself or latest by the following day. It is not a common practice now-a-days.

2 Ready delivery contracts: Such contracts are settled within a short period of time. Usually the period allowed is twelve days and the settlement takes place on the \following settlement day. No postponement is allowed in case of ready delivery contracts.'

Figure 7.1 : The Process of Purchase and Sale of Securities in the Stock Exchange


Buyer of Securities
Seller of Securities
CASH
SECURITIES
Broker 'X'
Broker 'Y'
Authorised Clerk
Authorised Clerk
Transaction
Inside Stock Exchange
Inside Stock Exchange
Transaction Confirmation
Settlement of Transaction
CASH
SECURITIES
CASH
SECURI ES
Broker 'X'
Broker 'Y'
SECURITIES
CASH
Buyer of Securities
Seller of Securities

3 Forward Delivery Contracts: Such contracts are also due for settlement on the following settlement day but they can be postponed to the next settlement day, if so desired. This facility is provided by the stock exchange only in those scrips which are included in the specified list (List A). Such transactions are meant for speculation where the buyer has no intention to take delivery and make payment. He simply covers it by another transaction and earns or loses the difference in prices.

For example Mr. Sanjay buys 1,000 shares of Modi Rubber at Rs. 50 per share in the hope that its price will go up. If the price rises as expected, he will settle it by a transaction for sale of 1,000 shares and pocket the difference, If the price falls, he may decide to settle it by a transaction for sale at a lower price and pay the difference. Alternatively, expecting the price to rise, he may seek postponement of its settlement to the next settlement day by paying the necessary charges. Technically, such postponement is known as 'Carry Over' or **'Badla'** and the charges paid are called **'badla** charges' (also known as contango or backwardation as explained later in this unit). Sometimes the professional badlawalas may advance the necessary sum of money to finance purchase of shares by the hull speculator at certain rate of interest and thus help him to postpone the sale.

Forward delivery contract is not the same **thing** as future trading. Future trading means entering **intò** a transaction to sell or buy at a future **date.·This** kind of trading is prohibited in India.

7.6 SOME IMPORTANT TERMS

The terminology used by the operators on the stock exchange is somewhat different from what is commonly used in business. The terms have been adopted for official records as well as reports on stock exchange transactions.

Bull or Long: A person who buys securities in the expectation of a rise in their prices, is called 'Bull'. He becomes active whenever there is anticipation of a rise in the prices of securities. He buys with the object of selling them in future. He is also known as tejiwala. If his expectations come true, he earns a profit. If the market goes against his expectation, he incurs a loss. Suppose, he makes a deal for purchase of 100 shares at Rs. 105, expecting it will go up. On the settlement day the price of the share rises to Rs. 110. He informs his broker to settle the deal. He earns a profit of Rs. 500. On the other hand, if the market price of the share goes down he may incur a loss on settlement of the transaction. In such a situation he can postpone the settlement due to unfavourable price by paying budla charges (also called contango). He is called 'bull' as he has a tendency to raise the price artificially like a bull who generally throws his victim upwards.

Bear: A person who sells short i.e., sells what he does not possess at the time of selling, is called a 'Bear'. He does so in the hope of buying at a lower price at the time of delivery. Thus a bear anticipating a fall in price in future sells at the current price which is high. If his expectations come true, he gains, otherwise he loses. If the market goes against him i.e. if the market prices rises, he can postpone his settlement by paying badla charges (also called backwardation). A sale of securities by bears is called 'short selling'. He has to buy them from the market for making delivery to the buyer.

Stag: A person is called a 'stag' if he deal's in the new issues of companies. He applies for shares on the.basis of prospectus, and sells these shares at a premium soon after the allotment is made to him. He is just like a bull, since he also foresees a rise in the price of the securities. He applies for a big allotment, since he has to pay only application money to the company at the time of application. A stag sometimes creates artificial demand for the securities in the market so as to cause a rise in their prices. If the response for such shares is poor, and he is allotted all the shares applied for, then he has to sell these shares at a discount. In such conditions he sustains loss.

Contango: Budla charges paid by a bull to the broker for carrying over his transaction to the next settlement date, is called 'contango', Contango amount depends upon the class of securities, their quantity, value, and interest rates prevailing in the market at the time of transaction. Usually it is equivalent to the 'middle price' of the difference between the agreed price and the market price prevailing on the day of the settlement.

Backwardation: This is also a type of badla charge payable to the bull by the bear seeking postponement of the transaction to the next settlement date.

Cum-Dividend: Cum means 'with' or 'including'. Where shares are quoted as Cum-Dividend, the buyer gets a right to receive the dividend on such shares which is payable after the date of sale. The purchase price includes the amount of dividend due. This is because the buyer becomes a registered shareholder and he is entitled to get dividend as and when it is declared by the company. Most transactions in securities are cum-dividend.

Ex-Dividend: This term refers to the price of shares purchased without the right to get the dividend from the company. The dividend declared or accrued is payable to the person whose name appears in the books of the company. Hence, when the buyer purchases the shares after the closure of the books of the company, he buys them ex-dividend.

Cornering: Cornering refers to the condition in the market in which almost the entire supply of a particular security is held by an individual or a group of individuals. In such a situation the bears find it difficult to buy them to meet their commitments of delivering the scrips. This term also refers to purchase of securities by an outsider in large quantities in order to oust the existing management of a company or to put them in an ernbarassing situation.

Margin Trading: It refers to the practice of buying and selling securities by depositing with the broker a certain percentage of the value of the securities involved in the transaction. The percentage of value so deposited is called 'Margin Money' or 'Margin'. The objective is to meet the loss, if any, out of this deposit. When the margin money is deposited, the broker credits the Margin Account of the customer. Deposit of margin money is a precondition for the securities to be held on account of the client. Where the margin falls short of the amount of loss suffered by the client on the securities held in his account, the broker may ask the client to deposit additional amount to cover the shortfall. In case he does not deposit such amount, the broker can sell the securities and recover the amount.

Arbitrage.: Buying in one market where the price is low and selling the same. securities in another market where the price is comparatively higher is termed as 'Arbitrage Operation'. Such dealings confer all the benefits of a continuous market, and bring the divergent prices of various stock exchanges to a uniform level. The scope of operations of the stock exchange is also expanded through such operations. The prices are equalised subject to the cost of communication and transfer of funds from one place to another..

Rigging the Market: When the prices of particular shares are artificially forced up in the market, it is known as 'Rigging'. This is generally the result of activities of bulls . (speculative buyers) who raise the demand and thereby push up the market price. Those who hold large blocks of shares often buy and sell to make the market active and then gradually unload their holdings at a profit.

Settlement Day: In every stock exchange a particular day is fixed for the settlement of transactions between buyers and sellers. This day may be every Monday or every Saturday of the week. In other words, there is a weekly settlement. The speculators may settle their deals on a particular settlement day or postpone it to the next settlement day on payment of the 'badla' charges. As stated earlier, postponement of settlement is allowed only in case of shares included in the specified list (List A) of the stock exchange concerned.

Blank Transfer: When shares are sold, the seller has to sign a transfer deed giving necessary particulars about the shares and the transferee, It also involves stamp duty which is payable at the prescribed rates. When the deed is filed with the company, the transfer is duly registered and the name of the transferee is recorded in place of that of the transferor. However, when the seller signs the transfer deed without filling in the name of the transferee it is known as 'blank transfer'. This type of transfer is found to be convenient where the speculators carry over their deals involving temporary purchase and sale of securities. Blank transfer permits speculators to buy and sell securities without paying stamp duty for some time. This tends to encourage excessive speculation. Hence, to discourage blank transfers it is required that the transfer deed in a prescribed form must be presented to the Registrar of Companies before it is signed by the transferor. The date of presentation is endorsed on the deed. Thereafter, the transfer deed must be delivered to the company for registration of the transfer within a certain period. In the case of listed securities, it must be delivered before the first closure of the Register of Members after the date of presentation endorsed on it. In the case of non-listed securities the deed must be delivered within two months from the date of presentation endorsed on it.

List A Securities or Specified Securities: In every stock exchange, there are certain specified securities in respect of which carry over facility is permitted. These securities are known as 'List A Securities' or 'Specified Securities'.

List B Securities or Cash Securities: Securities other than List A Securities are known as 'List B Securities' or 'Cash Securities'. The transactions in such securities have to be settled within a limited period. No postponement is allowed.

Jobber: There are two types of members in the London Stock Exchange known as brokers and jobbers. Every member of the London Stock Exchange has to declare whether he will act as a broker or a jobber. A broker is to act on behalf of the customers and derive his income through the commission he will charge on the purchase and sale of the securities. He is not allowed to buy or sell in his own name. The jobber, on the other hand, is an independent dealer in securities. He can purchase and sell securities in his own name and deal with a broker or with another jobber. He does not work on behalf of non-members. The distinction between a broker and a jobber is not followed in India. The member of the stock exchange can act as a broker and also buy and sell in his own name. At the Bombay Stock Exchange the members are unofficially divided into two categories: (i) **brokers,** and (ii) **tarawaniwalas. A** member who acts both as a broker and a jobber is known as 'Tarawaniwala'. In India most members fall in this category. .

Check your Progress B

1 You want to buy 100 scrips of Gama Ltd. State the various stages through which you have to proceed for the purpose.

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2 What is the difference between Spot Delivery Contract and Ready Delivery Contract?

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3 What is a Forward Delivery Contract?

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4 State whether the following statements are True or False.

i) Stock exchange provides liquidity to investment.

ii) Fluctuations in the value of securities reflect the economic and business conditions in the country.

iii) Stock exchange does not lead to excessive speculation.

iv) Buying of securities in one market where price is lower and selling the same in another market where the price is higher is called arbitrage operation.

v) Stock exchanges facilitate capital formation in the country.

5 Fill in the blanks.

i) **A** person who buys securities in the expectation of a rise in the price is called ....

ii) Ready delivery contracts are settled within .... days of the transaction.

iii) If the settlement is deferred at the request of the seller, the budla charges he pays is called ....

iv) Artificial forcing up of the market price of a particular share is called ....

v) Scrips are usually sold .... dividend.

7.7 LISTING OF SECURITIES ON A STOCK EXCHANGE

We have stated earlier that all securities issued by companies and other bodies are not traded in stock exchanges but only the listed securities are traded. Now, let us discuss in detail about this listing. Listing means addition of new securities to the existing list of securities being traded on a stock exchange. If a joint stock company or any other body who has issued new securities want them to be traded on the floor of stock exchange and their prices duly published, it has to get the securities included in the list of the stock exchange. For listing, the company has to make an application and furnish the prescribed information to the stock exchange. Section 19 of the Securities Contracts (Regulation) Rules 1957 lays down the minimum requirements with respect to the listing of securities on a stock exchange. **Listing implies that the securities have met the satisfaction of stock exchange authorities, in respect of certain prescribed standards of legality, security and work-manship.** When a security is admitted to dealings on a stock exchange, it does not guarantee the soundness or profitability of the company, in any manner. It is also not a certificate of the stock exchange for consideration by the investors. However, it indirectly gives an impression to the investor that the quoted security can be considered for investment, as the issuing company has satisfied the management of the stock exchange by fulfilling the required conditions and that there is no concealment. Listing provides a reasonable basis upon which the investor may assure himself about the genuineness of the company.

Advantages of Listing: The main advantage of listing of securities is that the investor gets all the required information about the securities he wants to buy or sell. Certain other advantages of listing are:

1 It provides a continuous market for securities.

2 It enhances the prestige of the company.

3 It provides an indirect check against manipulation of prices by the management.

From the point of view of a company, listing of securities is beneficial in two ways: i) it enhances credit worthiness of the company, and ii) it widens the market of the securities. From the point of view of investors, listing provides safety of dealing and liquidity.

But listing of securities of a company does not guarantee the financial soundness of a company. It also does not recommend the purchase of securities. It only **indicates that at the time of listing the company was legally incorporated and was solvent as a going concern.** This creates a favourable climate for the securities listed.

7.8 SPECULATION AND STOCK EXCHANGE

The word 'speculation' is derived from the Latin word 'speculare' which means 'to see from a distance or take a decision in anticipation of future happenings'. However, in the share market, it means dealing in securities keeping in view the present and future prices with the object of making profits from the difference of the two prices. Emery of USA has stated the meaning of speculation in the following words: "Speculation consists of buying and selling commodities, or securities, or other property, in the hope of.a profit from anticipated changes of value" Speculative transactions are different from investment transactions. Graham, Dodd and Cottle have explained the difference between speculation and investment as follows:

"Investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculation".

You can very well understand this difference if you know the working of a stock exchange. The stock exchange provides an arrangement for the marketing of listed securities which are also called 'scrips'. The actual functioning of this market consists of buying and selling of these scrips. The buyers and sellers undertake two types of operations; one for investment and the other for speculation. Those who buy securities so as to earn a regular income from the investment are called 'genuine investors'. They get delivery of the scrips on payment of the price. Such transactions are called investment transactions. In the second type of transactions, the object is to deal in the difference of price. The buyers buy scrips with the object of selling them in future at a profit, or sell now in the expectation of buying at a lower price in future. They are known as speculators and their transactions are known as speculative transactions.

Speculation and Investment: Even though speculation and investment are different in some 'respects, in practice it is very difficult to say who is a genuine investor and who is a pure speculator. Buyers and sellers are partly speculators and partly investors. There is a difference of degree only, Let us take the following example. A buyer agrees to purchase 100 shares at Rs. 110 per share. On the settlement date, the price goes up to Rs. 120 per share. The buyer may either ask the seller to deliver 100 shares and pay him at the rate of Rs. 110 and complete the transaction, or ask the seller to pay the difference of the two prices i.e. the price prevailing on the date of transaction (Rs.110) and the price prevailing on the date of settlement (Rs.120). If he insists on the delivery of shares, we may call it an investment transaction. But, if he settles the transaction by taking up the difference of Rs. 10 per share, it will be called a speculative transaction. Sometimes, a person who purchased shares with the intention of investment may decide to sell the shares and reap the benefit if the price of shares goes up very high. On the other hand, if the price declines very low, he may decide to sell to avoid heavier loss. Thus, a genuine investor may also think of buying and selling securities and take advantage of changes in the prices over time. But he cannot be called a speculator because his intention is to invest and not to make profit out of changing prices.

Speculation and Gambling: One may be inclined to think that speculation and gambling are sy.nonymous. No doubt, speculation and gambling have some common features. For instance, both depend upon uncertain happenings of the future, both involve risk of loss, and both lead to gain for someone and loss for another. In spite of these similarities, however, we can make the following distinctions.

1 Speculation is based on foresight while gambling does not involve use of foresight.

2 In speculation the intention is to gain from difference in prices while gambling is purely based on betting, either winning the bet or losing it.

3 The risk of loss is assumed and anticipated in speculation while gambling artificially creates risk of loss.

4 Speculation is a rational activity, based on reasoning while gambling is a kind of blind or reckless activity.

5 Speculation is a recognised activity, while gambling is a punishable act.

7.9 FACTORS AFFECTING PRICES IN A STOCK EXCHANGE

The prices of securities, particularly those of equity shares, sometimes fluctuate very widely and critically. The changes in price take place mainly because of buying and selling activities of speculators. But underlying their speculative dealings, there are one or more other factors responsible for the price fluctuations. Generally speaking, the fluctuations are due to the following factors.

I Interest rate: If there is a change in the rate of interest charged by banks on loans and overdrafts, there is a change in the speculative activities, and security prices also change as a consequence of it. Thus, if banks allow credit at lower interest rate, it may induce people to borrow money from banks and engage more in speculative activities to make profits. Hence, price of securities may go up as a result of speculative buying. However, if the interest on bank credit goes up, borrowing will be reduced and demand for securities will be relatively lower. Hence prices of securities will tend to go down.

2 Activities **of** the financial institutions: When financial institutions start buying securities on a large scale, prices tend to move up because it leads to high expectation among the public about the prospects of the company and there is increased demand all around. Similarly, if there is large scale selling of securities by financial institutions, the price tends to go down.

3 Performance **of** the company: The prospects of a company as regards future profits and dividend payment are often reflected in the rising or falling prices of its shares. This is because the profit earning capacity and expected dividend rates influence the expectations of investors about the rate of return on investment and future rise in prices. If the prospects are good, there is increased demand for shares, and prices move up. On the contrary, if a company's performance in terms of profit earning and dividend payment shows an unsatisfactory trend, the price of its shares start declining due to reduced demand.

4 **Business** cycles: Business conditions are periodically found to be subject to prosperity and depression. Prices of securities continue to rise during prosperity as bull speculators are active and go on purchasing securities. However, when speculators are unable to meet their liabilities due to lack of adequate funds, they are forced to bargain for sale as a result of which prices rapidly decline and cause a state of depression in the market.

5 Changes in **Board** of Directors: Sometimes, security prices change as a result of changes in the Board of Directors of particular companies. The death or resignation of a well known director may cause doubt or apprehension about the future prospects of the company concerned. In that situation, generally, there would be an adverse effect on the price of shares of that company.

6 **Sympathetic** fluctuation: The prices of securities traded in more than one stock exchange often change due to changes in another exchange. If the prices of some securities fall in one stock exchange due to some particular reason, it leads to a decline in the prices of the same securities in other exchanges too. This happens due to immediate communication among speculators.

7 Political events: Changes in the composition of government, changes in international relations, conflicts and political upheavals and wars between nations are always found to cause changes in the securities prices. This is because conditions of business and industry are generally affected by political events.

8 Changes in government policy: The changes in government policy with regard to taxation, import-export, price controls, licensing, etc. also influence the prices of securities, For example, if government decides to exempt dividends from income tax, the share prices will go up. If, on the other hand, government decides to raise income tax rates on company profits, the prices may fall. In fact, these days the policy changes by the government have become a major cause for an upswing or a downswing in prices of shares.

9 **Miscellaneous** factors: Various factors which may not be directly related with stock exchanges also affect prices of securities due to the psychological reaction of speculators. For example, unexpected changes in weather conditions, inadequate or excessive rainfall (which affects agricultural output), may bring about changes in the prices of shares of companies manufacturing **fertilisers,** edible oils, cotton textiles, etc. Similarly, lockout for a prolonged period may cause prices of shares to decline or illness of a powerful head of government may cause fall in security prices.

~hec Your Progress C

1 Why is listing of securities necessary?

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2 What is speculation?

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3 State whether each of the following statements is True or False.

i) Speculation is the same as gambling.

ii) It is normally difficult to distinguish between a speculative transaction and an investment transaction.

iii) In speculative transaction the intention is to gain from difference in prices.

iv) Speculation helps in establishing uniform prices of scrips in different stock exchanges.

v) Excessive speculation is not harmful.

vi) Listing of securities on a stock exchange guarantees that the company is financially sound.

vii) Listing of a security implies that the security has met the requirements of the stock exchange authorities.

viii) If a company's profits and the dividend rate are satisfactory, the prices of its shares will have a falling trend..

ix) Any security can **be** treated at the stock exchange.

4 Fill in the blanks.

i) Listing of security means addition of .... security to the list of secutities traded on a stock exchange.

ii) Listing of security provides a .... market for the security.

iii) If bear speculators are active, security prices have a tendency to go ....

iv) If interest on bank loan .... the prices of securities tend to go down.

7.10 ADVANTAGES AND SHORTCOMINGS

7.10.1 Advantages

Having discussed the functions of stock exchanges, we may outline their advantages from the point of view of:

1 Companies

2 Investors

3 Society as a whole

From the Companies' Point of View

i) **Increase in the credit and goodwill of the company:** Every company is not allowed to have its shares traded on the stock exchange. Permission is to be obtained by the company for getting its shares included in the list of securities to be bought and sold on the floor of the stock exchange. Before granting the permission, stock exchange authorities check whether the company is financially sound and managed by qualified people. Therefore, companies whose securities are listed are supposed to be sound companies. They enjoy better goodwill and credit in the market as compared with other companies.

ii) **Extensive markets:** The securities issued by companies and other corporate bodies are quoted on the stock exchanges and are traded on the floor of the exchanges. This increases the marketability of the securities. Investors all over the world come to know about the securities and get an opportunity to invest in such securities.

iii) **Increase in the value of securities:** As investors all over the world come to know about the availability of certain securities, the value of securities increases as a result of higher demand.

iy) **Knowledge about investment to the company:** The companies come to know from stock exchange quotations fluctuations in the price of securities as well as the intensity of buyers' demand. While planning for raising additional capital, proper decisions can be taken whether to issue shares or debentures and about the terms of issue.

From the Investor's Point of View

i) **Facility of investment:** The stock exchange provides facility of investment to the investors. Liquidity as well as safety of investment in securities are assured through the mechanism of stock exchange. Investors can buy and sell securities on the floor of stock exchange as and when they want to do so.

ii) **Protection of investors' interest:** Stock exchanges are well organised markets and are regulated under the Securities Contracts (Regulation) Act, 1956. Thus, they work under the control of the Central Government. Hence, the interest of the buyers and sellers of securities is safeguarded and protected.

iii) **Publication of quotations:** All the stock exchanges regularly publish the prices quoted for securities on the floor. This facilitates buyers as well as sellers in getting information of the prices of securities, which in turn helps them to decide whether to purchase or sell.

iv) **High collateral value:** Listed securities are preferred by banks and creditors as collateral against losses, since they can easily sell such securities in case of default of borrowers and debtors who have pledged these securities with them.

v) **Best possible use of capital:** Stock exchanges provide opportunities to the investors to compare the relative demands of different securities on the basis of sale and purchase of those securities. Consequently, the profitable companies attract more investors and get an edge over the less profitable ones. Thus, the investors are able to invest their savings in more profitable companies.

From the Point of View of Society as a Whole

If we look at the operations of a stock exchange from the point of view of society as a whole, its usefulness may be found in the role it plays in creating congenial environment for savings and investment.

i) **Facilitates capital formation:** The existence of stock exchange induces people to save as it provides avenues of investment and facilitates buying and selling of securities without difficulty. This leads to increased capital formation in the country, i.e., savings become productive capital.

ii) **Promotes industrial growth:** Long-term capital for large industrial firms can be procured by companies as savings become available for investment with the organised markets facilitating purchase and sale of securities. Promotion and expansion of industrial units in turn contribute to the industrial growth of the economy. The buying and selling of securities in stock exchanges take place not only among investors from within the country but also among foreign investors. The existence of stock exchange encourages flowof capital from abroad, and thus adds to the growth of industries.

iii) **Proper use of capital:** Investors are generally attracted towards the more profitable and growing industrial units. Since stock exchanges facilitate investments to be withdrawn from the less profitable and loss making companies (by sale of securities) and invested in more profitable undertakings, the financial resources are put to proper use and the economy as a whole benefits from it.

iv) **Reduces fluctuation of security prices:** When particular securities are purchased in anticipation of future rise in price, the existing low prices tend to go up. On the other hand, selling in anticipation of futuredecline in price leads to the existing high prices being checked. Thus, wide fluctuations in the prices of securities are prevented due to regular dealings in securities.

v) **Facilitates government borrowing:** Government securities which are issued by the Reserve Bank of India can also be bought and sold on the floor of stock exchanges. Investors who subscribe to the issue of government securities find it convenient to hold them as long as they want and also to sell them easily without loss due to the existence of stock exchanges. Hence governments depend a great deal on stock exchanges while raising loans.

7.10.2 Shortcomings

So far we have discussed how beneficial the stock exchanges are from the point of view of companies, the investors and the society as a whole. But, like other institutions, stock exchanges too are not free from limitations. If operations on stock exchanges are not controlled, they may be harmful to companies as well as investors, Let us, therefore, examine the shortcomings of the stock exchanges.

Briefly, the shortcomings of stock exchanges arise out of brokers' and jobbers' tendency to engage in speculative buying and selling of securities without legitimate reasons. This causes severe fluctuations in the security prices.

Excessive speculation: It is one of the common evils associated with stock exchange operations. Speculation implies buying or selling securities in anticipation of future prices. Speculators generally deal in securities with the main objective of gaining from the difference in prices. They do not have the intention of paying for the securities or taking delivery of securities if they are speculative buyers. Prices go up just because they make bids to buy. On the other hand, speculative sellers do not possess the securities, nor do they intend to receive payment and deliver securities. But, their bids to sell pushes prices down. When there is no genuine reason for prices to move up, high prices may suddenly crash if buyers are required to pay for the securities which they cannot generally do for lack of funds. Similarly, if the sellers are required to deliver securities they may not be able to do so. This kind of situation does not permit real investors to rely on the changes in securities prices as an index of the future prospects of a company.

Wide fluctuations in prices: Another shortcoming of stock exchange operations is that security prices may fluctuate due to unpredictable political, social and economic factors as well as due to rumours which may be spread by interested parties. Sudden changes in social, economic and political factors are not easily predictable. Speculators with knowledge and skill normally help to reduce price fluctuations. But when rumours are spread by speculators only to raise or reduce prices of particular securities for their own profit, there is excessive rise or fall of prices, and genuine investors are unable to decide whether to buy or sell. Many of them get panicky when prices of securities steeply decline. Others buy in haste just because prices are rising. In both cases, the investors may repent for selling or buying securities which may lead to losses.

7.11 REGULATION AND CONTROL OF STOCK EXCHANGES

We have discussed earlier the importance, functions and working of stock exchanges. They play an important role in the capital formation and industrial growth of the country. The members of the stock exchange, brokers, investors and speculators are the people who engage in stock market operations. All these people derive advantages from the working of the market. However, stock markets suffered from a number of evils in the past and were regarded as gambling dens of the brokers.

The attention of the Government was drawn from time to time to the ills of stock markets as a result of which the Securities Contracts (Regulation) Act, was passed in 1956 to regulate and control stock market operations in the wider interests of the financial markets, institutions and the public. The main provisions of this Act are as follows:

1 There shall be only one recognised stock exchange in one region. This will have a unitary control.

2 Dealers and brokers outside the area of the recognised stock exchange will be licensed.

3 A recognised stock exchange shall be entitled to frame its own bye-laws for regulation and control of contracts subject to the approval of the Central Government. The bye-laws may regulate (i) opening and closing of market; (ii) regulation of trading hours; (iii) establishment of clearing house; (iv) regulation of prohibition of blank transfer (now these are regulated by the Companies Act); (v) listing of securities on the stock exchange; (vi) regulation or prohibition of carry over or budla system; (vii) limitations on the volume of trading by members and on their open positions; (viii) fixing minimum and maximum prices for securities in emergencies; and (ix) separation of functions of jobbers and brokers and regulation of tarawani (jobbing) business.

4 The Central Government is empowered to make and amend bye-laws after consulting the governing bodies of these exchanges.

5 Dealings in future are prohibited, since they are regarded as gambling contracts.

6 The Central Government has a right to withdraw recognition to, or supersede, the governing body of the exchange in, abnormal situations.

7 A recognised stock exchange must submit periodical returns relating to its affairs and give information as required by the Government from time to time.

8 Central Government has wide powers relating to the listing of securities. It can compel any public limited company to list its securities. It can vary or set aside the refusal of a stock exchange to list securities on an appeal made by a company.

The Government of India has recently set up a high-power body known as the Securities Exchange Board of India which will provide necessary guidance for the healthy and orderly development of securities markets which will instil confidence among the investors and provide adequate protection to them.

Check Your Progress D

1 State whether the following statements are True or False.

i) Stock exchanges increase the credit and goodwill of a company.

ii) Stock exchange ensures safety to dealings in securities.

iii) Stock exchanges are regulated under the Companies Act, 1956.

iv) Dealings in future transactions in securities are not permitted in stock exchanges in India.

2 Tick mark the co..ect answer.

a) Stock exchanges facilitate buying and selling of securities as a

i) local market. ( )
ii) provincial market. ( )
iii) national market. ( )
iv) international market. ( )

b) Stock exchanges serve the need of
i) companies which need capital. ( )
ii) persons who want to invest. ( )
iii) society which wants to improve. ( )
iv) all the above ( )

c) Stock exchange operations lead to
i) wide fluctuations in prices. ( )
ii) normalisation of prices. ( )
iii) both (i) and (ii) ( )
iv) none of the above ( )

d) Stock exchanges come under the purview of
i) central government. ( )
ii) state government. ( )
iii) local municipality. ( )
iv) none of the above ( )

e) Stock exchanges facilitate
i) purchase and sale of securities. ( )
ii) speculation in securities. ( )
iii) gambling in securities. ( )
iv) all of them ( )

7.12 LET US SUM UP

Stock exchange is an important part of capital market. It means a market place for buying and selling of securities already issued by joint stock companies, public trusts, central and state governments and local authorities. It is an organised market controlled and recognised by the Central Government under the Securities Contracts (Regulation) Act, 1956. The members are entitled to deal in securities either on their own or through their agents (authorised clerks). All transactions on the floor of a stock exchange are regulated by the rules and bye-laws of the concerned stock exchange. The stock exchange provides avenues for savings to be invested not only at the national level but sometimes at international level. Stock exchanges not only provide liquidity and safety to the investor, but also provide capital to the industrial units and thus assist the industrial growth of the country.

To make a deal on the floor of a stock exchange, you have to contact a broker, seek his advice and place an order with him. Three types of transactions are generally undertaken in the stock exchange: i) spot delivery transactions, ii) ready delivery transactions, and iii) forward delivery transactions.

Bulls, Bears and Stags are three types of dealers who operate in the stock exchange. Bulls are those who expect price of securities to rise. Bears expect securities prices to fall in future. Stags deal in new securities issued by companies. They apply for a large number of securities and sell them soon after they are allotted to them. Certain terms used in the dealings on stock exchange have their special meaning. Examples of such terms are contango, backwardation, cornering, arbitrage, etc.

All securities of every company are not quoted on stock exchanges. The company has to take permission from the concerned stock exchange for getting its securities quoted. Such permission is termed as Listing of Securities and is granted only after the company fulfilled the requirements.

It is said that stock exchange encourages speculation and leads to fluctuations in the prices of securities quoted on its floor. But speculation also has its advantages. It equalises and normalises price fluctuations, apart from mobilising capital and widening the market of the securities. There are various factors which influence the prices on the stock exchange such as the financial position of the companies, speculative pressures, business cycles, political events and the activities of the financial institutions, etc.

Stock exchanges have several important economic functions and are advantageous to investors, companies and the society at large. Due to several malpractices in the working of these stock exchanges, the Central Government had to enact the Securities Contracts (Regulation) Act in 1956. Since then the stock exchanges have to get recognition from the Central Government and work under its control. They have also to frame their rules and bye-laws.

7.13 KEY WORDS

Arbitrage: Buying in one market where the price is low and selling it in another market where the price is comparatively high.

Authorised Clerk: An employee of the broker who is authorised to transact business at the stock exchange on behalf of the broker.

Backwardation: Budla charges paid by the seller (bear) for the postponement of transactions to the next settlement date.

Bears: Speculators who anticipate fall in prices in future and so they sell securities in the present to buy them in the future when the prices fall.

Badla Charges: Charges paid for the postponement of transactions to the next settlement date.

Bulls: Speculators who anticipate rise in the price of securities in future and so they buy securities in the present to sell them in future when the prices rise.

Carry Over: Postponing the settlement of a transaction to the next settlement day on payment of badla charges.

Contango: Badla charges paid by the buyer (bull) for the postponement of transactions to the next settlement date.

Contract Note: **A** statement sent by the broker to a client showing details of securities (including price) bought or sold on behalf of the client.

Cum-div: When the shares are quoted cum-div, the buyer gets a right to receive the dividend on such shares, payable or declared after the sale of such securities.

Ex-div: When the shares are quoted ex-div, the buyer is not entitled to receive the dividend to be declared or payable after the sale of such shares.

Forward Delivery Contract: A contract for purchase or sale of securities the settlement of which can be postponed to the next settlement day.

Jobber: A member of a stock exchange who buys and sells securities in his own name.

Margin: A deposit made by the customer with the broker to cover the anticipated loss.

Ready Delivery: A contract settled within seven days of the transaction i.e., on the settlement day fixed by the stock exchange.

Remisier: **A** person who helps in securing business for the broker.

Sauda Bahi: A note book used by brokers for daily record of purchases and sales of securities made on the floor of the stock exchange.

Scrips: Securities like shares, debentures, bonds, etc.

Settlement **Day:** The day fixed for the settlement of transactions on a stock exchange.

Speculation: Dealings in securities with the object of making profit from the difference in prices.

Spot Delivery: Contract settled on the same day on which the transaction takes place.

Stags: Speculators having bullish tendency, who apply in bulk for new issues of securities and sell them in the market soon after the allotment is made to them.

Stock or Securities Market: An organised market place on the floor of which securities are bought and sold.

Tarawaniwala: A member of the stock exchange who acts as a broker as well as a jobber.

7.14 SOME USEFUL BOOKS

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

Ramesh, M.S. 1985. *Principles & Practice of Modern Business Organisation, Administration & Management,* Kalyani Publishers: New Delhi. (Volume III, Chapter 17).

Singh, B.P., and T.N. Chhabra, 1988. *Business Organisation* and *Management,* Kitab Mahal: Allahabad. (Section Five, Chapter 19).

Sohni, S.K. 1985. *Stock Exchanges in India—Practices Problems Prospects,* North Publishing Corporation: Delhi.

7.15 ANSWERS TO CHECK YOUR PROGRESS

A 1 a) iii b) iv c) iii

B 4 i) True ii) True iii) False iv) True v) True

5 i) bull ii) 7 iii) backwardation iv) rigging v) cum

C 3 i) False. ii) True iii) True iv) True v) False
vi) False vii) True viii) False ix) False

4 i) new ii) continuous iii) down iv) rises/increases

D 1 i) True ii) True iii) False iv) True

2 a) iii b) iv c) iii d) i e) i

7.16 TERMINAL QUESTIONS

1 Define a stock exchange and explain fully its economic functions.

2 Explain briefly the importance of stock exchange in a modern society. What are its shortcomings?

3 Why is the stock exchange called a barometer of the economic and business conditions in a country?

4 Explain the following terms used in connection with dealings of securities.
i) Arbitrage ii) Forward Delivery Contracts iii) Bull iv) Rigging v) Contango
vi) Cum-dividend vii) Margin Trading viii) Authorised Clerk.

5 Why do prices of securities traded on a stock exchange fluctuate widely and frequently'? Discuss tlie causes briefly.

6 What do you mean by listing? State briefly the advantages of listing securities on a stock exchange from the point of view of a company and an investor.

7 Describe the method of trading on a stock exchange. State tlie procedure to be followed if you decide to sell *500* shares of a conipany which you hold. The shares were allotted to you at par value of Rs. 10 each.

8 What were the reasons of passing the Securities Contract (Regulation) Act, 1956? State its main features.

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

APPENDIX TO
UNIT 6: SOURCES OF LONG-TERM FINANCE AND UNDERWRITING

Ever since the Government of India initiated the economic liberlisation programme in 1991, there are several developments in capital market. Hence there is a need to revise this unit to incorporate all such changes. Some of the major developments in the capital market which are relevant to you are discussed in this Appendix.

In Section **6.3.1** Capital Market of this Unit, the discussion on Control of Capital Issues (pages 26 & 27) is to be deleted. This delition is necessary in view of the abolition of the Controller of Capital Issues in June 1992.

In section **6.3.4** Foreign Sources (Page 31) we have discussed three main foreign sources viz., foreign collaborators, international financial institutions and non-resident Indians, as sources of long-term finance. In this context you have to add International Capital Market as the fourth source. From 1992 onwards Government of India permitted Indian companies to raise capital in the international capital markets in the form of Global Depository Receipts (GDRs) and Bonds. This is briefly stated under point 12 of Capital Market Reforms discussed below.

CAPITAL MARKET REFORMS

The Government of India initiated several capital market reforms, as part of economic reforms programme started in June 1991. The capital market reforms programme of the government is mainly aimed at protecting investors' interest, improving market efficiency, making stock market transactions more transparent, curbing unfair trade practices, and bringing Indian capital market upto international standards. The main aspects of capital market reforms are listed below:

1. **Abolition of** Controller of Capital Issues : Capital Issues (Control) Act 1947 was repealed and the office of the Controller of Capital Issues (CCI) was abolished in June 1992. Thus, all the controls over price and premium of shares were removed. Companies are now free to approach capital market whenever they want and fix the premium on shares as they wish, after getting clearance from Securities Exchange Board of India (SEBI).

2. Statutory Recognition to SEBI: Statutory recognition was granted to the Securities Exchange Board of India (SEBI) in February 1992 to regulate and reform the capital market in India. SEBI has been vested with powers concerning various aspects of the capital market such as (a) regulating the stock exchanges, various intermediaries and mutual funds, (b) promoting investor's education and training of intermediaries and (c) prohibiting insider trading, fraudulent and unfair trade practices in the securities market. SEBI initiated several measures in this direction.

3. Measures in the Primary Market: New reforms by SEBI in the primary market included improved disclosure standards in the public issue documents, introduction of prudential norms and simplifications of issue procedures. Companies are now required to disclose all material facts and specific risk factors associated with their projects while making public issues. All the issue documents are to be compulsorily vetted by SEBI to ensure that the disclosures are not only adequate but also authentic and accurate, so that the investors in the primary market are able to take informed investment decisions.

   'Merchant Banker' and 'Banker to the Issue' are brought under the regulatory frame work of SEBl and a code of conduct issued.

   The due diligence certificate by lead managers regarding the disclosures made in the offer document has been made a part of the offer document itself for better accountability and ttansparancy on the part of the lead managers.

   SEBI introduced a code of advertisement for public issues for ensuring fair and truthful disclosures. To reduce cost of issue, underwriting of issues is made optional. However, this is subject to the condition that if an issue was not underwritten and was not able to collect 90 per cent of the amount offered to public, the entire amount collected would be refunded to the investors.

UNIT 8 ADVERTISING

Structure

8.0 Objectives
8.1 Introduction
8.2 What is Advertising?
8.3 Difference Between Advertisement and Publicity
8.3.1 What is Publicity
8.3.2 How Does Advertisement Differ from Publicity?
8.4 Objectives of Advertisement
8.5 Role of Advertising in the Society
8.5 1 Arguments Against Advertising
8.5.2 Arguments in Support of Advertising
8.6 Essentials of an Effective Advertisement
8.6.1 Features Relating to the Message
8.6.2 Features Relating to ConsumerReacl.
8.7 Let Us Sum Up
8.8 Key Words
8.9 Some Useful Books
8.10 Answers to Check Your Progress
8.11 Terminal Questions

8.0 OBJECTIVES

After reading this unit, you should be able to:

- define advertisement
- distinguish between advertisement and publicity
- identify the purposes of advertising for a business firm
- appreciate the role of advertising in the society
- outline the features of an effective advertisement

8.1 INTRODUCTION

While listening to the radio, or viewing television, or reading a newspaper/magazine, or walking on a street, you must have come across a number of advertisement messages. These messages mostly appeal to people to buy certain products or services. Indeed, advertisements are used by companies to communicate how their products or services may be of use to customers. In modem industrial economies, advertising plays a very important role acquainting the public with the nature and quality of products or services available in the market.

In this Unit we shall discuss what is meant by advertising, how it is different from publicity, the objectives of advertising, the role of advertising in the society and tho features of an effective advertisement.

8.2 WHAT IS ADVERTISING?

Let us start with an understanding of what is meant by advertising. The American Marketing Association has defined advertising as "any paid form of non-personal presentation of ideas, goods or services by an identified sponsor". This definition includes the following four expressions:

i) Paid form
ii) Non-personal presentation
iii) Ideas, goods and services
iv) . Identified sponsor

To understand the definition clearly, it is necessary to clarify these expressions. Let us discuss these expressions in detail.

i) **Paid form:** For every advertisement, some money has to be paid to the mediurr which carries the message. For instance, if the message is published in a magazine, payment must be made for printing and the space used in that magazine. If the matter is printed without any charge, it will not be treated as an advertisement

ii) **Non-personal presentation:** When a salesman directly talks to the customer about any product, it is personal presentation. If the message is communicated through mass media like radio, television, newspaper, magazine, direct mail, hoardings, etc., it is called non-personal presentation. In the case of advertising, the message is conveyed through non-personal media. In other words, there is no face-to-face communication by salesmen. It implies that if the message is presented to the customer by a salesman, it would not be treated as advertising.

iii) Ideas, goods and **services:** This implies that advertising may be intended to helt selling not only goods but also ideas and services. For instance, banks, insurance companies, airlines, restaurants, *dry* cleaners, and similar organisations advertise their services and ideas underlying the usefulness of savings, travelling, eating palatable food, etc.. just as manufacturers of automobiles, soaps or hair oil advertise the usefulness of their products. Thus, the phrase ideas, goods and services explains that advertising is concerned with much more than the promotion of only tangible goods.

iv) Identified **sponsor:** The sponsor of an advertisement is the advertiser. The phrase identified sponsor means that the producer or seller who advertises the product should be known through the advertised message. In other words, the receiver of the message should be able to identify both of source and purpose of the advertisement. If it is not sponsored by any individual or institution, it would not come under advertisement.

Now look at the message presented in Figure 8.1 carefully. We shall analyse this message to find out whether it may be treated as an advertisement or not. First, the message is printed in the newspaper which is a non-personal medium. Secondly, the payment must have been made to the newspaper in which it appeared. Thirdly, the message is about the quality of a product—OCM suitings the perfect fabric. Fourthly, the name of the sponsor or advertiser i.e., VXL India Ltd., is clearly mentioned. It is also obvious that the purpose of the advertisement is to induce customers to buy OCM suitings. We may, therefore, conclude that the printed message in Figure 8.1 is an advertisement. The points to be noted in this advertisement are:

Product	:	OCM Fabric (Textiles)
Medium	:	Newspaper
Message	:	OCM Suitings the perfect fabric, *A* prodhct of VXL India Ltd.
Sponsor		VXL India Ltd.
Payment	:	The sponsor of the message paid for printing and space used in the newspaper at the rates fixed by the publishers.

Check Your Progress A

Look at Figure 8.2 and examine it carefully. Write down the particulars relating to the media, product, message and sponsor. State whether you can call it an advertisement. While doing this exercise, you may refer to Figure 8.1

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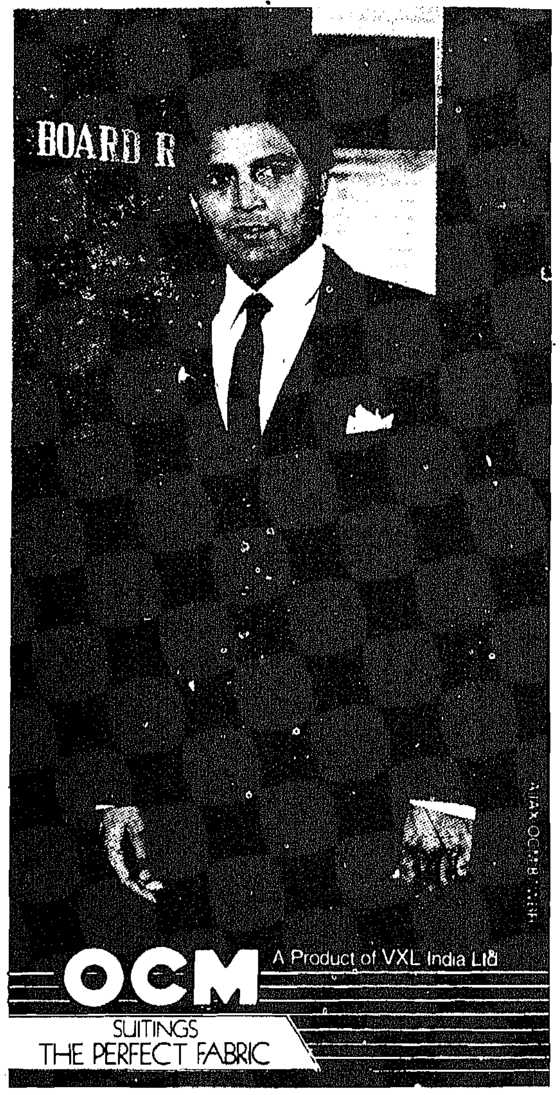
Figure 8.1 Example of an Advertisement



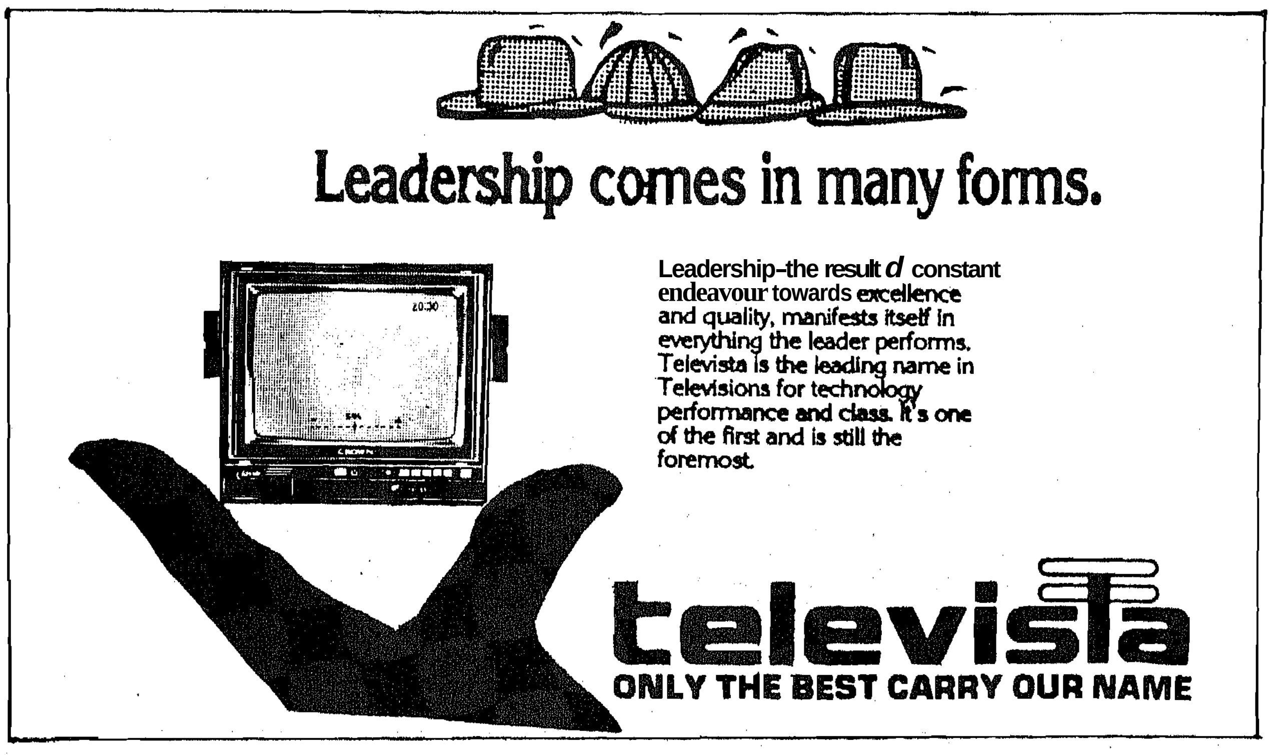
OCM

A Product of VXL India Ltd

SUITINGS
THE PERFECT FABRIC

Source : Produced from a newspaper

Fig. 8.2



Leadership comes in many forms.

Leadership-the result d constant endeavour towards excellence and quality, manifests itself in everything the leader performs. Televista is the leading name in Televisions for technology performance and class. It's one of the first and is still the foremost.

televista

ONLY THE BEST CARRY OUR NAME

8.3 DIFFERENCE BETWEEN ADVERTISEMENT AND PUBLICITY

Is advertisement different from publicity? Sometimes advertisement and publicity are wrongly interpreted to mean one and the same-thing. In fact, advertisement is different from publicity. Before we discuss how they are different, let us first understand what publicity is.

8.3.1 What is Publicity?

Publicity refers to the communication of any non-sponsored commercially significant information about a company or its product to the public through non-personal media without any financial charge to the company. In this explanation you can notice the following four expressions:

i) Non-sponsored
ii) Commercially significant information
iii) Through non-personal media
iv) Without a financial charge to the company

Let us now discuss these four expressions in more detail to understand the meaning of publicity very clearly.

i) Non-sponsored: The information is not sponsored by the company. It is published or communicated voluntarily by the media. In other words, there is no sponsor of the publicity material.

ii) Commercially significant **information:** Information about the company or its product, are communicated in publicity. The information should be commercially significant to the company.

iii) **Disseminated** by non-personal **media:** The information may be presented by non-personal media like radio, television, newspaper or magazine, etc. The mqsage may be conveyed through discussions or debates (as in radio or TV), or editorial or news items (as in newspapers or magazines).

iv) **Without a financial** charge to the company: The publicity matter is presented voluntarily by the media. There is no payment made by the company to the media for disseminating that information.

Publicity may be favourable or unfavourable to the company. When the publicity favourably reports about a product, it can positively influence the demand, for that product. On the other hand, unfavourable publicity may lead to reduced sale of the product. Let us consider some simple examples of favourable and unfavourable publicity. You may have read film reviews in magazines or newspapers. These reviews are written by the magazine or newspaper staff. The producer of the film is in no way connected with it. In these reviews, there are comments on the story, music, photography, performance of main artists, etc. These reviews count as publicity. If the comments in the review are not good, the readers have a negative impression about the film and they are not eager to see the film. This is an example of unfavourable publicity. If the comments are good in the review, there is a positive impression about the film in the mind of the reader and many of them will see it. If is an example of favourable publicity.

In an attempt to obtain favourable publicity, companies engage in public relations. These public relations activities do not come under the purview of marketing department. It is, normally, managed by a special department called Public Relations Department.

Check Your Progress B

Look at the film review presented below. It is an example of publicity. Read it carefully and state with reasons whether it would have positive or negative influence on readers.

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Sunday TV films

"Aaina"

(Hindi/1974/5-45 p.m.)

A melodramatic tale of a family immersed in trouble. Its increasing problems are made more problematic by the quick multiplication of children with the priest father gradually being denuded of clients. The harassed mother is forever complaining — what with six children to support and a new one on the way.

Luckily, the eldest sister is a loving kind and keeps the younger ones happy by playing and telling them stories. Once she decided to play the role of an all-powerful Devi and asked the kids to name their wishes and they shall be fulfilled. Little did she realise then that the role would stick to her for ever.

Time comes when she had to take up the role of the mock drama in real life in order lo feed the hungry mouths. Initially, she takes up a job but finally lands in the world's oldest profession as the family demands go up. The climax comes when the "goddess Didi" is disowned by all those whom she supports and brings up.

Her only solace in those days is themirror in which she keeps looking at her face and there is a sympathetic friend too. Dialogue is rather well worded and on the whole a well made film within the formula format.

K. Balachander, the multi-lingual South Indian movie maker, directs one of his early Hindi ventures. There is fine music by Naushad and the lead role is played by Mumtaz rather poignantly. Others include Rajesh Khanna, Nirupa Roy and Hangal.

8.3.2 How does Advertisement Differ from Publicity?

We have learnt what advertising is and what publicity is. Now we are in a position to analyse the difference between these two. Read Table 8.1 carefully. The characteristics of both advertising and publicity are presented. After reading this table, you should be able to make out the difference between these two terms.

Table 8.1

Features of Advertising and Publicity

Particulars	Advertising	Publicity
1 Media	Presented by non-personal media such as radio, TV, newspaper, magazine, etc.	Presented by non-personal medium such as radio. TV, newspaper, magazine, etc.
2 Sponsor	There is an identifiable sponsor. Normally a company sponsors it for its product or service.	There is no identifiable sponsor. Media present the information voluntarily.
3 Payment	The company has to pay money to the media for the space or time used.	Company does not make any payment to the media.
4 Purpose	It is intended to give a favourable impression about the company or its product.	It may have a favourable or unfavourable influence on the public about the company or its product.

Check Your Progress C

1 Read Table 8.1 carefully and point out the similarities and differences between advertising and publicity.

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2 Three cases are presented below. Briefly explain whether they can be called advertisement or publicity or none of the two.

i) A sales representative from a drug manufacturing company visited a doctor, and explained to him the usefulness of various drugs manufactured by that company.

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ii) Mrs. Renu uses 'Vajradanti' tooth paste regularly. One day she told her neighbour Mrs. Kamala that Vajradanti is the best tooth paste available in India. After this, Mrs. Kamala also started using Vajradanti tooth paste.

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iii) One car manufacturing company advertised that their car gives 15 km per a litre of petrol consumed. After a few months, one leading newspaper published an article stating that the car gives only 10 km per a litre and that the manufacturers are misleading the public. After the publication of this article, there is a slight drop in the sales of the car.

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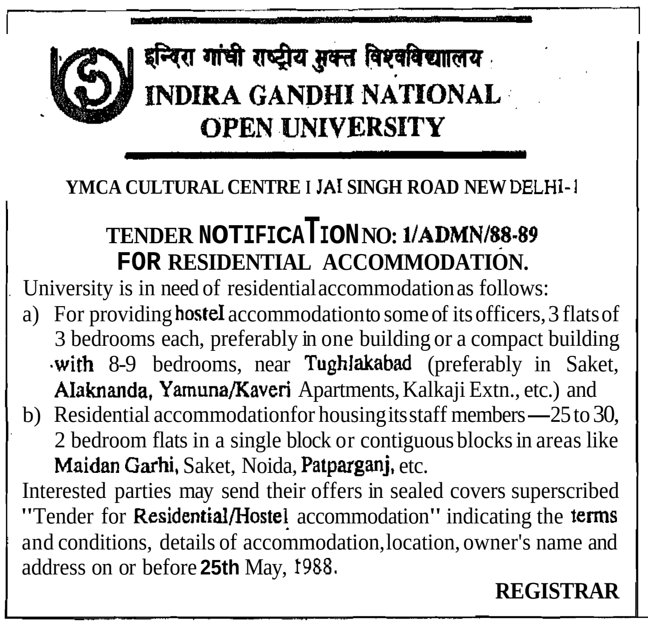
3 Look at the two items presented below. Study them carefully and identify which is an advertisement and which is publicity. Give your reasons.

Item I



इन्दिरा गांधी राष्ट्रीय मुक्त विश्वविद्यालय
INDIRA GANDHI NATIONAL OPEN UNIVERSITY

YMCA CULTURAL CENTRE I JAI SINGH ROAD NEW DELHI-1

TENDER NOTIFICATION NO: 1/ADMN/88-89 FOR RESIDENTIAL ACCOMMODATION.

University is in need of residential accommodation as follows:

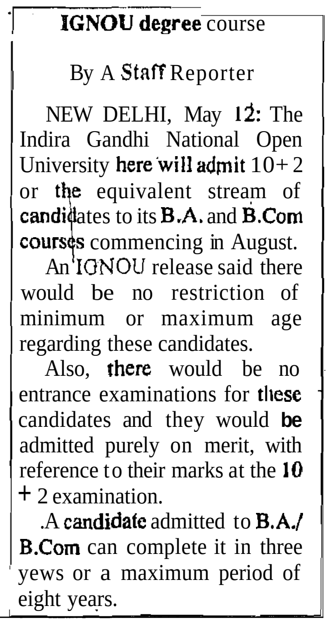
a) For providing hostel accommodation to some of its officers, 3 flats of 3 bedrooms each, preferably in one building or a compact building with 8-9 bedrooms, near Tughlakabad (preferably in Saket, Alaknanda, Yamuna/Kaveri Apartments, Kalkaji Extn., etc.) and

b) Residential accommodation for housing its staff members—25 to 30, 2 bedroom flats in a single block or contiguous blocks in areas like Maidan Garhi, Saket, Noida, Patparganj, etc.

Interested parties may send their offers in sealed covers superscribed "Tender for Residential/Hostel accommodation" indicating the terms and conditions, details of accommodation, location, owner's name and address on or before 25th May, 1988.

REGISTRAR

Item 11



IGNOU degree course

By A Staff Reporter

NEW DELHI, May 12: The Indira Gandhi National Open University here will admit 10+2 or the equivalent stream of candidates to its B.A. and B.Com courses commencing in August.

An IGNOU release said there would be no restriction of minimum or maximum age regarding these candidates.

Also, there would be no entrance examinations for these candidates and they would be admitted purely on merit, with reference to their marks at the 10 + 2 examination.

.A candidate admitted to B.A./B.Com can complete it in three yews or a maximum period of eight years.

8.4 OBJECTIVES OF ADVERTISEMENT

You have learnt what advertising is and how it is different from publicity. We will now discuss the objectives of advertising. Business firms advertise with one or more of the following objectives,

1 Introduction of new products
2 'Inducing potential customers to buy
3 Reminding users
4 To create brand image
5 To intimate customers about new uses of a product
6 To highlight brand character
7 Dealer support
8 Trafficking the retail trade
9 Miscellaneous

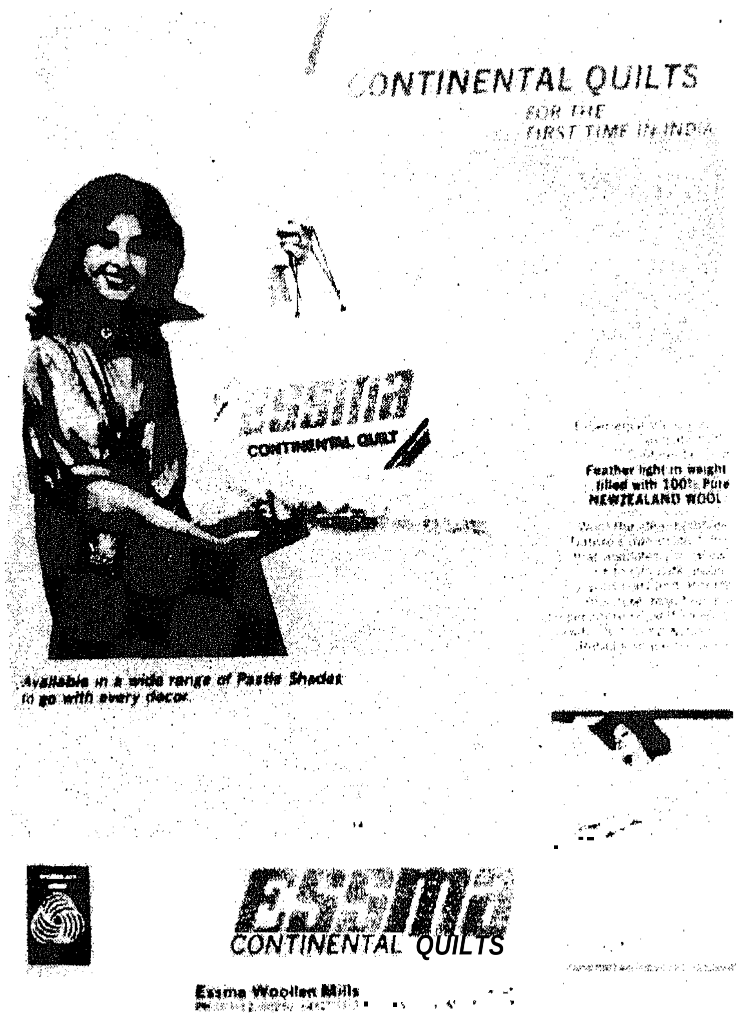
1 **Introduction of new products:** Manufacturers Introduce new products from time to time so as to compete with other manufacturers who might have succeeded in winning over customers of the existing product. Advertising the new product is necessary so

that consumers know about the introduction of the product, its usefulness, where it may be available, how to get more information about the product, etc. Indeed, advertising is highly important to promote the sale of new products.

For example look at Figure 8.4. You can see how Essma Woollen Mills advertised when it introduced the Continental Quilts.

Figure 8.4

Advertisement introducing a new product. It explains the features of a new product and also give address for trade enquiries.


CONTINENTAL QUILTS
FOR THE
FIRST TIME IN INDIA
Essma
CONTINENTAL QUILT
Feather light in weight
filled with 100% Pure
NEWZEALAND WOOL
Available in a wide range of Pastle Shades
to go with every decor.
ESSMA
CONTINENTAL QUILTS
Essma Woollen Mills

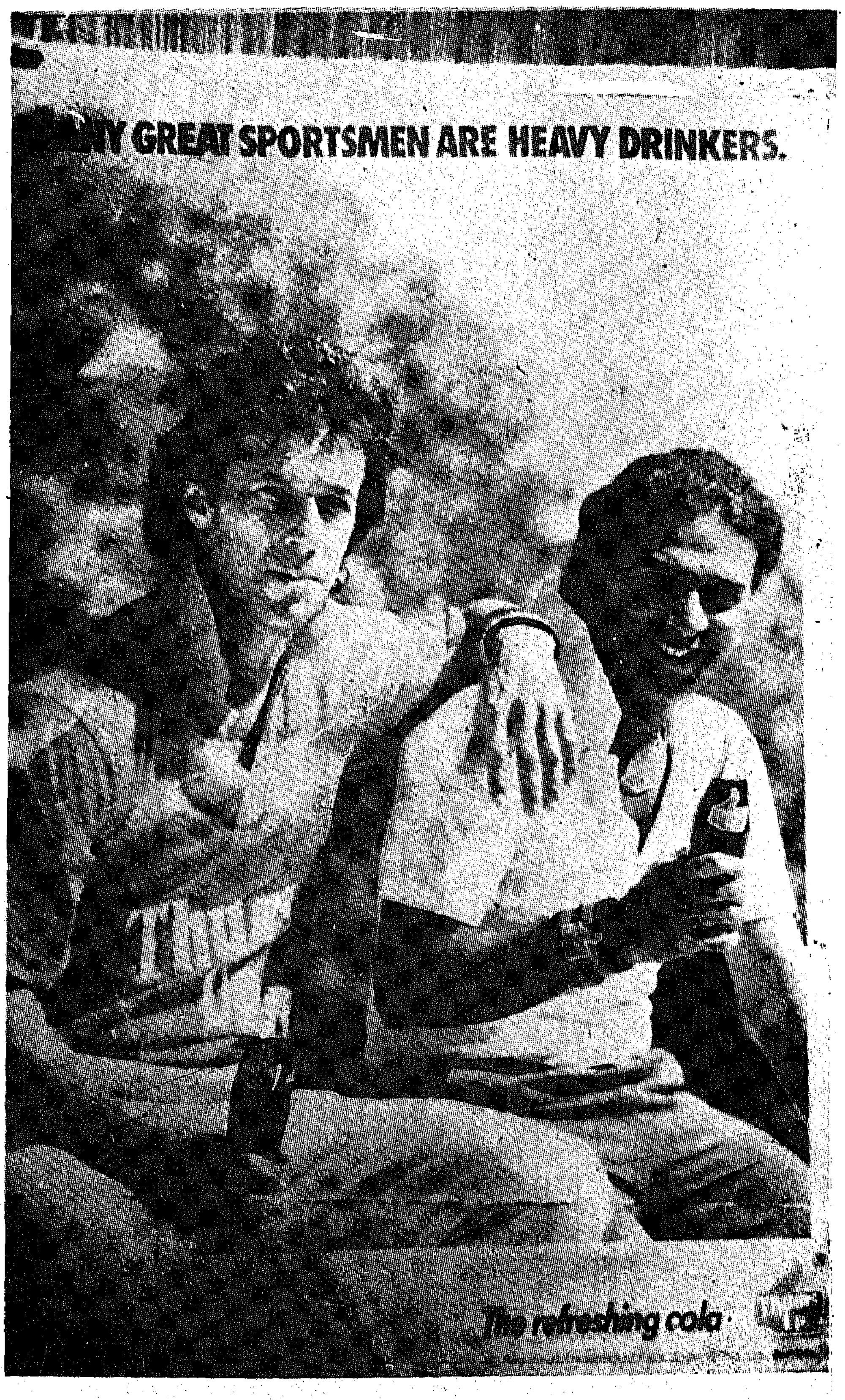
2 Indúcing potential customers to buy: Another important objective of advertising - to induce potential customers to buy the product. Advertising is one of the best means by which the sale of an existing product can be increased. For this purpose, the advertisement should emphasise the usefulness of the product, its quality, price advantage, etc., so as to win over potential buyers and make them actual buyers. If the product is so advertised, traders expect sales to increase and keep larger stocks for sale. Thus, advertising leads to immediate buying action among customers as well as traders.

3 Reminding users: In a competitive market new products are introduced quite frequently by different firms. All these products are advertised in the market. As a result, old brands are likely to be forgotten by the consumers. To offset this possibility, manufacturers continue to advertise their products to maintain the buyers' interest. Thus, advertisements are also designed to. serve as a reminder to existing customers.

4 To create brand image: Business firms very often advertise for establishing an image for the product (brand) and create customer loyalty for that product. When customers develop brand loyalty, they are not inclined to shift to other brands easily. This objective of advertising has great significance in the case of well-known manufacturers of products.

Look at the advertisement for 'Thums Up' soft drink presented in Figure 8.5. The sentence at the top says, 'many great players are heavy drinkers' and shows two great cricket players enjoying the drink. It is mainly intended to create an image that Thums Up is a refreshing drink which is accepted by many great players. The brand name of the drink 'Thums Up' is impressed upon the public by associating it with two great players.

Figure 8.5
Advertisement Intended to Create Brand Image

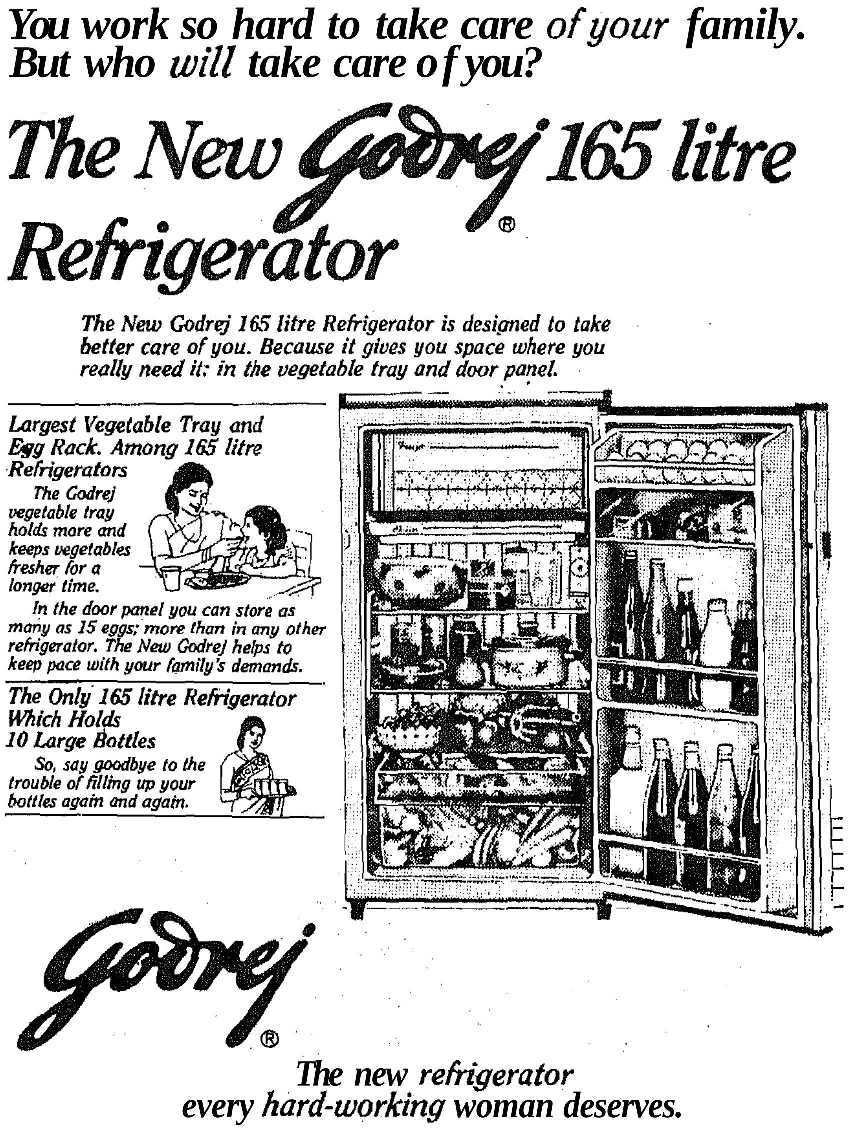

Y GREAT SPORTSMEN ARE HEAVY DRINKERS.
Thu
The refreshing cola

5 **To intimate customers about new uses of a product:** Advertising is sometimes used to convey new uses of an existing product to the customers or to draw their attention to some new features of the product. The basic objective of advertising in this case is to convince the customers about the superiority of a product in comparison with other products in the same line.

6 **To highlight brand character:** For certain products. consumers feel that a particular characteristic is very important. Its existence determines the buyers' choice of a particular brand out of several brands. If the product has that feature, advertising is used to stress it and demonstrate its advantages. Similarly, if the product has a special feature which is linked with a desirable consumer benefit, advertising is used to emphasise it.

Look at the advertisement presented in Figure 8.6. It says how godrej 165 litre refrigerator is designed to establish its superiority over the other refrigerators.

Figure 8.6
Advertisement Highlighting the Rrand Character



You work so hard to take care of your family. But who will take care of you?

The New Godrej 165 litre Refrigerator ®

The New Godrej 165 litre Refrigerator is designed to take better care of you. Because it gives you space where you really need it: in the vegetable tray and door panel.

Largest Vegetable Tray and Egg Rack. Among 165 litre Refrigerators

The Godrej vegetable tray holds more and keeps vegetables fresher for a longer time.

In the door panel you can store as many as 15 eggs; more than in any other refrigerator. The New Godrej helps to keep pace with your family's demands.

The Only 165 litre Refrigerator Which Holds 10 Large Bottles

So, say goodbye to the trouble of filling up your bottles again and again.

Godrej ®

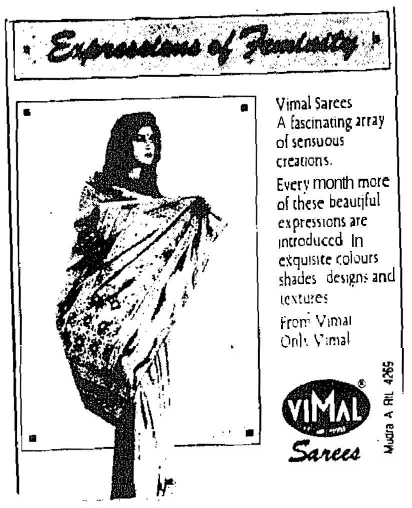
The new refrigerator every hard-working woman deserves.

7 **Dealer support**: Sometimes the aim of advertisement is to provide support to dealers and **distributors.** Thus, there are many advertisements in newspapers, in which the list of dealers and distributors are mentioned along with the particulars of the product.

Look at the Figure 8.7. In this advertisement, apart from certain details about the product, a list of dealers is also presented at the bottom.

8 **Trafficking the retail trade (increasing retail sale):** On certain occasions, the objective of advertisement is to increase retail sale through off-season or special festival discounts, gift schemes, clearance sales, etc. The objective of such advertisements is to draw the attention of customers towards the special offers.

Figure 8.7
An Advertisement Giving the List of Dealers



Expressions of Feminity

Vimal Sarees
A fascinating array of sensuous creations.

Every month more of these beautiful expressions are introduced In exquisite colours shades designs and textures

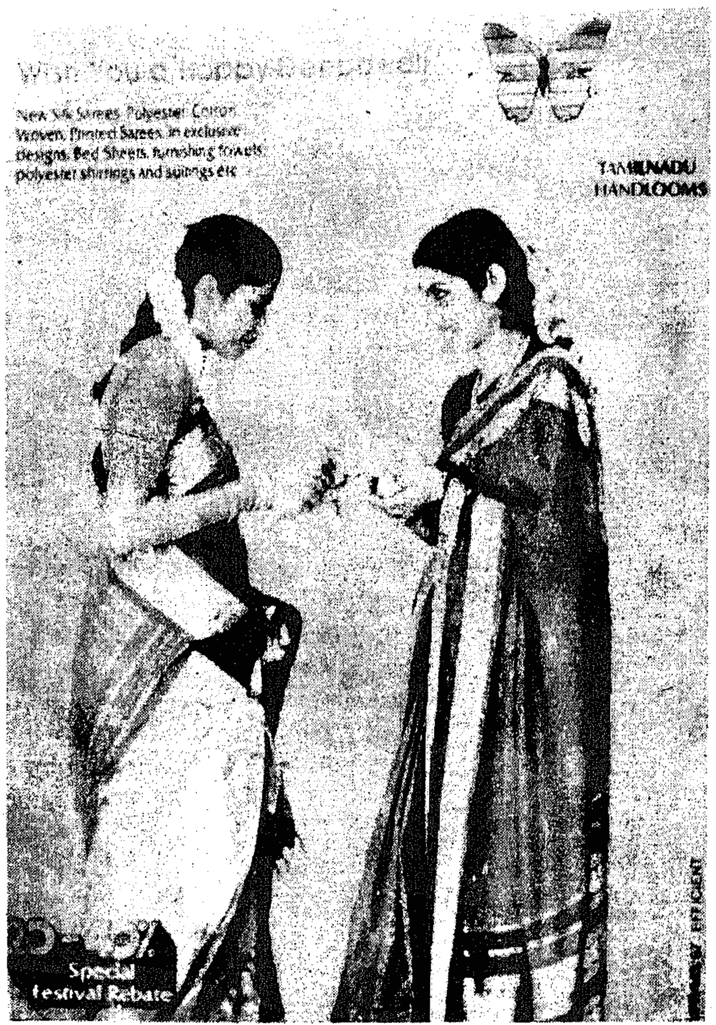
From Vimal
Only Vimal

VIMAL SHOWROOMS — THE LARGEST NATIONWIDE RETAIL NETWORK-67 IN DELHI AND 1200 ALL OVER INDIA.

Authorised showrooms in West Delhi: Jyoti Textiles, C-4, E Market, Janakpuri • Kumar Deep Nangal Raya, Jail Rod • Gupta Textiles AI Shopping Centre, Shalimar Bagh • Krishna New Market, Tilak Nagar • Libas Main Market, Uttam Nagar • Vimal Deep Main Market, Rajouri Garden • Kataria Textorium Krishnapuri, Sangam Market, Near Vikas Puri Ean. • Nitin Textiles B-2/35, Janakpuri. • Tilak Textiles 1137 O, Main Road, Najafgarh.

Study the advertisement presented in Figure 8.8. earefully. Along with the infonnation regarding product range. it gives infonnation about 20-40% speeial festival rebate offered by Co-Optex Tamilnadu Handlooms.

Figure 8.8
Advertisement Intended for Trafficking Ihe Retail Trade



New Silk Sarees, Polyester Cotton Woven, Printed Sarees, in exclusive designs, Bed Sheets, furnishing towels polyester shirtings and suitings etc

9 Miscellaneous: In some cases the objective of the advertisement is to inform the customers in remote areas which are not accessable to salesmen. Similarly, it is also aimed at informing customers in far off places or outside the country about new products.

8.5 ROLE OF ADVERTISING IN THE SOCIETY

In the previous section you have learnt about the objectives of advertising and the usefulness of advertising for an individual firm. From the social point of view, it may be said that advertisement has a positive effect on economic development. But this point of view is not accepted by all. There are arguments both for and against the use of advertisement in society. Let us first examine the arguments against advertising from the social point of view.

8.5.1 Arguments Against Advertising

1 Advertising leads to higher prices: Many hold the view that advertising leads to higher prices of goods. Advertising involves considerable expenditure. If that expenditure is avoided, the cost of goods may be reduced and the consumer can get the product at a cheaper price. If the money spent on advertising is used for improving the quality of the product, consumers may get a better product for the same price.

2 Advertising leads to monopoly: It is well known that large business firms establish brand image through advertising. Consumers develop brand loyalty. Then it becomes difficult for new producers to enter the market. In other words, advertising enables the existing large producers to block new competitors from entering the market. Thus, advertising acts as a barrier to entry and thereby leads to monopoly. Moreover, increased advertising often results in increased sales. Due to this possibility, established firms spend more and more on advertising and increase their sales. In this process they earn larger profits which enable them to spend even'more on advertising. Thus, new entrants who do not have large financial resources find it difficult to compete with such established firms.

3 Advertising results in inefficient resource allocation: Advertisements are intended not so much for the benefit of consumers. They are mainly directed to influence the consumer demand to fit whatever has been produced. In other words, advertisements are aimed mainly to change the tastes of people so that they will buy whatever is manufactured. This leads to distortion in consumption expenditure and increases the producers market power. Thus, advertising indirectly determines what people should consume. In this process productive resources i.e., land, labour and capital, may not be used in the best interest of the society.

4 Advertising causes undesirable social effects: There are certain other criticisms about the social effects and cultural impact of advertising.

a) Objectionable appeals like sex, horror, etc., are used in advertisements to attract the customers' attention.

b) Consumers are exposed to hundreds and thousands of product appeals which they may not be able to buy and enjoy. This may create frustration and disappointment in many cases.

c) Advertising is used for promoting objectionable and harmful goods like cigarettes, liquors, etc.

d) It influences the values and life styles of people in society. Often it is used to promote products that satisfy the materialistic requirements of consumers. Advertising is, thus, accused of promoting materialistic values in the society.

e) Advertisements occasionally portray certain things objectionable to some sections of the society creating tensions between different groups of people.

5 Advertising may act against the freedom of press: Mass media earn huge income from advertisements. If the media are dePendent on income from advertisements sponsored by la few large business firms, it may be difficult to disseminate infonnation in public interest when it is unfavourable to those big business firms. Big sponsoring firms can threaten the media owners by refusing their advertisements and dictate what media have to do. Thus, the financial dependence of media on advertisements may act against the freedom of press.

6 Advertising encourages unnecessary competition: There is a distinction between informative advertising and competitive advertising. Informative advertising is that which passes on the useful information about a product or service to the customers. Such advertising is desirable. On the other hand, the competitive advertising is primarily meant to shift demand from one brand to another brand. In this case the advertisement has not created any additional demand. Therefore, such advertising is undesirable. In some cases, even the product features mentioned in the advertisement do not compare with the product when inspected. This type of misleading advertising is all the more undesirable.

8.5.2 Arguments in Support of Advertising

We have noted above that advertising is not always beneficial to society. However, it offers certain advantages as well. The arguments in favour of advertising run as follows:

1 Advertising leads to reduction in the cost of goods: Some people hold the opinion that advertising may lead to a reduction in the cost of goods. When consumers come to know about any product through advertisements, the demand for that product increases and production is increased accordingly. Increase in production leads to economies of scale. The benefits resulting from the economies of scale offset the cost of advertising. On the whole, the cost of production need not necessarily increase due to advertising. Besides, advertising costs are much less than other forms of business communication like personal selling. In the absence of advertising, business firms may adopt other more expensive methods.

2 Advertising need not necessarily lead to monopoly: It is not always true that advertising results in monopoly. It cannot be said that the first advertiser always wins the consumers' patronage and the later entrants have a disadvantage due to late entry. There is no evidence to believe that increased advertising always results in increased sales. The fact that the soap and cigarette manufacturers constantly introduce new brands shows that the consumers like some novelty. If the new entrant has a better product, there is always a better chance of its acceptance by consumers. There are many instances of new comers successfully competing with entrenched leaders.

3 Advertising directs allocation of resources according to demand: By creating demand for goods, advertising influences the allocation of resources. It informs people about products available in the market. Based on this information, consumers choose and buy those products which satisfy their needs more effectively. Thus, the goods which satisfy consumer needs better are more in demand, and manufacturers allocate their resources accordingly. Thus, advertising directs the allocation of resources in accordance with the demand for goods and contributes to economic development.

4 Advertising and social values: It is argued that the social values and customs are subjective. What is objectionable to one person may not be objectionable to another person. Similarly, what is good at one point of time may not be good at another point of time. It is accepted that advertising is misused occasionally by unscrupulous businessmen. But advertisement as such should not be blamed for its misuse. This misuse of advertisement may be controlled through statutory regulations.

5 Advertising encourages autonomy of mass media: Mass media such as newspapers and magazines earn huge income from advertisements which make the media financially self-supporting, Thus, the publishers of newspapers and magazines are able to sell them at a fairly lower price. Without advertisements the price of newspapers and magazines would be much higher. The earnings from advertisements make the media financially self-supporting. Because of this financial autonomy, media can publish matters of public interest freely and frankly. Thus, advertising may be said to increase freedom of the prices.

6 Advertising provides useful information: It is through advertisement that consumers get useful information relating to products, prices, quality, terms of sale, servicing, etc. It is the main sources of information, particularly for those who live in remote areas and cannot be approached by salesmen. Thus, advertising plays an informative role which is beneficial to consumers.

7 Advertising generates employment: A point in favour of advertising is that it generates employment. A large number of artists, designers, models, technicians, etc., work in advertising agencies and mass media, and earn their livelihood.

8.6 ESSENTIALS OF AN EFFECTIVE ADVERTISEMENT

As you know, the ultimate purpose of advertisement is to induce the customers and influence them to buy the goods and services. To be effective, the advertisement must have right type of message communicated through proper media so as to reach the right people at the right time and at the lowest cost possible. To achieve this, advertisement should be properly planned and designed. Otherwise, it will fail to achieve its purpose and the money spent on it will be a waste.

Designing an effective advertisement'is a challenging task. There is no definite formula for that purpose. But certain guidelines may be kept in view while designing an advertisement. The essential characteristics of a good advertisement may be divided into two broad categories:

1) Features relating to the message
2) Features relating to consumer reach

Let us discuss each of these types of characteristics in detail.

8.6.1 Features Relating to the Message

The impact of an advertisement depends not only upon what is said about the product, but also how it is said. The message should be such as to win the attention and interest of the target audience. So, while designing the advertisement message, one should keep the following points in mind.

1 **Desirability:** The message should say something desirable and interesting about the product. Otherwise, the advertisement may fail to induce the customers to buy the product.

2 **Exclusive:** Customers should know how the product advertised is better than the other products. So, the advertisement message should point out the unique features of the product. In other word;, it should say something exclusive or distinctive about the product which does not apply to any other brand in that product category. Then only people may realise why and how the product is better than others.

3 **Believable:** Whatever is stated in the message should be believable. For instance, if the message conveys imaginary qualities of any product, people will never take the advertisement seriously. The message should actually compare with the product which the customer may verify so as to be convinced. Therefore, the message should be believable and provable.

4 **Attractive:** If the message is attractive, it will draw the attention of the customers very easily. If the message is not catchy, it will not have any effect on the minds of people. Therefore, such words or pictures which may draw the attention of customers should be used in the advertisem'ent.

5 **Memorable and easy to recall:** The message should be easy to remember, so that it may be easy to recall it. Whenever customers go for shopping, the advertisement message should come to their mind and remind them about the product. Therefore, the words used in the message should be easy to memorise and recall.

8.6.2 Features Relating to Consumer Reach

Apart from the message, the impact of an advertisement also depends on how well it reaches the target customers. For this purpose, the following points should be borne in mind while designing the advertisement.

1 **Appropriate media:** The advertisement message should be presented through the media to which the target customers have access. For example, if the majority of the target customers do not have television sets, the message presented by TV transmission will not reach them. Similarly, if the majority of customers are illiterate, the message presented in newspapers may not reach them. So, the use of appropriate media is highly important for the effectiveness of advertisements.

2 **Frequency:** Frequency refers to the number of times any advertisement is repeated within a specified period of time. It also refers to the time gap between two or more

advertisements. In other words, it refers to how many times and at what intervals the advertisement is repeated. The main purpose of repetition is to keep the message alive in the memory of the customers. If the frequency is less, people may not remember the message. If the frequency is more, people may get irritated and may stop giving attention to it. So, the frequency should be optimum.

3 **Timing:** The specific time of advertising the message is an equally important aspect of advertisement. For example, if the advertisement appears on the T.V. when most of the customers are not viewing it, the effect will be much less as compared with the effect when a majority of the customers are viewing the T.V. programme. Hence, the timing of the advertisement should be so detennined that it may reach the majority of customers.

Check Your Progress D

1 List out the purposes for which advertising is used by the business firms.

....

....

....

2 Differentiate between informative advertising and competitive advertising.

....

....

....

3 State the features of an effective advertisement.

....

....

....

4 Which of the following statements are True and which are False?

i) Advertising is not at all useful to the society.

ii) Advertising creates employment.

iii) Advertising always encourages monopoly.

iv) Advertisement need not be attractive to draw the attention of the customers.

v) Some advertisements have undesirable social and cultural impact.

vi) Advertising through newspaper is appropriate when the potential customers are mostly illiterate,

8.7 LET US SUM UP

Advertising is any paid form of non-personal presentation of ideas, goods or services by an identified sponsor. Publicity is non-sponsored commercially significant information about a company or its product disseminated to the public by non-personal media without a financial charge to the company.

Advertising is different from publicity, although both use non-personal media. Advertising is sponsored by some company and payment is made to the media for .disseminating that message. On the other hand, publicity is not sponsored by any company and no payment is made to the media.

Business firms use advertising with one or more of the following objectives: 1) introduction of new products, 2) inducing potential customers to buy, 3) reminding users, 4) to create brand image, 5) to intimate customers about new uses of a product, 6) to highlight brand character, 7) dealer support, 8) trafficking the retail trade, and 9) other objectives like informing customers in remote areas if they are not accessible to salesmen.

While advertising serves many useful purposes and benefit individual firms, it may have both positive and negative effects from the social point of view. Advertising may unnecessarily raise the prices of goods particularly,when expenses are incurred on competitive advertising simply to divert customers from other products without any real benefit to them. Large business firms establish brand image through advertising and are thus able to block the entry of new competitors in the market. This may lead to monopoly. However, if new comers can offer better products they may be able to compete with entrenched leaders.

Advertising indirectly determines what people should consume as it is directed to influence consumer demands to fit whatever has been produced. Therefore, productive resources may not be used in the best interest of society. Moreover, advertisements often have harmful effects on the social and cultural values of the people.

Society is also benefited in several ways as a result of advertisements sponsored by business firms. Advertising leads to the allocation of resources in accordance with the demand for goods and contributes to economic development. It provides useful information to consumers, gencrates employment, and helps mass media to publish matters of public interest freely and frankly.

To be effective, advertisements must have the right type of message communicated through proper media so as to reach the right people at the right time and at the lowest possible cost. The message should communicate something desirable and distinctive about the product advertised. The message should be believable, attractive, easy to remember and recall. It should be coinmunicated through appropriate media and repeated as often as is necessary to keep the message alive. The timing of the advertising should be so determined that it may reach the majority of target customers.

8.8 KEYWORDS

Advertising: Any paid form of non-personal communication of ideas, goods or services by an identified sponsor.

Publicity: Commercially significant information about a company or its product disseminated by a non-personal media without a financial charge to the company.

Brand Loyalty: Buyers' inclination to stick to a particular brand of product while making purchases.

Brand Image: Favourable opinion that goes with a particular brand name.

Mass Media: Channels or vehicles of communication which may be used to convey messages to large numbers of people.

8.9 SOME USEFUL BOOKS

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

Kotler, Philip, 1986. *Marketing Management—Analysis, Planning, and Control,* Prentice-Hall of India: New Delhi. (Chapter 20).

Ramesh, M.S. 1985. *Principles and Practice of Business Organisation & Management,* Kitab Mahal: Allahabad. (Section Six, Chapter 25).

Wright, John S., Willis L. Winter, Jr., and Sherilyn K. Zeigler, 1984. *Advertising,* Tata McGraw-Hill: New Delhi. (Chapters 1, 2, & 4).

8.10 ANSWERS TO CHECK YOUR PROGRESS

A	Product	'Televista' Television
	Media	Newspaper
	Message	Leadership comes in many forms. Leadership—the result of constant endeavour towards excellence and quality, manifests itself in everything the leader performs. Televista is the leading name in Televisions

for technology performance and class. It is one of the first and is still the foremost.
Televista—Only the best carry our name.

Sponsor Manufacturer of 'Televista' TVs or its' agent.

B Reviewer says that the film 'Aaina' is a well made film within the formula format. It is also stated that the dialogue is well worded, fine music by Naushad and the lead role is played by Mumtaz rather poignantly. On the whole, the review may have some positive influence on the reader.

C 1 **Similarity**: In both these cases there is no face-to-face communication with the target audience. Both of them are presented through non-personal mass medium like radio, television, newspaper, magazine, etc.

Differences: There is an identifiable sponsor for advertisement whereas in the case of publicity there is no identifiable sponsor.

In the case of advertisement the company pays money to the media which present the message. The company does not pay anything to the media in the case of publicity.

Advertisement messages are mainly intended to create favourable influence about the company or its product. Publicity may give a favourable or unfavourable impression about the company or its product.

2 i) Presented by a sales representative which is a personal communication. Therefore it is neither advertisement nor publicity.

ii) This is presented by an individual which does not come under mass media. So, it is neither advertisement nor publicity.

iii) Newspaper, a non-personal media, presented the information voluntarily. Company did not pay any money to the newspaper. It comes under publicity (unfavourable publicity).

3 Item 1 is an advertisement. It is sponsored by Indira Gandhi National Open University (Registrar) calling for tenders for ,residential accommodation.

Item 2 is publicity. It is written by the staff reporter and published by the newspaper voluntarily for the information of its readers.

D4 i) False ii) True iii) False iv) False
v) True vi) False

8.1 TERMINAL QUESTIONS

1 What is the main purpose of advertising? What are the various objectives served by advertisements?

2 Explain the usefulness of advertising from the consumers' point of view.

3 In what respects can advertisements be harmful to society?

4 What are the characteristics of a good advertisement? Suggest guidelines for designing an effective advertisement.

5 'Advertisement is a waste'. Do you agree with this view? Give reasons for your argument.

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

UNIT 9 ADVERTISING MEDIA

Structure

9.0 Objectives
9.1 Introduction
9.2 Meaning and Importance of Media
9.3 Types of Media and Their characteristics
  9.3.1 Press Media
  9.3.2 Radio
  9.3.3 Television
  9.3.4 Outdoor Media
  9.3.5 Direct Mail
  9.3.6 Miscellaneous
9.4 Requisites of an Ideal Medium
9.5 Evaluation of Media
9.6 Choice of Media
9.7 Role of Advertising Agencies
9.8 Let Us Sum Up
9.9 Key Words
9.10 Some Useful Books
9.11 Answers to Check Your Progress
9.12 Terminal Questions

9.0 OBJECTIVES

After studying this unit, you should be able to:

- analyse the importance of media in advertising
- outline the characteristics of each medium of advertising
- state the features of an ideal medium
- describe the factors influencing choice of media
- explain the role of advertising agencies

9.1 INTRODUCTION

In Unit **8** you have learnt what is advertising, how it is different from publicity, the objectives of advertising, the role of advertising in the society and the features of an effective advertisement. As you know, for business firms advertising is a very important means of communicating with the consumers about products or services, their usefulness, quality, place where they are available, etc. The basic objective of all this is to promote sales. This objective is fulfilled only when the advertisement message reaches the intended customers. In this regard the media used i.e., the means which carry the message, is very important. In this unit we shall discuss the importance of media in advertising, characteristics of various advertising media, features of an ideal medium, and the factors influencing the choice of media.

9.2 MEANING AND IMPORTANCE OF MEDIA

The method or means adopted to communicate the message of an advertisement is known, as the medium of advertising. In other words, medium is the vehicle or carrier of advertising message to the target customers or prospects. Thus, newspaper is a medium of advertising because it carries messages in print about products and services. Similarly, radio is another medium of advertising to broadcast and communicate advertisements to the listeners. Advertisements through television carry the message about products and services to viewers. Posters, handbills, cinema slides, outdoor display of goods, etc., are also used for advertising purposes. These are all media of advertising. The basic purpose of using the media is to bring products and services to the notice of potential customers.

	for technology performance and class. It is one of the first and is,still the foremost. Televista—Only the best carry our name.
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D 4 i) False ii) True iii) False iv) False
v) True vi) False

8.11 TERMINAL QUESTIONS

1 What is the main purpose of advertising? What are the various objectives served by advertisements?

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3 In what respects can advertisements be harmful to society?

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Advertising consists of preparing visual or oral message and their communication for making people aware of and favourably inclined towards a product or service or a point of view. The underlying objective of all advertising is to promote sales. With the mass production of goods in modem times, sales promotion inevitably requires services of mass media which can carry the advertising message to the largest possible number of potential consumers. The media of advertising thus play a vital role in the sale of goods and services. Without the use of suitable media it is impossible to think of promoting sales in markets with hundreds and thousands of potential buyers. This is because salesmen can personally contact only a limited number of individuals or retail shops. Likewise, producers and traders cannot contact many people personally to pass on information relating to their products or services. Small producers and small traders may be able to sell their articles through personal approach. This method of sales promotion cannot be used in the case of mass production industries of to-day. Indeed growth of large scale industries and development of new methods of communication have added to the importance of advertising through different media of mass appeal like radio, television, film, etc.

The use of media not only facilitates communication of the sponsored message to the largest possible number of consumers but also enables repetition of the message as often as may be necessary. This helps to reinforce the effect of advertising as well as to remind and sustain the customers interest in a product or service.

Use of particular types of media makes it possible to convey information in as much detail. as required by adjusting the size of the message to space or time. For example, press media (newspapers and magazines) may be used on payment of charges for as much space as needed, or radio and television may be used for advertising a product on the basis of time to be devoted. Of course, the cost of using larger space or longer time, is naturally more.

Mass media (which are used for reaching the public in distant parts of a country or abroad) may thus be regarded as one of the best means of creating demand and promoting sales. Even in the case of small business firms, use of certain types of media like handbills, posters and signboards, serves the purpose of reaching many more people than is possible through personal contacts. The media used for local purposes are relatively less expensive than personal selling.

Above all, media advertising provides useful support to personal selling. Salesmen and traders find it easier to impress potential customers about the usefulness or quality of products when the prospective buyers are already informed about the same through advertisements. Thus media advertising may be regarded as complimentary to personal selling.

9.3 TYPES OF MEDIA AND THEIR CHARACTERISTICS

A variety of media are used for advertising purpose. Different types of media, however, differ as regards geographical coverage, the type of customers that media can reach, nature of appeal to customers, cost involved, etc. On the basis of their distinguished features, the media may be divided into the following broad categories:

i) Press (Newspapers and Magazines)

ii) Radio

iii) Television

iv) Outdoor media

v) Direct mail

vi) Miscellaneous

Let us discuss the characteristic features of each of these media and their suitability for different purposes.

9.3.1 Press Media

Press medium is a print medium which comprises of newspapers and magazines. The main difference between newspapers and magazines is the periodicity of their publication. Newspapers are published daily, whereas magazines are published periodically i.e., 'weekly, fortnightly, monthly, quarterly or biannually. In both cases, however, the message-is conveyed through words in print, sometimes along with pictures or photographs. Words in print can be made as attractive, appealing and informative as possible, so also the accompanying picture. But newspapers and magazines have certain distinct features of their own, which are outlined below.

Newspapers : Published in different languages, newspapers are widely and regularly read by the educated public. Reading newspaper is the daily habit 'of many people in cities and towns and some literate people in the villages. Many have also become accustomed to advertisements in newspapers and look for them as sources of information. The circulation of some of the national dailies in India runs into several millions. Newspapers published in regional languages have also wide circulation, sometimes in more than one state. Thus, as a medium of advertising, newspapers reach a very large number of people. Secondly, newspaper advertising is relatively cheaper than other media like radio and television. The space to be used can be decided in accordance with the need and cost involved. Thirdly, newspapers provide the facility of repealing the message every day, if necessary. Besides, in case of urgency, there is scope for inserting an advertisement without much loss of time. Finally, it is possible to select a particular newspaper suitable for the audience in view. For national coverage, a newspaper which has nationwide circulation can be selected. For regional coverage, a newspaper published in that regional language can be selected. Since newspapers are read by the general public, they may be used as suitable media for goods of mass consumption. Many people read the newspapers in the morning and put them aside afterwards. So, the life of the advertisement in a newspaper is short.

Magazines : Magazines are also called periodicals as they are published at periodical intervals — weekly, fortnightly, monthly and so on. Different types of magazines are published for different categories of readers. For example, there are popular general magazines containing feature articles, news and stories e.g. India Today, Illustrated Weekly, Dharm Yug, etc.

There are magazines for children (e.g. Target, Chandamama, etc.) which include stories of their interest. There are magazines like Business India, Fortune, Commerce, etc., for businessmen and executives. Similarly, there are sports magazines (e.g. Sports Week, Sports Star, etc.), women's magazines (e.g. Femina, Women's Era), professional magazines (e.g. Indian Journal of Marketing, Indian Medical Journal, etc.), film magazines (e.g. Star & Style, Filmfare, etc.) and so on.

From the point of view of circulation, magazines are not as widely read as newspapers. On the other hand each magazine has a distinct category of readers. Since magazines are generally read over a period of time, they have longer life than newspapers. Thus, advertisers use magazines as media selectively according to the audience to be reached. For example, medical books, drugs, surgical equipment, medical instruments, etc., are generally advertised in medical journals. Manufacturers of office equipment, computers, etc., advertise their products in business magazines, trade journals, and so on. On the whole, the cost of advertising in magazines is relatively cheaper compared'to other media like radio and T.V.

However, magazines have certain limitations. One relates to the timing of publication which is periodical. Although the published advertisement has a longer life, they are published periodically and not daily like newspapers. The other limitation is the lack of flexibility in the choice of size and design of the advertisement. The design cannot be changed as quickly as in the case of a newspaper. Moreover, the circulation of a magazine does not always indicate the number of readers or the time devoted by the readers in reading it. A magazine having limited circulation may be read more thoroughly or it may be read by many more persons than another magazine with a large circulation.

9.3.2 Radio

Broadcasting as a medium of advertising has become increasingly popular in India due to the availability of radio sets at prices which people of low income can also afford. In India radio sets are owned by a large number of population. Thus, advertisement appeals can reach the general public in different parts of the country very conveniently through radio broadcasts. In India advertisements are broadcast by the All India Radio (Vividh Bharati Programme) in specified channels. Radio Pakistan and Radio Ceylon also broadcast the advertisements for Indian population. As a mass medium, radio broadcasting is well suited for various consumer goods having a mass appeal such as movies, electric fans, refrigerators, sewing machines, leather goods, travelling bags, etc. The advantage of radio advertising is that, being an audio medium, it does not require education to receive the message. The listeners need not be literates. Besides, the message which is orally communicated may be more impressive than the message in print. The limitations of radio advertising are: 1) it is more expensive than press advertising, 2) the life of the advertisement is very short, and 3) it is difficult to remember the message in detail.

9.3.3 Television

The importance of television as a medium of mass communication has significantly increased in India over the last 15 years. But its importance as a medium of advertising has grown with the use of satellite transmission and establishment of more relay stations to cover the remote parts of the country.

Individuals who cannot afford to buy TV sets are able to watch TV Programmes in community centres and public places. Use of television for advertising is increasing in recent times due to its extensive coverage and the impact of visual communication on the viewers. Its combination of sound, vision and movement permits the use of advertisement to demonstrate the product and its advantages. For this reason this medium is more effective than the press and radio. The major limitation of this medium is the heavy cost of advertising, particularly for advertisement before or after popular programme, known as prime time. Hence, only the large enterprises are in a position to make use of this medium. Another limitation is that the duration of a commercial advertisement is only for a few seconds. Also viewers often find it difficult to assimilate a large number of advertisements within a short span of time.

9.3.4 Outdoor Media

Outdoor media of advertising refer to the media used to reach people when they are out of doors or travelling rather than at home or in the office. Pamphlets, posters, hoardings (bill boards), neon signs, and electric displays come under this category of media. Pamphlets (printed handbills) are quite often used as a medium of advertising for sales promotion in a local area. Pamphlets are distributed among passers by at street crossings, railway stations or bus terminals, roadside market places, etc. Posters (message printed on Paper) are generally fixed on walls, roadside pillars lamp posts, etc. Posters are also fixed inside public transport vehicles like trams, buses and railway coaches. In these cases space is provided on payment.

Neon signs and electric displays are usually installed on roof tops or at busy street crossings so as to draw the attention of people. These are visible only in the night. Hoardings (bill boards) refer to large boards carrying the message, sometimes with life size pictures, and installed at public places. Hoardings are specially designed to draw the attention of the public. As the size of the hoardings is normally large, advertisement is visible from a distance.

Outdoor media like pamphlets, posters, neon signs, electric displays and hoardings have different degrees of attention value. Pamphlets have temporary impact on the people who receive them when they are passing by and often have other matters in their mind. Posters have the disadvantage that only those who look at them may notice their existence. Besides, posters in public places are likely to have a short existence either due to superimposition of other posters or their removal by other postening agents. Neon signs and electrical displays normally attract more public attention but these are effective only during the night time. Hoardings have the maximum attention value due to the big size and installation at prominent locations.

The cost of hoardings is quite high due to the heavy initial expenditure required for its preparation and installation. The rent to be paid for locating it at a public place is also quite high. Neon signs and electric displays involve fairly high initial costs for preparation and installation. It also involves considerable recumng expenditure for use of neon gas or electrical energy besides rent to be paid for location at public places. Posters fixed on walls or pillars may be initially less expensive. Posters fixed on the space provided in public transport (buses and railway coaches) involve payment of periodic charges. However all outdoor media are by and large less expensive than radio and television advertising.

9.3.5 Direct Mail

Sending personalised letters by post to the prospective customers is a method of advertising which often pays. These communications are mostly in the form of circulars and sometimes accompanied by catalogues or price lists. The idea behind mailing circular letters is to approach the customers directly with the advertising message and to arouse his interest in the product or service with detailed explanation in a convincing manner. A mailing list is thus prepared and the letter is carefully drafted with personalised wordings.

The message having a personal touch is expected to be more effective. The in may be elaborated and hence likely to be more convincing. Addressed to individual, name, the message can draw the attention of the customer without distraction from competing advertisements.

Direct mail cannot be a suitable medium for advertising products meant for public use on a mass-scale. It is best suited for products where the people to be contacted can be easily identified. For example, a company manufacturing or distributing pharmaceutical products (medicines) may easily identify the doctors or chemists for direct communication of information relating to the products. Similarly, a book publishing company may conveniently identify university teachers and send circular letters to promote the sale of its publications. But, for promoting the sale of (say) toilet soap or wrist watches, or pen direct mail is not a suitable means of advertising. It would be expensive and time consuming to undertake direct mailing of circular letters to innumerable consumers of such products who are widely scattered. Booklets, pamphlets, catalogues, etc., sent by post to prospective customers also come under direct mail. These are also suitable only in the case of a selective group of customers.

9.3.6 Miscellaneous

Apart from the media discussed above, there are several other types of media used for advertising. Some such media are slide projection in cinema houses, films, exhibitions, display in show-cases, etc. Calendars, diaries, key-rings, purses, paper weights, etc., imprinted with a message along with the advertiser's name and address are also considered as advertising media. Projection of slides in the cinema theatre before and during the film show is one of the cheaper means of advertising. Projection of short-films before the commencement of feature film is a relatively more expensive medium of advertising. But it has the advantages similar to that of television advertising. Moreover these short films are usually of longer duration (about 5 minutes) than TV commercials. However, slides or films are viewed only by local people present in the theatre during the show time.

Exhibitions also provide opportunities for advertising goods. Consumer goods can be displayed and the use of industrial goods like machinery, can be demonstrated in the exhibition. The limitation of exhibitions is that their duration is restricted to a specified period.

Show cases displaying goods arc located in public places like railway stations, airports, ,bus terminals, etc., to attract the attention of the public. Rent is payable for the space. Attractivenessof the products and the manner they are displayed are the main features of this advertising medium.

Check Your Progress A

1 What is an advertising medium?

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2 Which of the following statements are True and which are False?

i) Newspaper advertising is relatively cheaper than television advertising."

ii) As advertising media, specialised magazines an: most suitable for consumer goods of daily use.

iii) Radio advertising is not as effective as television advertising.

iv) Many more consumers can be reached through newspapers than through radio broadcasts.

v) Hoardings have greater attention value than posters.

vi) Direct mail is most suitable for advertising consumer goods.

3 Match the items in Column A with the items in Column B.

Column A	Column B
i) Radio	a) Print medium
ii) Television	b) Visual medium
iii) Newspaper	c) Audio-visual medium
iv) Neonsign	d) Audio medium

9.4 REQUISITES OF AN IDEAL MEDIUM

You have learnt about the characteristic features of different media. Now let us learn what are the requisites of an ideal medium of advertising. Broadly speaking, the ideal medium should have the following characteristics:

1) **Reach:** The medium should be such as to reach the largest possible number of the target audience.

2) Message: It should be possible to convey the message adequately through the medium.

3) Economy: The medium must be economical from the point of view of cost.

4) Flexible: It should provide flexibility of size, design, layout, colour, etc.

5) Scope **of** repetition: The medium should provide adequate scope for repeating the message, if necessary, at frequent intervals.

6) Effective: The use of the medium should result in achieving the goal of sales promorion.

9.5 EVALUATION OF MEDIA

You have learnt about various media and the requisites of an ideal medium of advertising. Now the question is which **can** be regarded as the best medium. As a matter of fact, no single medium can be considered suitable in all situations. For this, let us evaluate each media in the light of the characteristics of an ideal medium. Look at Table 9.1 for comparative study of various media.

Table 9.1

Features of Advertising Media

	Newspaper	Magazine	Radio	Television	Outdoor	Direct Mail
Circulation or reach	Maximum circulation among educated people	Restricted circulation among educated people	Reaches large number of people	Viewers nre less than the listeners of radio	Mostly by local people	Limited to the members on the mailing list
Duration of attention	Very Short period of one or two hours	Extended over a week or more	For a few seconds	For a few seconds	Brief attention, uncertain	Brief nttention, certain
Cost	Variable according to space	Less expensive than newspaper	More expensive than newspapers & magazines	Most expensive	Less expensive than newspapers except for bill boards	Moderately expensive. Depend on the size of mailing list.
Flexibility of size, design, etc.	Highly flexible	Less flexible than newspapers	Restricted flexibility depending on available time	Restricted flexibility due to high cost & dcpending on available time	Moderately flexible depending on cost	Highly flexible
Suitability	Goods for mass consumption	Industrial and specialised goods	Goods for mass consumption	Mass consumption goods	Goods with brand names	Goods having well defined mnrkets

Degree of audience	Possible for regional and linguistic selectivity	Greater degree of selectivity	Limited. Possible for regional and linguistic selectivity	Limited. Possible for regional and linguistic selectivity	Regional selectivity	Greater degree of selectivity
Repetitive value	Possible to repeat every day	Restricted to frequency of publication	Quick repetition possible	Quick repitition possible	Seen every time the prospect passed by it	Depends on frequency of mailing

If you analyse the table carefully, you will realise that no single medium is having all the requisites of an ideal medium. Each medium is ideal in some aspects and not ideal In others. For instance, newspaper and magazines have wide circulation, flexibility, scope for audience selectivity, etc., but they are not suitable for communicating to illiterate people. Television is a visual media which is very effective, but it is the most expensive medium. Radio does not have visual impact. Outdoor media suits local advertising only.. Direct mail is not suitable when the prospective customers are very large. 'Thus, a particular medium may be suitable in one situation but not suitable in others. Hence, you have to be careful in the selection of the medium and make your choice according to the requirements of a given situation.

9.6 CHOICE OF MEDIA

You have learnt that these are different types of media available for advertising and each medium had certain distinct characteristics of its own. No single medium has all the ideal features. A particular medium which is suitable in one situation may not be suitable in other situations. So the manufacturer or distributor (trader) is required to select one or more media which will be most suitable for his purpose. The following factors influence the choice of media:

1) Character of the media
2) Nature of the product to be advertised
3) Type of audience
4) Coverage
5) Cost

1 **Character of the medium:** To judge the suitability of any medium, the characters of different types of media should be analysed on a factual basis. The fòllowing aspects of the media are to be considered before choosing any particular medium.

a) The geographical coverage of the medium i.e. national, regional or local.

b) The, frequency and duration of exposure of the message to the audience.

c) Method of communication i.e., visual, oral, both visual and oral, etc.

d) Power of the medium to reach special categories of audience e.g. children, ladies, business executives, etc. This is also called audience selectivity.

e) Scheduling flexibility is another factor. Producing a TV advertisement takes more time than producing a newspaper advertisement. Similarly, withdrawal of advertisement with a short notice is not possible with some media.

f) Production quality of the media.

g) Degree of permanence or durability in the sense that how long the advertisement can remain before prospective customers' eyes or within their grasp. A TV advertisement disappears within a few seconds whereas an hoarding continues delivering the same message to the passing public for a year or more.

Thus for a large manufacturer, a medium with the national coverage will be more suitable. To build up brand image, frequency of exposure may be more important than duration of exposure. On the other hand, to provide very detailed information about the product, duration may be more important. Demonstrating the usefulness of Polaroid camera may require a medium to make oral and visual presentation. To advertise ladies garments it may be useful to select women's magazines like the Femina or Women's Era.

2 **Nature of** the product: Consumer goods need to be advertised with different types of appeal for effectiveness. Familiar goods of daily consumption do not require elaborate description, while industrial machinery may require technical details to be explained. The size of advertisement and the time of exposure required vary according to the nature of the products. Again, advertisement for consumer goods can reach the largest possible number of people through mass media like newspapers, radio and'television. But industrial goods may be more effectively advertised through trade and technical magazines. Advertisement of garments is best done in multi-colour printing in magazines.

3 Type of audience: Media habits of the target audience to be reached is one of the important factors to be considered while selecting the medium. If the target audience are illiterate, press medium (newspapers and magazines) is ineffective. Similarly, if the target customers are in villages where there are no TV sets, advertising by TV is a waste. The most effective medium to reach housewives in the urban areas may be the radio or television, and for-business executives it may be a professional magazine. Therefore, the characteristics of the target customers with respect to media are very important in selecting proper medium.

4 Coverage: How many and what percentage of the potential buyers can be approached through each possible medium are also determining factors in the choice of a medium. One medium may be able to reach more number of target customers than the other media. Therefore, a medium which can reach the maximum number of target customers should be preferred. For instance, if target audience are illiterate and do not have TV sets, short films in the cinema halls may be more effective. Similarly, the number of doctors who can be reached through direct mail is expected to be more than the number who can be reached through any other medium. To advertise sewing machines to the urban customers, women's magazines may be more appropriate as the appeal will reach many more ladies through this medium.

5 Cost: The most important factor determining the choice of a medium is the cost involved. Cost of a medium may be analysed in two ways: 1) absolute cost, and **2)** cost related to audience size. Absolute cost is the actual charge for buying a certain amount of time or space in a medium. If the small firm had set aside a small amount for advertising, it cannot afford to use an expensive medium. For instance TV is a very expensive medium whereas newspaper advertising is relatively cheaper. However, what is important is not the absolute cost of using each medium but the size of the target, audience reached in relation to the cost. Relative cost is a comparative cost. It is the absolute cost related to the size of the audience served by the choosen medium. For instance, charges for a full page advertisement in two different magazines may be exactly the same. But if one magazine has a circulation of **3** lakh and the other has a circulation of 4 lakh, advertisers choose the second magazine as it reaches more number of customers for the same money.

9.7 ROLE OF ADVERTISING AGENCIES

In advertising, we find three major participants: 1) media owners, 2) sponsors, and 3) advertising agencies. The owners of different media may be regarded as the sellers of space or time for the respective media, while the buyers of the media space or time are the sponsors or advertisers. The advertisers and media owners in many cases directly deal with each other, The advertiser selects the medium and negotiates the terms and conditions with the media owners, who have prescribed rates depending on the size, design, duration, etc., of the advertisement. Large manufacturing companies often have expert staff of their own to design the advertisement and decide on the media according to budgetary allocation for advertising and sales promotion.

However, over the years, advertising agencies have developed to undertake the advertising function on behalf of the advertisers. The skill and expertise which characterise the advertising agencies enable large companies to take advantage of their services on payment of a 'fee' or 'commission' besides the cost of preparing the layout, design, etc., of the advertisement. Most of the agencies handle all aspects of advertising including media selection on behalf of their clients. These agencies perform an important role in providing expert services as media specialists which the advertisers would not be able to develop in their own organisation. Some of the agencies are also enlisted with the media owners as recognised agencies for grant of discount on the contracts for space and time. A part of this discount is shared with the client advertisers of the agencies. Thus, the area of contact between the advertisers and media owners is reduced.

Check **Your** Progress B

1 List the features of an ideal medium of advertising?

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2 What is the main difference between TV medium and Radio medium?

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3 Which of the following statements are True and which are Fnlse?

i) The life of the advertisement message is shorter in newspaper medium compared to magazine medium.

ii) An ideal medium is always least expensive.

iii) Advertising agencies take up the responsibility of distributing the goods.

iv) If the target customers are illiterate, press is not a suitable medium for advertising,

v) Direct mail is the best medium when the target customers are very few.

vi) Outdoor media is suitable for advertising at national level.

vii) TV medium is the most effective but also the most expensive medium.

viii) Professional magazine is suitable for advertising sophisticated electronics equipment. .

4 Match the items in Column A with the items in Column B.

Column **A**	Column B
i) Toys	a) TV
ii) Demonstration	b) Hoardings
iii) Few customers	c) Children's magazines
iv) Customers in small area	d) Women's magazines
v) Sarees	e) Mail order

9.8 LET US SUM UP

The method or means adopted to communicate the message of an advertisement is known as the medium of advertising. The growth of large scale industries and development of modem methods of communication have added to the importance of advertising through different media of mass appeal. The media not only facilitate communication of the sponsored message but also enable repetition of the message as often as necessary. Use of a particular medium also makes it possible to convey information in as much detail as required. Above all, media advertising provides useful support to personal selling.

The various types of media which advertisers can use may be divided into the following categories: (i) press (newspapers and magazines), (ii) radio, (iii) television, (iv) outdoor media, (v) direct mail, and (vi) miscellaneous.

Press medium consists of newspapers and magazines. The main difference between these two types is that the newspapers are published daily while magazines are published periodically i.e., weekly, fortnightly, monthly, etc. As a medium of advertising, newspapers serve the purpose of reaching a very large number of literate people. It is relatively cheaper than radio or television. It provides scope for repeating the message every day, if necessary. The advertiser can also select newspapers with national or regional or local coverage as needed. This medium is suitable for advertising the products of mass consumption. But, newspapers have a temporary impact on the readers. Magazines are published periodically and reach different categories of literate people. Magazines are not as widely read as newspapers. On the other hand, each magazine has a distinct category of readers. Thus, magazines may be used selectively according to the audience to be reached. However, there is a time gap between the publication of magazines. Besides, it does not provide adequate flexibility in the choice of design, size, etc., of the advertisement. The circulation of magazines does not always indicate the number of readers.

As a mass medium, radio broadcasting is very suitable for consumplion goods and products having mass appeal. The listeners include all categories of people who may or may not be literates. Oral communication is relatively more impressive than printed messages. But the message needs repetition as it is difficult for the listeners to remember what they have heard. Moreover, it is a more expensive medium than press advertising.

For commercial advertising television has become increasingly popular. Its effectiveness as a medium is much greater than the radio due to the combination of sound, vision and movement. Consumer goods of all types are widely advertised through television. The limitations of this medium are: i) heavy cost involved, and ii) the duration of the message telecast is very short, hardly a couple of seconds. And it is difficult for viewers to assimilate a large number of advertisements within a short span of time.

Outdoor medium of advertising is the medium used to reach people when they are out of doors or travelling. Included in this category are: pamphlets, posters, hoardings, neon signs, and electric displays. These media have different degrees of attention value. There are differences in cost of using these outdoor media, the more expensive being the hoardings, neon signs, and electrical display. On the whole, however, outdoor medium is less expensive than radio and television advertising.

Direct mail includes sales letters, bulletins, booklets, catalogues, etc., mailed to individuals directly by the advertiser. Of these, the sales letters are expected to be more effective as they convey the message with a personal touch. Also it permits detailed explanation to be conveyed in a more convincing manner. Personalised communication can be more impressive. It can draw the customers attention without distraction from competing advertisements. The medium is more suitable for advertising products to a selected category of identifiable persons.

Several other types of media used by advertisers are: slide projections, films, exhibitions, display in show cases, and free distribution of calendars, diaries, key rings, purses, etc.. imprinted with a short message.

The ideal medium of advertising should have the following characteristics. Widest reach or coverage, adequate communication of message, economical, flexible, scope of repetition, frequency of exposure, and effective from the point of view of results. No single medium is having all these ideal features. Each medium is ideal in some aspects and not ideal in other aspects. The choice of a suitable medium is influenced by the following factors: (1) character of the media, (2) nature of the product, **(3)** type of audience, (4) coverage, and (5) cost.

Advertising agencies perform the useful functions of providing expert services as media specialists to the large advertisers on payment of a fee or commission. They handle all aspects of advertising including media selection on behalf of their clients.

9.9 KEY WORDS

Audio Media: Communicating messages through sound i.e. words spoken or musical notes produced as in tbe case of radio.

Audio-visual Media: Communicating messages **by** means of sound as well as visuals as in the case of TV.

Media: The means of communicating advertising message, the vehicles of communication.

Personal Selling: Selling through salesmen.

Print Media: Communicating message through newspaper and magazines.

9.10 SOME USEFUL BOOKS

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

Kotler, Philip, **1986.** ***Marketing Management-Analysis, Planning and Control,*** Prentice-Hall of India: New Delhi. (Chapter 20).

Sing, B.P., and T.N. Chhabra, **1988.** ***Business Organisation and Management,*** Kitab Mahal: Allahabad. (Part one, Chapter 25).

Ramesh, M.S., **1985.** ***Principles and Practice of Business Organisation & Management,*** Kitab Mahal: Allahabad. (Section Six, Chapter 25).

Wright, John S., Willis L. Winter Jr., and Sherilyn K. Zeigler, 1984. ***Advertising,*** Tata McGraw-Hill: New Delhi. (Chapters 1, 2 & **4).**

9.11 ANSWERS TO CHECK YOUR PROGRESS

A 2	i) True	ii) False	iii) True	iv) False	v) True
	vi) False				
3	i) d	ii) c	iii) a	iv) b	
B 3	i) True	ii) False	iii) False	iv) True	v) True
	vi) False	vii) True	viii) True		
4	i) c	ii) a	iii) e	iv) b	v) d

9.12 TERMINAL QUESTIONS

1 What do you understand by advertising media? Discuss the importance of media for advertising.

2 Analyse the features of the following media of advertising :

i) Radio
ii) Newspaper
iii) Television

3 What is meant by outdoor media of advertising? Mention at least three outdoor media and explain their features.

4 Discuss briefly the features of an ideal advertising medium. What are the factors to be taken into consideration while choosing a suitable medium?

5 Write short notes on the following:

i) Direct mail as a medium of advertising
ii) Role of advertising agencies
iii) Advertising through magazines
iv) Cost of advertising as a determinant of suitable medium.

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

UNIT 10 HOME TRADE AND CHANNELS OF DISTRIBUTION

Structure

10.0 Objectives
10.1 Introduction
10.2 Home Trade and Distribution System
10.3 What is a Channel of Distribution?
10.4 Functions of Channels of Distribution
10.5 Channels of Distribution Used
10.5.1 Channels of Distribution used for Consumer Goods
10.5.2 Channels of Distribution used for Industrial Goods
10.6 Factors Influencing the Choice of Channel
10.7 Types of Middlemen
10.7.1 Functional Middlemen
10.7.2 Merchant Middlemen
10.8 Role of Middlemen
10.9 Let Us Sum Up
10.10 Key Words
10.11 Some Useful Books
10.12 Answers to Check Your Progress
10.13 Terminal Questions

10.0 OBJECTIVES

After studying this unit, you should be able to:

- explain home trade and the nature of distribution system
- state the meaning and functions of channel of distribution
- describe the common distribution channels used
- outline the factors influencing the choice of a distribution channel
- explain the role of middlemen in the distribution system
- distinguish between different types of middlemen

10.1 INTRODUCTION

As you know, in the modem society the production of goods takes place on a large scale in factories concentrated in few localities while the consumers are scattered throughout the country. For instance, textile mills are concentrated at a few places like Bombay, Ahmedabad, Coimbattor, etc., while the cloth is used by all the people in the country. Similarly Maruti cars are manufactured at Delhi while the users are spread in all parts of the country. Samething is true of agricultural commodities. Apples are produced mainly in Kashmir Valley and Himachal Pradesh whereas they are consumed by people throughout the country. Another such example is tea which is mainly produced in Assam while it is consumed everywhere in the country. Thus, in most of the cases goods are produced at one place while they are consumed at various other places. It is not possible for all the consumers to know the place where goods are produced and contact the producers directly. Similarly, it is not possible for all the producers to contact the consumers directly and sell the goods. Hence, it is essential to move the goods from the place of production to the markets where consumers can buy them, Otherwise, production has no value and it becomes waste.

There is another barrier which arise due to time lag between production and consumption. The goods produced are not consumed at the same point of time. Some goods are produced--throughout the year, but their consumption is seasonal. For example, umbrellas and raincoats are used only during rainy season, woollen garments are used only during winter season. In some other cases, goods are produced during a specific season while they are consumed continuously throughout the year. For example foodgrains are produced by farmers during a particular season and are consumed throughout the year. Thus, in many cases, there is time lag between production and consumption.

Producers and consumers are, thus, separated by place and time. Production has no value unless goods are supplied to the consumers at the right place and at the right time. Hence the distribution of goods assumes importance in the business operations. It is the distribution system which moves the goods from the place of production and make them available to the consumers at the right place and right time. In this unit you will learn how the distribution system facilitates the flow of goods from producer to consumer and what channels are generally used for the distribution of consumers' and producers' goods. You will also study the factors that affect the choice of a channel and the role of various types of middlemen involved in the distribution system.

10.2 HOME TRADE AND DISTRIBUTION SYSTEM

As you know that the goods produced in a country can be sold within the country or outside the country. When the exchange (sale and purchase) of goods takes place within the boundaries of a country, it is known as home trade. It is also called **domestic** trade. Similarly, if the exchange of goods takes place across the boundaries of a country, it is called foreign trade. You will learn in detail about the foreign trade in Unit 12. In this unit we will discuss about the home trade only.

You know a large variety of goods are traded within the country in markets located in cities, towns and villages. You can notice small shops such as provision stores, medical stores, cloth stores, etc. which display a variety of goods for customers to buy. You will observe that these shops are located in places where the customers can conveniently reach and make their purchases. All the goods sold in these shops must have been produced elsewhere either in the factories or in the agricultural farms. How the goods produced in the factories or farms reach these shops located in cities, towns and villages? Somebody must have taken that responsibility and performed various functions necessary to move the products from the place of production to the places where the consumers can buy. The system which is concerned with the movement of goods from the point of production to the pdint of consumption may be called distribution system. The distribution system performs a variety of functions to ensure the smooth and continuous flow of goods. We can list the functions of a distribution system as follows:

1) Buying and Assembling: For selling the goods, they have to be bought first. For buying the goods, it may be necessary to contact producers in different places. Purchases must be made in adequate quantities so that it becomes economical for handling. In this process, goods may have to be procured from different sources of supply and assembled in a warehouse or godown till the time they are sold.

2) Standardisation and Grading: To facilitate the sale and purchase of goods, different varieties must be sorted out so that goods of uniform quality may be offered for sale. Manufactured goods are generally graded according to size, shape, colour, quality etc., at the time of production itself. So there is no need for grading afterwards. But agricultural products have to be graded according to the differences in their quality because the farmers normally do not undertake grading before they sell them in the market.

3) Branding: The producers often select their own brand names for the goods they market. These brand names help easy identification of the goods offered for sale e.g., Postman oil, Hamam soap, Onida TV, Brooke Bond Coffee, etc. By using brand name the producer or seller tries to distinguish his products from other competing brands.

4) Packing and Packaging: Certain types of goods have to be put in proper containers or packed properly to prevent damage in course of transportation or storage or handling. On the other hand, presenting goods in convenient packages, boxes, tins, or bottles, is necessary for easy handling by buyers or for resale. Thus, packing as well as packaging of goods is necessary to facilitate the sale of goods.

Besides these major functions there are certain other functions like transportation, risk bearing, market information, financing, warehousing, etc. All these functions are to be performed by various agencies involved in the distribution system.

Check Your Progress A

1) Distinguish between home trade and foreign trade?

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2 Which of the following statements are True and which are False?

i) Distribution means only buying and selling of goods.

ii) Brand names help buyers to identify the products easily.

iii) Grading and Packaging mean the same thing.

iv) The distribution system means transportation of goods from factories to markets.

v) Collection of goods from different sources of supply is known as assembling.

3 State whether the following transactions come under home trade or foreign trade.

i) A wholesaler in Bombay sold goods to a retailer in Delhi.

ii) Mr. Rajesh bought a colour TV for his personal use from a dealer in Delhi. Later Mr. Rajesh migrated to Nepal and carried the TV with him.

iii) A wholesaler in Madras bought cameras from a manufacturer in Japan.

iv) A Manufacturer in Hyderabad sold leather goods to a wholesaler in London.

10.3 WHAT IS A CHANNEL OF DISTRIBUTION?

You have learnt that the distribution system is concerned with the movement of goods from the point of production to the point of consumption which involves a variety of functions. You also learnt that such functions are performed by various agencies involved in the distribution system. The main participants in the distribution system are: (i) the manufacturers, (ii) the intermediaries, (iii) the facilitating agencies, and (iv) the consumer's. Let us study the role of each participant.

Manufacturers produce the goods. In the distribution system this is the starting point for the goods. The second category of participants i.e., intermediaries, are involved in direct negotiation between buyers and sellers whether or not they take title to goods. These intermediaries locate the manufacturers who produce various products, identify the needs of the consumers and distribute the goods. In the process they perform various functions like buying, selling, assembling, standardisation and grading, packing and packaging, risk bearing, etc. Facilitating agencies are the independent business organisations other than intermediaries. They help the distribution of goods from originalors to users. These agencies facilitate the smooth distribution of goods from producers, through intermediaries, to consumers. The major facilitating agencies are advertising agencies, banking institutions, insurance companies, transportation agencies, and warehousing companies. You have learnt about these agencies as 'aids to trade' in Unit 1. The fourth category of participants in the distribution system, i.c. consumers, are the final destination for goods in the distribution system.

Channel of distribution is mainly concemed with second participant i.e., the intermediaries. The term 'Channel of Distribution' refers to the route taken by goods as they flow from the producer to the consumer. This flow of goods may mean its physical distribution and/or the transfer of title (ownership). Channel of distribution is mainly concemed with the transfer of title to a product which may be effected directly or through a chain of intermediaries. You know most producers do not sell goods directly to the consumer. They make use of a variety of intermediaries known as middlemen. These middlemen who take title to goods or assist in transferring the title to goods as they move from the producer to the consumer are called the channel of distribution. Thus, the ***channel of distribution is a network of institutions that perform a variety of interrelated and coordinated functions in the movement of goods from producers to consumers.***

10.4 FUNCTIONS OF CHANNELS OF DISTRIBUTION

The functions performed by channel of distribution may be grouped into three categories as follows:

1 . Transactional Functions
2 Logistical Functions
3 Facilitating Functions

1 **Transactional Functions:** Functions necessary to a transaction of the goods are called transactional functions. Buying, and risk bearing functions come under this category. Participants in the channel of distribution undertake these three functions. Producers sell the goods and intermediaries buy them. Later intermediaries sell the goods and consumers buy them. Because of this buying and selling by the channel participants, title to goods change hands and goods flow from producer to consumer. If there is no willingness for buying and selling, there would be no transaction. When goods are bought, it involves risk also. For instance, an intermediary bought goods from the producer with the intention of selling at a profit. But he incurred loss due to fall in price. All the participants in the distribution channel assume such risk of loss.

2 **Logistical functions:** The functions involved in the physical exchange of goods are called logistical functions. Distribution channel performs some functions like assembling, storage, grading and transportation which are essential for physical exchange of goods.

Goods are assembled in sufficient quantity to constitute an efficient selling and shipping quantity. Sometimes, it is also necessary to assemble a variety of goods to provide an assortment of items desired by buyers. Grading and packing of goods facilitate handling and sale of goods promptly. Proper storage of goods prevents loss or damage as well as helps regular supply of goods to consumers whenever they want. Transportation makes goods available at the place at which the buyers are located. In the channel of distribution all these functions are performed so that various types of goods may reach the market place at proper time and may be conveniently sold to the ultimate consumers.

3 **Facilitating functions:** These furictions facilitate both the transaction as well as physical exchange of goods. These facilitating functions of the channel include postpurchase service and maintenance, financing, market information, etc. Sellers provide necessary information to buyers in addition to after-sales services and financial assistance in the form of sale on credit. Similarly, traders are often guided by producers to help them in selling goods, while the traders also inform producers about the customers opinion about the products.

Thus, the channel of distribution performs a variety of functions such as buying, selling, risk bearing, assembling, storage, grading, transportation, post purchase service and maintenance, financing, market information, etc. But the relative importance of these functions may vary according to the nature of the goods. For example, transportation and storage are more important for perishable goods and bulky materials, such as coal, petroleum products, iron ore, etc. In the case of automobiles'and sophisticated electronic goods like computers, after sales service is very important.

10.5 CHANNELS OF DISTRIBUTION USED

You have learnt about the nature and functions of channels of distribution. We shall now discuss the channels of distribution commonly used by the producers.

We can classify the distribution channels into two broad categories: (1) direct channels, and (2) indirect channels (use of middlemen).

1 **Direct Channels:** When the producers sell their goods directly to the consumers it is called a direct channel. No middlemen is present between the producer and the consumer.

They' establish direct link with the consumers through travelling salesmen or through their own retail shops or show-rooms. The producer or manufacturer may employ salesmen to book orders by contacting the potential users, and supply may be arranged from the stock held by the producer himself. Alternatively, the producer may set up retail shops/show rooms in different localities and sell goods directly to the customers as shown below. .

1 Producer → Travelling Salesman → Consumer
2 Producer → Retail shop/showroom → Consumer

2 **Indirect channels: In** the case of all the products it is not possible for the manufacturer to supply goods directly to the consumers. So may be middlemen like wholesaler, retailer and mercantile agents may be engaged in the channel of distribution. When the middlemen are engaged, it is called an indirect channel. As shown below, there could be four indirect channels.

1 Producer → Retailer → Consumer
2 Producer → Wholesaler → Consumer
3 Producer → Wholesaler → Retailer → Consumer
4 Producer → Agent → Wholesaler → Retailer → Consumer

The manufacturer may supply goods directly to retail traders. In this case the producer ascertains the requirements of retailers at periodical intervals and goods supplied accordingly. As and when required, the retailer may also procure goods from the producer's godown located in that region. In the same way, the producer can supply goods to the consumers by using the services of the wholesale trader. Alternatively, the producer can use the services of the wholesaler as well as the retailer. In this case the manufacturer may supply his products in bulk to wholesalers. The retailer may buy periodically from the wholesaler and sell the same to the consumers located in his locality. Another alternative channel of distribution consists of mercantile agent, wholesaler and retailer. In this case, the manufacturer deals with a mercantile agent. Then the wholesalers buy the goods from the agents and sell the same to retailers. In turn the retailer sells it to the ultimate consumers.

We have understood that there are a number of channels of distribution prevalent. Let us 'now examine how these channels of distribution are varying from one type of product to another type. Basically we can classify the goods into two categories: 1) consumer goods, and 2) industrial goods. Let us now discuss briefly about the channels of distribution for these two categories of products.

10.5.1 Channels of Distribution Used for Consumer Goods

As you know, the goods which are consumed by the household consumers are called consumer goods. Under this category you can find a very wide range of items such as food items, stationery, cars, clothing, shoes, household electrical appliances, TV sets, transistors, etc. The channel of distribution used for different products is not the same. Channels are different from one type of product to the other. Look at Figure 10.1 carefully. It gives the idea about the channels of distribution for some of the consumer goods.

As shown in the figure, sometimes consumers go directly to the factory and buy the goods or order the goods from the catalogue. Durable consumer goods like cars, clothing, furniture, textbooks, shoes, etc., are generally distributed through retailer. In many cases showrooms are established by the manufacturer himself which undertake the retail trade. For example, Bata Shoe Company sells shoes through its showrooms. Consumer goods like auto spare parts, stereos, video recorder, etc., are distributed through wholesalers and retailers. Consumer goods of daily need like foodgrains, sugar, salt, edible oil, soap, paper, pencils, etc., are generally distributed through agent or broker, wholesaler and retailer.

10.5.2 Channels of Distribution Used for Industrial Goods

As you know, the goods which are consumed by industry for further production of goods are called industrial goods. Under this category there are a variety of products such as machinery, equipment, industrial raw-materials (e.g. sugarcane, cotton, coffee, oilseeds, iron ore, etc.), electrical and electronic components, etc. The channels of distribution are not similar for all the products under this category. Look at Figure 10.2 carefully. It presents the channels of distribution for some of the industrial goods.

High value industrial goods like mainframe computers, aircraft, heavy machinery, etc., are supplied directly to the buyers. In these cases manufacturers procure orders by mail on the basis of catalogues and price lists. Sometimes salesmen are also used to contact the buyers. Relatively less expensive items like trucks, conveyor systems, etc., are supplied through distributors. You know industries consume many agricultural products. For instance, tea leaves are processed to prepare tea powder which we use for preparing tea. Agricultural products like corn, coffee, soyabeans, etc., are procured by the industrial buyers through' agent middlemen. When electrical components are imported from foreign markets, they are procured through an agent and industrial distributor.

Figure 10.1
Channets of Distribution for Consumer Goods

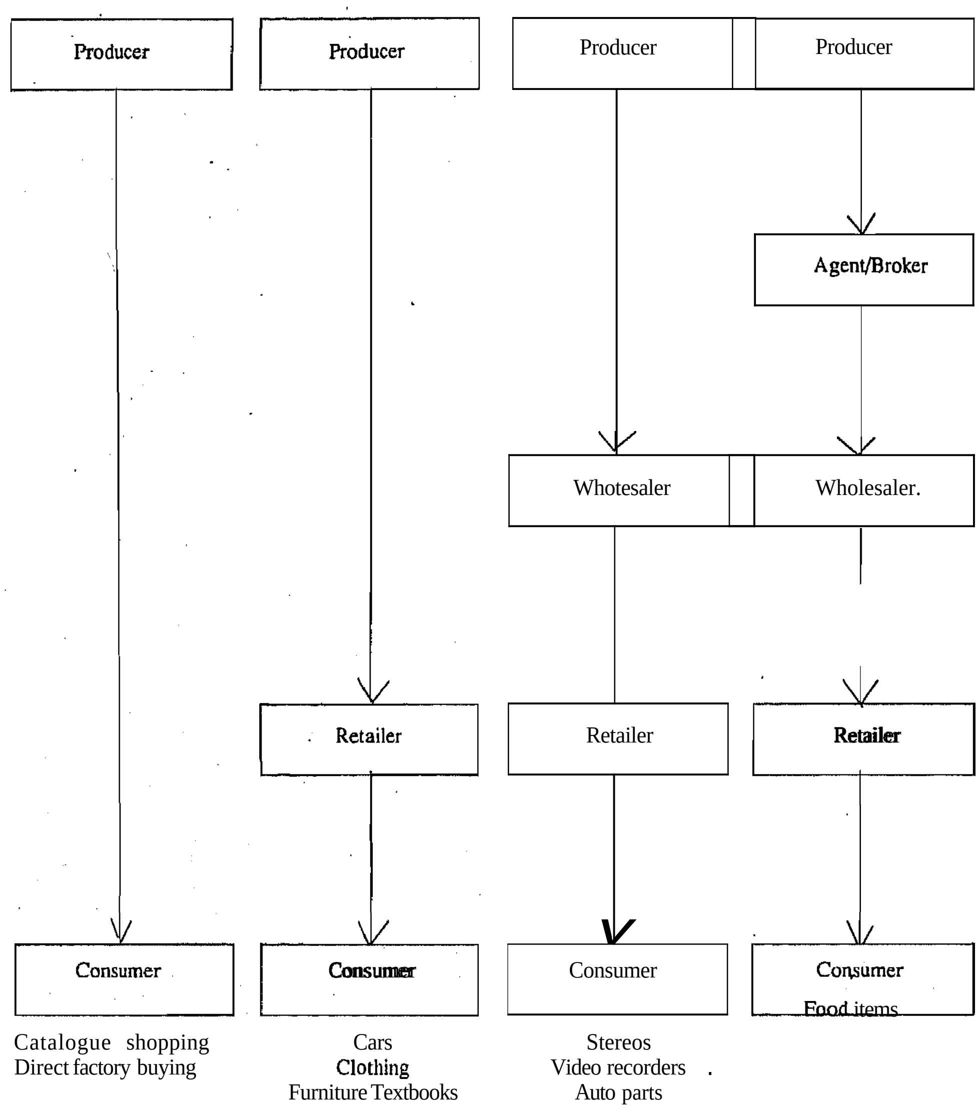
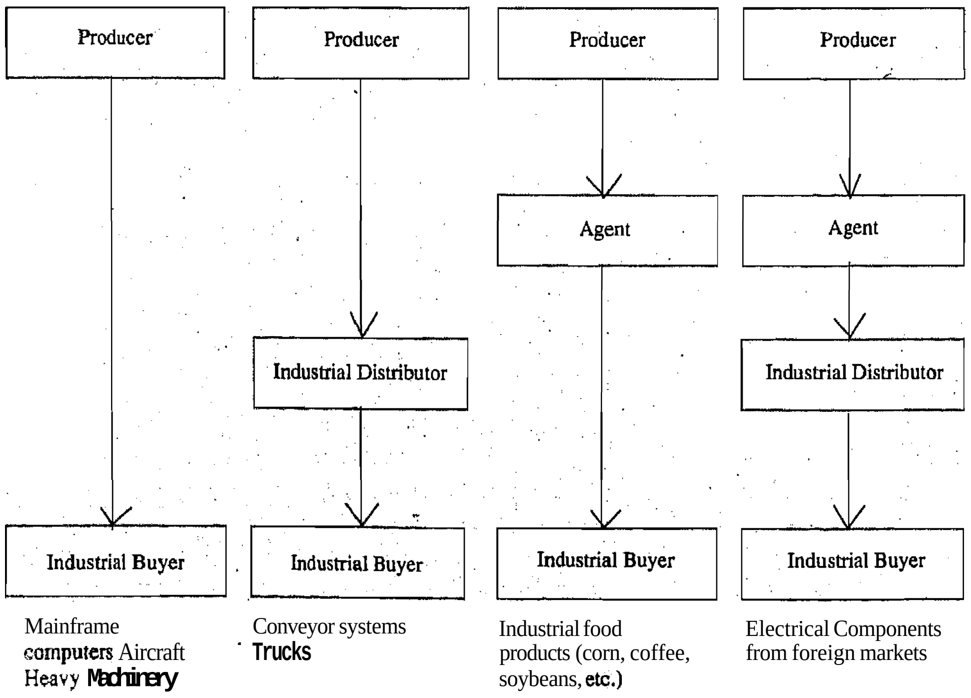

Producer
Producer
Producer
Producer
Agent/Broker
Whotesaler
Wholesaler.
Retailer
Retailer
Retailer
Consumer
Consumer
Consumer
Consumer
Food items
Catalogue shopping
Direct factory buying
Cars
Clothing
Furniture Textbooks
Stereos
Video recorders
Auto parts

Figure 10.2
Channels of Distribution for Industrial Goods


Producer
Producer
Producer
Producer
Agent
Agent
Industrial Distributor
Industrial Distributor
Industrial Buyer
Industrial Buyer
Industrial Buyer
Industrial Buyer
Mainframe computers Aircraft Heavy Machinery
Conveyor systems
Trucks
Industrial food products (corn, coffee, soybeans, etc.)
Electrical Components from foreign markets

10.6 FACTORS INFLUENCING THE CHOICE OF CHANNEL

We have learnt that there are a number of channels used for distributing the goods. There are direct channels and indirect channels, short channels as well as long channels. We also learnt that the different channels are used for different types of products. When there are alternatives available, the selection of an appropriate channel becomes a very important decision for the producers. The choice of channel for distribution of any product should be such that it effectively meets the need of customers in different markets at reasonable cost. The following factors generally influence the choice of the channel of distribution :

1 Distribution policy
2 Characteristics of the product
3 The target customers in view
4 Supply characteristics
5 Types of middlemen in the field
6 Channel competition
7 Potential volume of sales
8 Costs of distribution
9 Profits expected in the long-run

1 Distribution policy : Where the manufacturer is interested in distributing his products through all possible outlets, it is desirable to use more than one channel to reach the target customers. This is known as intensive distribution policy. The purpose in this case is to make the product available as near to the consumers as possible. Consumer goods of frequent use like pens, pencils, paper, soap, hair nil, etc., are distributed through a large nymber of wholesalers and retail traders.

If goods are meant for customers who are very particular about their quality and usefulness, manufacturers adopt a selective distribution policy. In that case, few selective channels which can be relied upon for their efficiency of operation are used. For examples, goods like computers and TV sets, which require special services, are distributed through selected outlets like dealers with established reputation of dealing in those products and having a sound financial position.

Sometimes, companies, manufacturing complex machinery, scientific instrument, etc., appoint particular agents for distribution of the products. In other words, the manufacturers prefer a single outlet. The agents or distributors become exclusive dealers of the items because of their technical knowledge and experience of dealing in that particular product line. This is known as exclusive distribution policy. Thus, the choice of the distribution channel is dependent on the distribution policy adopted by the producer of goods.

2 Characteristics of the product : The nature of the product influence the choice of channel. For example, perishable products like eggs, milk, etc., are supplied either directly or through the short channels. In the case of heavy and bulky products (e.g. cement, steel) where distribution and handling costs are more, short channels are preferred. Sophisticated electrical and electronics equipment which require careful handling are also generally distributed directly or through short channels. On the other hand. long channels are found in the case of light-weight and small-size items like dress material, readymade garments, pocket calculators, stationery, toothpaste, toothbrush, etc. Similarly, simple mechanical products like electronic toys, time-clocks, etc., are supplied through long channels for intensive distribution.

3 Characteristics of target customers : If the number of customers is large and geographical area is extensive, long and multiple channels are necessary for intensive distribution of goods. This is also suitable where the consumers are in the habit of making frequent purchases of small quantities at irregular intervals. Short channels and direct selling are possible in the case of few customers who purchase large quantities at regular intervals and they are concentrated in a small area.

4 Supply characteristics : Goods produced by a small number of producers concentrated in one region are generally distributed through short channels. Paiticularly this is more so if each producer controls a fairly large share of the market. Long channels are suitable if a large number of producers in different regions produce and supply the goods.

5 Types of middlemen : Availability of suitable middlemen in the channel of distribution

is another factor in the selection of the channel. This is because different functions like standardisation, grading, packing, branding, storage, after sale servicing, etc., are expected to be performed by middlemen. Efficiency of distribution depends upon the size, location and financial position of middlemen. If the middlemen in a specific channel are dependable and efficient that channel may be preferred by producers.

6 **Channel competition** : There are different situations in which manufacturers compete with each other for availing the services of particular wholesalers. Similarly, wholesalers often compete with each other to deal with particular retailers or carrying particular brands of products. Sometimes producers use the same channel which is used by their competing producers. If any producer arranges exclusive distribution through a particular wholesaler, other producers also do the same. Thus, selection of **a** channel may depend on the competition prevailing in the distribution system.

7 **Potential volume of sales** : The choice of the channel depends upon the target volume of business. The ability to reach target customers and the volume of sales varies between different channels. One outlet may not be adequate for achieving the target in which case more channels need to be used. Of course, the competitive situation must be taken into account while examining the potential volume of sale through different channels:

8 Cost **of distribution** : The various functions carried out in the channel of distribution add to the cost of distribution. While choosing a channel, the distribution costs of each channel should be calculated and its impact on the consumer price should be analysed. **A** channel which is less expensive is normally preferred. Sometimes, a channel which is convenient to the customers is preferred even if it is more expensive. In such cases the choice is based on the convenience of the customers rather than the cost of distribution.

9 Long-run **effect** on **profit** : Direct distribution, short channels, and long channels have different implications with regard to the profits in the short-run and long-run. If demand for a product is high, reaching the maximum number of customers through more than one channel may be profitable. But the demand may decline in course of time if competing products appear in the market. It may not be economical then to use long channels. So, while choosing a channel one should keep in mind the future market implications as well.

Check Your Progress B

1 What is a channel of distribution?

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2 Distinguish between intensive distribution and exclusive distribution.

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3 What is a direct channel of distribution ?

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4 Which of the following statements are True and which are False?

i) Buying and selling of goods take place only once or twice in any channel of distribution.

ii) Industrial distributor or dealer is an essential link in the channel of distribution of industrial goods.

iii) Consumer goods of daily use are distributed by manufacturers only through the retail shops under their control.

ıv) Traders not only undertake storage and transportation of goods but also bear the risks of loss or damage.

v) Larger the number of middlemen, longer is the channel of distribution.

vi) The purpose of intensive distribution policy is to make the products available in markets nearest to the consumers.

vii) Long channels are suitable for the distribution of light weight and small size articles.

viii) Efficiency of distribution depends upon the size and location of middlemen in the channel of distribution.

10.7 TYPES OF MIDDLEMEN

Middlemen act as links between the producers or dealers of goods and the consumers. Broadly speaking, they may be divided into two categories:

i) Functional'middlenien or mercantile agents
ii) Merchant middlemen

10.7.1 Functional Middlemen

Those who undertake various marketing functions in the process of distribution of goods without having ownership rights are called functional middlemen. These functional middlemen operate on behalf of owners. They perform a specific function or undertake general functions relating to purchase and sale. These middlemen are also called 'mercantile agents'. Depending on the functions performed, the functional middlemen may be classified into five categories. Let us discuss about them briefly.

1 Factors: A middleman who keeps the goods of others and sells them with the approval of the owner is known as a 'factor'. The goods are normally in his possession or under his control. With the approval of the owner the factor can sell the goods as agent, or sell in his own name, or pledge goods in his possession, or can do all such acts as can be done by the owner of the goods. After the sale of goods, he receives the payment from the buyer. He receives commission'at a fixed percentage on sales from his principal.

2 Brokers: Middlemen who bring together the buyers and sellers and negotiate the terms and conditions o i sale on behalf of either the buyer or seller are known as **brokers.** When a broker acts on behalf of the buyer, he is known as buying agent. If the owner of goods employs a broker for sale of the goods, the broker is known as a selling agent. For his services, the broker receives a fixed percentage of the value of transaction as brokerage from the employer i.e., either buyer or seller.

3 Commission Agent: The commission agent is a middleman who sells goods as an agent of the owner. He takes the possession of the goods, negotiates the terms of sale with the intending buyers, and arranges transfer of title of the goods to the buyer. If necessary, the commission agent also performs various other functions like storage, grading, packagmg, etc. For his services, the commission agent receives remuneration from his principal as a percentage of the value of goods sold.

4 Del Credere Agents: Generally if any mercantile agent sells goods on credit with the approval of the owner, he is not responsible for any loss which may arise due to non-payment by the buyer. The owner or principal has to bear the risk of loss on account of such bad debts. When a mercantile agent sells the goods on credit and assumes the risk of bad debts, he is known as a del credere agent. For bearing such risk of bad debts, additional commission as a fixed percentage of the amount of credit sales is given to him. This additional commission is called del credere commission. In other words, the del-credere agent bears the loss which may arise on account of bad debt and the owner is protected against the loss.

5 Auctioneers: Middlemen appointed as agents to sell goods by auction are known as auctioneers. They assemble goods from different parties and act on their behalf to sell them to intending buyers. The date and time of auction are announced in advance. Goods are displayed for inspection by interested buyers, Bids are then invited by the auctioneer

from those present at the time of auction. Sometimes a minimum price is fixed for specific items known as reserve price and bids are not accepted below that reserve price. The goods are sold to the highest bidder. The auctioneer gets commission from the principal (seller) as a percentage on the sale price.

10.7.2 Merchant Middlemen

Middlemen who act on their own right buying and selling goods at a profit, are called merchant middlemen or merchants. They acquire title to the goods and bear the risks of trade besides performing various functions like storing, grading, packing and packaging, etc. Merchant middlemeh may be divided into two categories.

i) Wholesale traders
ii) Retail traders

Merchants who buy goods from producers or manufacturefsor their agents and sell the same to industrial consumers or retail traders are known as wholesale traders. The middlemen who buy goods from producers or wholesalers and sell the same to ultimate consumers are known as retail traders. Thus, retailers act as the final link in the channel of distribution. You will study in more detail about wholesalers and retailers in Unit 11.

Check Your Progress C

1 Differentiate Between mercantile agents and merchant middlemen.

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2 Distinguish between a commission agent and a del credere agent.

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3 Differentiate between a wholesaler and a retailer.

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4 Fill in the blanks.

i) Manufacturers can use capital more profitably through ....activities.

ii) Middlemen are specialised in performing..........functions.

iii) Middlemen who undertake marketing functions without having title to goods are called.............

iv) Merchant middlemen include.............and.............

5 'Which of the following statements are True and which are False?

i) Mercantile agents as well as merchant middlemen earn commission when they sell goods.

ii) Brokers negotiate the terms of sale and purchase on behalf of either the buyer or the seller.

iii) Retailers buy goods for resale to other traders.

iv) The commission agent generally has the possession of goods which he sells.

v) Auctioneers act as agents of sellers.

10.8 ROLE OF MIDDLEMEN

You have learnt that the producers use a host of middlemen bearing a variety of names.

Some people often question the wide use ofmiddlemen and feel that it may not only delay the availability of goods but also add to the cost of distribution and hence, the price charged from customers may be higher. But it is not the case in practice. In fact, the middlemen play a very useful role in the distribution of goods by providing a variety of functions at reasonable cost. They undertake all the channel functions such as assembling, grading, packaging, storing, financing, risk-bearing, etc. We may however put them more specifically as follows:

1 Provide local convenience to consumers : Merchant middlemen like retailers are located at convenient shopping centres. They provide ready delivery of goods to the consumers at-convenient points.

2 Provide field stocks : The agents and wholesalers are spread all over the country. They buy in bulk and keep the goods in stock. The retailers can approach them any time and buy their requirement. The producers, therefore, need not provide stock of their goods in different cities which would be quite a cumbersome activity involving huge investment and management problems.

3 Financing :The agents finance the distribution activity in many ways. They often pay cash for their bulk purchases from the producers and even advance money to them against their orders. The funding of field stocks is thus fully handled by the middlemen.

4 Servicing : They arrange for the after sales services and handle all kinds of complaints by the consumers locally. The manufacturer does not have to open his own service centres at all places.

5 ,Acting as channels of communication : The middlemen are in constant touch with different producers and the market. They can proyide feed back about the market to the producers on the one hand and pass on information about thk products to the consumers on the other.

6 Help in promotion ; They also help the sales promotional activity through displays and salesmanship. It is literally impossible for the producers to organise such activity through any other means. Even otherwise, the middlemen being local people are more effective.

Apart from the variety of services provided by the middlemen, what makes their role more important is the fact that they handle them more efficiently and usually at a reasonable cost. They are better equipped to perform these functions because they possess special knowledge and skills, experience and contacts. The manufacturers would find it very difficult to organise the distribution network and provide the necessary funds. You should remember that the distribution of goods and provision of essential services is a gigantic task which involve huge funds and management problems. By making use of middlemen the manufacturers are freed from the botheration of distribution. They can concentrate on productiori activity which may be more profitable. Not only that, in case of mass consumption items it is almost impossible to the producers to organise direct sale in every nook and comer of the country.

10.9 LET US SUM UP,

Home trade consists of buying and selling or exchange of goods within the boundaries of a country. Producers and consumers are separated by place and time. Distribution system eliminates these barriers and move the goods from producers to the consumers. Channel of distribution refers to a network of institutions that perform a variety of interrelated and coordinated functions in the movement of products from producer to consumers. The .functions performed in the channels of distribution are of three kinds: (i) transactional functions which are necessary tor purchase and sale, (ii) logistical functions which are required for physical exchange of goods, and (iii) facilitating functions which facilitate the transactions as well as physical exchange.

Channels of distribution can be grouped into two categories: (1) direct selling by manufacturers, and (2) use of middlemen such as agents, wholesalers and retailers (indirect onannel). Channel of distribution for consumer goods of daily use consists of agents or orokers, wholesalers and retailers as intermediaries. Durable consumer goods are generally distributed through showrooms of manufacturers,·or through retailers called dealers. Capital goods are often sold directly by manufacturers, Sometimes distributors, dealers or agents are employed for supply of such goods.

channel). Channel of distribution for consumer goods of daily use consists of agents or brokers, wholesalers and retailers as intermediaries. Durable consumer goods are generally distributed through showrooms of manufacturers, or through retailers called dealers. Capital goods are often sold directly by manufacturers. Sometimes distributors, dealers or agents are employed for supply of such goods.

The channel suitable for distribution of a specific product depends on a number of factors such as : (i) distribution policy, (ii) characteristics of the product, (iii) characteristics of target customers, (iv) supply characteristics, (v) types of middlemen in the channel, (vi) potential volume of sales, (vii) cost of distribution, (viii) profits expected in the long-run, and (ix) channel competition.

Middlemen may be divided into two categories (1) functional middlemen, and (2) merchant middlemen. The functional middlemen perform various marketing functions without having ownership rights. Included in this category are : Factors, Brokers, Commission Agents, Del Credere Agents, and Auctioneers. Merchant Middlemen or merchants buy and sell goods for a profit on their own right and having title to the goods. There are two categories of merchant middlemen : (1) Wholesalers, and (2) Retailers.

The role of middlemen in the distribution of goods lies in the marketing functions which they perform. They are important because their specialisation enables them to perform the functions more efficiently and at a lower cost.

10.10, KEY WORDS

Assembling : Procurement and collection of goods from different sources of supply.

Auctioneer : A middleman appointed as an agent to sell goods by auction.

Branding : Selecting brand names for various products for differentiation.

Broker : A middleman who brings together the buyer and seller, and negotiate the terms and conditions of sale on behalf of either buyer or seller.

Channel of Distribution : A network of institutions involved in distribution of goods from producers to consumers.

Commission Agent : A middleman who sells goods on commission basis on behalf of the owner.

Del Credere Agent : An agent middleman authorised to sell goods on credit and who assumes the risk of bad debts.

Factor : A mercantile agent who keeps the goods of others for sale. He can sell the goods in his own name, pledge and do all acts necessary for sale.

Grading : Sorting out goods of uniform size, quality, or other specifications.

Mercantile Agent : A functional Middleman who undertakes specific functions of sale or purchase of goods as agent of the owner without having ownership right.

Merchant Middleman : A middleman such as wholesaler or retailer who buys and sells goods in his own name and performs necessary functions in that connection.

Middleman : An intermediary between the producer and the consumer to help distribution ofgoods.

Packing : Making packs or putting goods in containers to prevent spoilage, breakage, etc., during their transportation.

10.11 SOME USEFUL BOOKS

Amarchand D., and B. Varada Rajan, 1983. *An Introduction to Marketing,* Vikas Publishing House: New Delhi. (Chapter 2).

Bhushan, Y.K.1987. *Fundamentals of Business Organisation & Management,* Sultan Chand & Sons: New Delhi, (Part Seven, Chapter. 3).

Musselman, Vernon A., and John H. Jackson, 1985. *Inti-oduction to Modern Business,* Prentice-Hall of India: New Delhi. (Pan Four, Chapter 13).

Ramesh, M.S. 1985. *Principles and Practice of Modern Business Organisation, Administration & Management,* Kalyani Publishers: New Delhi. (Volume III, Chapter 6).

Singh, B.P. and T.N. Chhabra, 1988. *Business Organisation and Management*, Kitab Mahal : Allahabad. (Section Six, Chapter 26).

10.12 ANSWERS TO CHECK YOUR PROGRESS

A	2	i) False	ii) True	iii) False	iv) False	v) True
	3	i) Home trade	ii) Home trade	iii) Foreign trade	iv) Foreign trade	
B	4	i) False	ii) False	iii) False	iv) True	v) True
		vi) True	vii) True	viii) True		
C	4	i) Production	ii) marketing	iii) functional middlemen		
		iv) wholesalers, retailers				
	5	i) False	ii) True	iii) False	iv) True	v) True

10.13 TERMINAL QUESTIONS

1 What is a channel of distribution? Explain briefly the channels of distribution used for consumer goods and industrial goods.

2 Outline the factors which influence the choice of distribution channel.

3 Who is a middleman? Explain brietly the role and importance of middlemen in the distribution system.

4 Explain briefly about various types of middlemen.

5 Write explanatory notes on:
a) Direct channel
b) Short channel and long channel
c) Functions carried out by the Channel of distribution
d) Merchant middlemen

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

UNIT 11 WHOLESALERS AND RETAILERS

Structure

11.0 Objectives
11.1 Introduction
11.2 Who is a Wholesaler?
11.3 Importance of Wholesalers
11.4 Types of Wholesalers
11:5 Functions of Wholesalers
11.6 Services of Wholesalers
11.6.1 Services to Manufacturers
11.6.2 Services to Retailers
11.6.3 Elimination of Wholesalers
11.7 Meaning and Importance of Retailing
11.8 Functions of Retailers
11.9 Services of Retailers
11.10 Itinerant Retailers
11.11 Fixed Shop Retailers
11.11.1 Small Scale Retail Shops
11.11.2 Large Scale Retail Shops
11.12 Let Us Sum Up
11.13 Keywords
11.14 Some Useful Books
11.15 Answers to Check Your Progress
11.16 Terminal Questions

11.0 OBJECTIVES

After studying this unit you should be able to:

- explain the nature and importance of wholesale trade
- distinguish between different types of wholesalers
- describe the services of wholesalers
- state the meaning of retailing
- explain the functions of retailers
- distinguish between different types of retailers
- narrate the features of different types of retail stores.

11.1 INTRODUCTION

The main objective of every-manufacturer is to make his goods available to the users. He wants to ensure that the consumers should be able to buy the goods at convenient places. As you know, even if manufacturers wish, it may not be possible for them to reach every consumer directly. This is because production takes place in a limited number of factories' or workshops whereas the consumers are spread over large temtories. So, most of the large-scale producers take the help of middlemen for supply of goods to the ultimate consumers. In the previous unit it was mentioned that wholesalers and retailers are two categories of middlemen who can be engaged by manufacturers for supplying their products to the target consumers. In this unit we discuss the role of wholesalers and retailers in the market.

11.2 WHO IS A WHOLESALER?

Simply stated, wholesalers are those who happen to be engaged in wholesaling or wholesale trade. In a broad sense, any individual or business firm selling goods in relatively large quantities to buyers other than the ultimate consumers may be called a wholesaler. Thus manufacturers who sell their products directly to retailers may be regarded as wholesalers. However. in a more specific sense the term wholesaler may be defined as a merchant middleman eagaged in buying and reseliing of goods to retailers and other merchants, or to industrial or commercial users. Wholesalers do not sell the products to ultimate consumers. The wholesalers belong to the category of merchant middlemen who acquire title to the goods they handle. Agents or brokers may also act as wholesale middlemen but they do not acquire the title to goods. Wholesalers act as middlemen between producers or importers of goods on the one hand, and retailers or industrial users on the other. The goods traded by wholesalers may include agricultural commodities, forest products, minerals as well as manufactured goods.

11.3 IMPORTANCE OF WHOLESALERS

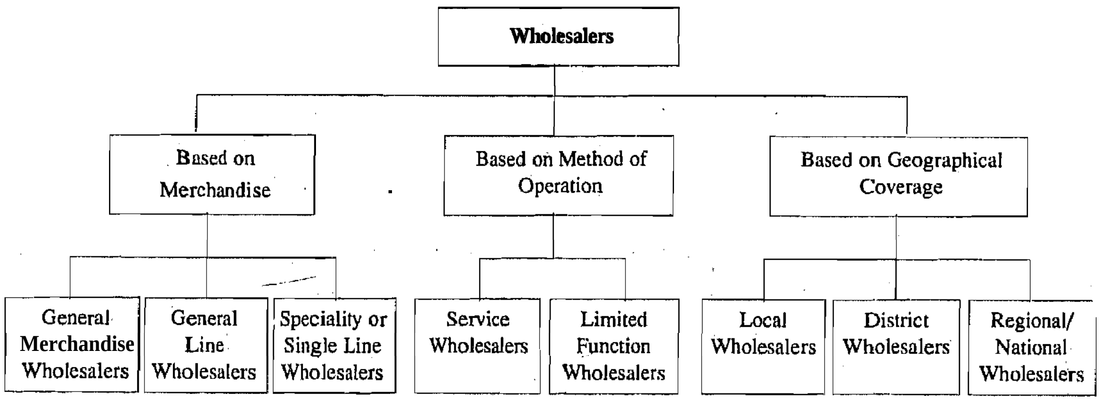
Manufacturing companies often do not have adequate capital to employ salesmen to contact the large number of retailers. Many small retailers run their business in remote areas and to contact them may be too expensive. Morover, small retailers generally prefer to buy products in small quantities due to their limited capital, lack of market information and sources of supply. The wholesalers solve the problems of manufacturers as well as small retailers. A wholesaler can place sufficiently large order with the manufacturer keeping in view the requirements of a number of small retailers in his area. In that process, the wholesaler is in a position to meet the small orders of retailers.

From the society point of view, distribution of goods may be efficient because bf the specialised knowledge and skill of wholesalers. On the other hand, manufacturers can concentrate on efficient production of goods. Naturally, they do not undertake the distribution of their products because their efficiency in manufacturing would suffer on account of divided attention.

111.4 TYPES OF WHOLESALERS

Wholesalers, may deal in a large or limited variety of products, restrict their activities mainly to wholesaling or perform various functions incidental to their trade, and may operate in small or large geographical territories. Accordingly, wholesalers may be classified on three different bases: (1) merchandise dealt with, (2) method of operation, and (3) coverage of geographical area. Look at Figure 11.1 for classification of wholesalers.

Figure 11.1
Types of Wholesalers


Wholesalers
Based on Merchandise
Based on Method of Operation
Based on Geographical Coverage
General Merchandise Wholesalers
General Line Wholesalers
Speciality or Single Line Wholesalers
Service Wholesalers
Limited Function Wholesalers
Local Wholesalers
District Wholesalers
Regional/ National Wholesalers

Merchandise Basis

On the basis of goods dealt with by the wholesalers we may distinguish three types of wholesalers:

i) **General** merchandise wholesalers—those who deal in two or more unrelated types of products. For instance, a wholesaler may deal in a number of consumer durables like, electrical goods, sports goods, cosmetics, hosiery, etc.

ii) General-line **wholesalers**—those who carry a number of goods in the same product line. For instance, a wholesaler may carry convenience goods of daily household necessity like soaps, detergents, toothpaste, razor blades, etc., or may stock cereals and provisions like wheat, rice, dal, etc.

iii) Single-line or speciality wholesalers—those who restrict their operation to a narrow range of products or specific products. Wholesalers dealing in a few varieties of textiles (cloth), or carrying varieties of printing paper only may be called speciality wholesalers, or single-line wholesalers.

Method of Operation

On the basis of the method of operations, wholesalers may be divided into two categories:

i) Service wholesalers—those who perform a variety of functions like advertising, grading, branding, packaging, etc., on behalf of manufacturers and retailers.

ii) **Limited** function wholesalers—those who undertake to carry out a few limited functions, like packaging or grading.

Territory Covered

On the basis of the geographical coverage of dealings, wholesalers may be grouped into three types:

i) Local wholesalers—those who restrict their operation to a particular city or town and supply products to retailers in that area.

ii) District **wholesalers**—those who have dealings with retailers located in a district.

iii) Regional **or** national wholesalers—those who specialise in products having a national market and are nationally advertised. They have dealings with retailers located in a region or a country.

Check Your Progress **A**

1 Who is a wholesaler'?

....

....

....

....

....

2 State which of the following statements are True and which are False.

i) Any businessman buying and selling goods on a large scale may be called a wholesaler.

ii) Distribution of goods take place with greater efficiency due to the existence of wholesalers.

iii) A local wholesaler is one who meets the needs of only one or two retailers.

iv) Service wholesalers are those middlemen who arrange supply of **services** like transport,

3 Fill in the blanks with appropriate words.

i) Wholesalers are in a position to meet the_____ orders of retailers.

ii) Wholesalers generally supply goods to buyers other than the ultimate ________

iii) Wholesalers serve retailers as well as ______.

iv) Single line wholesalers deal in different _____ of a single product line.

10.5 FUNCTIONS OF WHOLESALERS

In the preceding section we have learnt that wholesalers perform limited functions or undertake a variety of functions. Actually, the functions of a wholesaler depend upon the nature of the products dealt with and the business policy of that particular wholesaler. Of course every wholesaler must carry out the minimum functions of buying, storing and supplying one or more products. Besides these primary activities, several other functions may also be performed by wholesalers Broadly, the functions of wholesalers may be **grouped** as **fallows:**

1 Assembling products : The basic function of every wholesaler is that of procuring goods From manufacturers and holding large enough stocks for sale to the retailers:

2 Arranging storage : The wholesaler has to make arrangements for holding stocks to meet the needs of retailers from time to time. He must see that goods in stock are not spoiled or damaged. For proper storage he may have his own warehouse or hire one.

3 Grading and **packaging** : Wholesalers who usually purchase in bulk rnay have to do the grading of products, i.e., sort out the products according to quality or size or other factors. For the convenience, it may also be necessary for wholesalers to undertake packaging of goods.

4 Transporting **goods** : The wholesaler is generally required to arrange transportation of the goods procured from the place of manufacture to his godown. Often he is also to arrange delivery of the goods to retailers according to their needs.

5 Distribution of goods : Goods assembled and held in stock must be rnade available to the retailers who may be scattered in different parts of a city or region. For this purpose, advertisement and employment of salesmen must be undertaken by the wholesaler.

6 Financial : As a general practice wholesalers provide credit facility to retailers. Thus, payment can be made by retailers after goods have been sold by them or when their clients have cleared their accounts.

Financing of retail trade is a very common function of wholesalers. Sometimes, wholesalers also advance money to manufacturer against orders placed for purchase of goods. This is another type of financing done by wholesalers.

7 Risk-bearing : Procurement and holding large stocks of goods in anticipation of demand from retailers involves considerable risk of loss for the wholesalers. If market conditions change due to reduced demand or entry of competitors, the wholesalers end up with huge unsold stock.

8 Price fixation : The prices of goods which consumers have to pay depend upon the prices fixed by wholesalers and charged from retailers. This is an important function to be performed by wholesalers because a number of factors including prices of competing goods, effect of prices on demand, etc., have to be taken into account.

11.6 ,SERVICES OF WHOLESALERS

We have already learnt how wholesalers serve manufacturers and retailers by buying goods in large quantities, holding stocks and supplying smaller quantities to the retailers. In that way the wholesalers act as a bridge between producers and retailers. Let us now examine closely the services rendered by whblesalers to the manufacturers and retailers.

11.6.1 Services to Manufacturers

The wholesalers perform several important functions for the manufacturers which may be stated as follows:

1 The wholesalers place large orders with the manufacturers or procure large quantities of goods from manufacturers. Thereby manufacturers are relieved of the task of marketing their goods, and they can concentrate on production only. Manufacturers need not necessarily hold large stock in their godown. Hence there is saving of expenses on storage and warehousing.

2 Wholesalers remain in close touch with the retailers. They get regular infotmation from the retailers about changes in the consumer's demand for particular products as also about competing products. On the basis of such information, wholesalers place orders with manufacturers. Thus, wholesaler's purchase orders reflect the changing market conditions. Hence the volume of production can be regulated by the manufacturers in accordance with the changing market conditions as reflected by the wholesaler's purchase orders.

3 Often the wholesalers place orders in advance on the basis of their expectations regarding future demand of products even though the current demand is low. This helps manufacturers to continue their production on an even pace.

4 Wholesalers may also participate in the advertising of products jointly with the producers, which is of great advantage to both the parties.

11.6.2 Service to Retailers

Retail traders are benefited by the services of wholesalers to a greater extent than the manufacturers. The more important of the services to retailers are as follows:

1 A variety of goods can be procured by retailers in small quantities from the wholesalers. Most retailers serve a large number of customers. Thus different types of products have to be stored by a retailer to meet the needs of individual consumers. It is difficult for him to buy the products from different manufacturers in small quantities. He can easily do so by contacting a few wholesalers.

2 Small retailers can get repeated supplies of products from wholesalers. Thus they are able to run their business with a relatively small amount of capital. Large stocks are not to be held by them, so there is saving of storage space as well.

3 Wholesalers have expert knowledge of the lines of products they deal with. They procure the items from the best sources, that is from producers who supply the best quality at competitive prices. Retailers also get advantage of the wholesalers' specialised knowledge of the products.

4 Retailers are protected from the risk of loss which would arise if they were to hold large stocks of any product. It is the wholesalers who bear the maximum business risks arising out of falling demand for products.

5 Most wholesalers supply goods on credit to the retailers. This enables small retailers to pay for the goods after sale or customer payment on account. The working capital required for retail trading is thus relatively small.

6 Generally retailers come to know about new products or items of trade only through the wholesalers who deal with manufacturers. Whenever any new product is introduced, wholesalers bring it to the notice of retailers either through salesmen or display in showrooms.

11.6.3 Elimination of Wholesalers

We have learnt about the functions performed by wholesalers and the services rendered by them to the manufacturers and the retailers. What about the consumer? Does the existence of wholesalers in the distribution channel serve any useful purpose for the consumers as well? Apparently, the wholesalers do not directly serve consumers who need adequate supply of goods at reasonable prices. In fact some people who argue that there is no need for the presence of wholesalers in the distribution channel and that they should be eliminated. These arguements are as follows:

1 There are a number of wholesalers who interpose between the producer and the consumer, and the price paid by the consumers included the profit margin of these wholesalers. This leads to a higher price of the product for the consumers.

2 The wholesalers merely act as transfer agents. They do not render any corresponding service for the profits they earn.

3 The wholesalers hold large stocks. They often manipulate the supply to push up the prices specially during periods of scarcity.

Those who feel that the presence of the wholesaler in the distribution channel is'of vital importance argue as follows:

1 Wholesalers relieve the manufacturers from the distribution function and this enables the manufacturers to concentrate on production activity.

2 They are closer to the market. They can concentrate on the localised marketing strategies without the distractions of manufacturing problems.

3 They have good understanding of holding and handling the inventories which involve heavy investment.

Thus, they believe that it is not possible to eliminate the wholesalers completely in each and every area of business activity. However, they do not rule out the Possibility of reducing the multiplicity of wholesalers in the channel, particularly the functional wholesalers. Some people suggest the cooperative societies as an alternative to the wholesalers. But, in the light of the inherent weaknesses of the cooperative societies in India, one does not feel optimistic about the success of cooperatives in eliminating the wholesalers. Possibly the advent of large scale retailing could solve the problem because the producers prefer to deal directly with them. On account of the valuable services provided by the wholesalers in the distribution of mass consumption items, their elimination can cause hardship to the consumers.

Check Your Progress B

1 Fill in the blanks selecting the most appropriate word from those given in brackets.

i) Wholesalers save the manufacturers of the necessity of holding ...., stocks of their products. (large/year-end)

ii) .... of goods is done by wholesalers for the convenience of retailers. (pricing /packaging)

iii) Assembling function of wholesalers is closely related with the ....function. (storage/pricing)

iv) Most wholesalers supply goods on.........to retailers. (credit/lease)

2 Which of the following statements are True and which are False?

i) Wholesalers finance retail traders by lending money without interest.

ii) Manufacturers can concentrate on production because wholesalers take over the responsibility of marketing.

iii) It is only the wholesalers, not the manufacturers, who are concerned with changes in the product market conditions.

iv) Retail price of goods is determined on the basis of price charged by the wholesalers.

v) Advertising a product is only the manufacturers' responsibility, not the wholesalers'.

11.7 MEANING AND IMPORTANCE OF RETAILING

In simple words retailing refers to all transactions which involve sale of goods to the ultimate consumers for personal consumption. If the buyer uses the goods for reselling purposes it will not be treated as a retailing transaction. Any individual or business unit or shop primarily engaged in retail selling is known as a retailer or retail **store.** In a general sense, even a manufacturer or wholesaler may sometimes engage in sale of goods to the ultimate consumers. But they are not called retailers as retailing is not the major activity of a manufacturer or wholesaler. Thus a retailer or retail store is one whose business consists primarily of sale of goods to consumers for their own use, but not for resale in business. Retail business may include other types of transactions also. It will be treated as a retailing business if more than half of its total sales revenue is from retail trading.

A retailer is a middleman because retailing involves procuring goods from suppliers (generally wholesalers) and selling them to consumers for their personal use. Retailers perform the very important task of making goods available to consumers, which after all is the objective that underlies the production of goods. Retailers thus form a vital link in the channel of distribution of products.

Since the retailers deal with a large number of consumers of many different categories, the role of retailers in the physical distribution of goods is clearly of vital importance. The retailers act as a link between the producers or wholesalers on the one hand and the consumers on the other. Without retailers, neither the products would sell in distant places, nor would it be possible for consumers to buy goods of their choice in shops located nearby. Due to large-scale manufacture of a wide variety of consumer goods and the necessity of making them available to individuals living in distant villages, cities and towns, retailers are now regarded as the most important middlemen in the chain of distribution of goods.

11.8 FUNCTIONS OF RETAILERS

Like the wholesalers, retailers also perform a variety of functions connected with the buying and selling of goods. Briefly stated, they perform the following functions.

1 **Estimating the demand** : All retailers—big or small—have to make an estimate of the demand for different products and have to determine the nature of products that consumers need to be supplied.

2 , **Procurement of goods** : Most retailers deal in a variety of products. So they may have to procure goods from different wholesalers. Besides, they must decide to buy from those wholesalers who supply goods suited to the requirements of consumers as to quality and price.

3 **Transportation** : Usually the retailers are to arrange the transportation of goods procured from the wholesalers' place. Sometimes delivery is also arranged by the wholesalers on the basis of orders placed with their salesmen.

4 **Storing goods** : Small-scale retailers have limited space for the goods to be kept in stock. Large retail stores often have godowns to store different varieties of goods in adequate quantities. But in all cases, gootls have to be held in stock so as to meet the customers' needs. For this purpose storage of goods must be so arranged that customers may be served without delay. They must be given an opportunity to select goods of their choice. This is often done by display of goods on shelves and in show-cases.

5 **Grading and packaging** : Large-scale retailers often have to sort out goods according to the quality and price to be charged. They also make convenient packages of goods for the benefit of consumers. For instance, fruit vendors purchase apples in containers (boxes), sort out on the basis of size and charge different rates for different sizes. Spices which are procured in bags, may be divided into small packets of 100 or 200 grams each.

6 **Risk-bearing**: Since goods are held in stock, the retailers are to bear the risk of loss on account of deterioration of quality, fire, theft, etc. Large retail stores are insured to cover the risks of theft or fire. But losses due to damage or deterioration of quality caused by improper storage cannot be insured.

7 **Selling** : The main function of retailers is selling the goods to ultimate consumers. They have to satisfy the needs and preferences of different types of customers and deal with them tactfully and politely so as to make them regular buyers.

1.9 SERVICES OF RETAILERS

As middlemen engaged in the distribution of goods, retailers deal with wholesalers and consumers. Manufacturers as well as wholesalers depend a great deal on retailers for reaching the ultimate consumers to supply various products. Retailers provide the necessary outlet for goods and thus render very useful service to the wholesalers and also to the producers indirectly. The services of retailers to the consumers are significant in several ways:

1 **Holding ready stocks** : By holding stocks, retailers supply varieties of goods of daily use to consumers. Besides, consumers are also given opportunity to make their choice from serveral varieties produced by different finns.

2 **Display of goods** : By displaying goods on shelves or in show-cases, retailers bring new products to the notice of customers. They also keep the customers informed about the latest varieties of goods available for sale by explaining their qualities and prices. Customers are also given demonstration of new products on the sales counter.

3 **Advice to consumers** : Very often retailers help the customers to make their decision to buy certain goods by advising them on the merits and use of particular varieties of products.

4 **Personal services** : Apart from meeting the needs of different types of customers, retailers also offer a variety of services like home delivery, sale on credit, etc.

Check **Your Progress C**

1 Which of following statements are True and which are False?

i) Retailers always buy goods from manufacturers.

ii) Manufacturers selling goods to consumers cannot be called retailers.

iii) Retail trade includes sale of goods by one retailer to another retailer.

iv) Display of goods in show cases is one of the functions of retailers.

v) Goods are always delivered by wholesalers to the retailers.

vi) Retailers never advise customers about the quality of goods to avoid responsibility.

2 Fill in the blanks.

i) Retailing means sale of goods to consumers for...... use.

ii) Retailers generally procure goods from ....

iii) Goods are **.....**by the retailer to bring new products to the notice of customers.

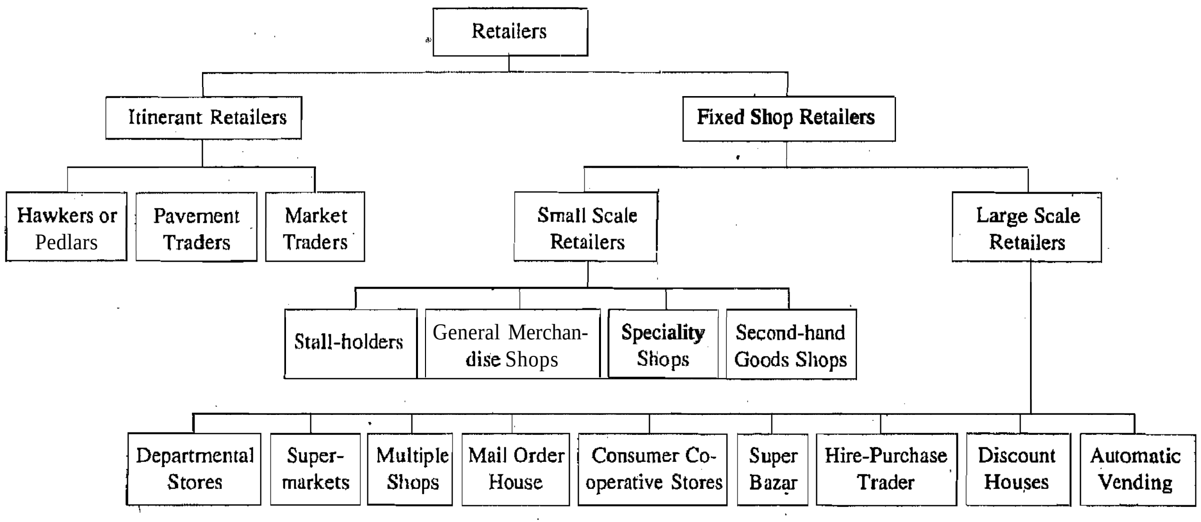
11.10 ITINERANT RETAILERS

Retail trade can be undertaken by individuals, partnership firms, companies as well as cooperative societies. Retailers may carry on their activities at various locations on a small scale or large scale. In fact there are innumerable ways that retail trade can take place. Broadly speaking, we may devide the retailers into two categories :

1 Itinerant retailers
2 Fixed shop retailers

Look at Figure l 1.2 for different types of retailers.

Figure 11.2
Types of Retailers


Retailers
Itinerant Retailers
Fixed Shop Retailers
Hawkers or Pedlars
Pavement Traders
Market Traders
Small Scale Retailers
Large Scale Retailers
Stall-holders
General Merchandise Shops
Speciality Shops
Second-hand Goods Shops
Departmental Stores
Super-markets
Multiple Shops
Mail Order House
Consumer Co-operative Stores
Super Bazar
Hire-Purchase Trader
Discount Houses
Automatic Vending

Retail traders who carry on business moving about from place to place to sell their goods are known as itinerant retailers. They do not have any fixed place of business. They either move from house to house with their goods, or change their place of business frequently according to convenience and sales prospects. Thus these itinerant retailers move about and try to reach as nearer to the buyers as possible.

Types **of Itenerant** Retailers : There are three types of itinerant traders :

1) Hawkers or pedlars
2) Pavement traders
3) Market traders. ,

1 Hawkers **or** Pedlars : These retailers move from door to door in **residential localities** and sell their wares which may consist of **vegetables, fruits,** utensils, toys, **icecream,** snacks, etc. They carry their articles in bags **or** trays hanging **from shoulders,** on bicycles, in push carts, small motor vans, or horse-drawn **carriages.**

2 **Pavement Traders** : Pavement traders are found in busy market areas, street crossings, in front of railway stations and bus terminals. The goods traded by them include items like hand bags, cut-pieces of cloth, readymade garments, footwear, household utensils, toys, books and journal, pens and pencils, fruits, vegetables, etc. These traders sometimes put up temporary sheds or make-shift platforms for display of goods. More often they spread their wares on pavements at different places depending on the prospects of sale.

3 **Market Traders** : This type of itinerant retailers generally sell their goods in weekly markets held in small towns or villages. They move from one market to another in the neighbouring places on the particular days fixed for the market.

Services of Itinerant Retailers : These retailers serve consumers at the nearest and the most convenient places. They serve either at the consumers' door-step or on busy places through which consumers pass through. Thus, housewives and working people find it very convenient to buy goods from itinerant traders like hawkers and pavement traders. Market traders in small towns and villages are also very useful to the consumers as they do not have fixed shops within easy reach. All itinerant retailers save time and effort of customers in buying articles of ordinary use. Housewives have the satisfaction of shopping leisurely at their doorstep.

11.11 FIXED SHOP RETAILERS

Fixed shop retailers carry on their business in a certain premises. They locate their stores at fixed places where customers can easily reach and make their purchases. The main difference between the itinerant retailers and fixed shop retailers is that the itinerant retailers do not have a fixed place of business whereas the fixed shop retailers carry on their business in a certain premises.

Fixed shop retailers may be divided into two broad types according to the volume of business and methods of operation :

1 Small-scale retailers
2 Large-scale retailers

Small scale retailers generally deal in a limited range of products like stationery, provisions (grocery), confectionery, vegetables, fruits, elc. General stores selling a limited number of varieties of different goods of daily household consumption also come in the category of small-scale retailers. Large scale retailers include retail stores like departmental stores and super markets which deal in and stock a wide range of products and cater to the needs of fairly large numbers of customers. Now let us discuss in detail these categories.

11.11.1 Small-scale Retail Shops

Small-scale retail shops include those small shops dealing with iniscellaneous products of regular use, and shops selling particular products of different varieties. They hold small stocks and do their business in fixed shops located in residential areas or market places. According to the nature of goods sold the small relail shops may be divided into four categories as follows :

1 Stalls on streets
2 General merchandise shops
3 Speciality shops
4 Second-hand goods sellers

1 **Stalls on streets** : Small shops on the road side are very common in cities and towns. These are set up as stalls in front of large stores or in residential areas selling a limited variety of products of regular use like stationery, grocery, toilet products, biscuits, etc. The shops are located within easy reach of consumers' residence or nearby roads or street-crossings, or bus stops. These retailers meet the needs of customers at convenient locations. They supply goods of regular use for which customers are not prepared to go to central markets.

2 **General merchandise shops** : These are small retail stores which deal in all types of general consumer goods of regular use including provisions, bread, butter, stationery

and toiletry, paper and pencils, cigarettes, matches, etc. These shops are located in thickly inhabited residential areas and busy markets. Consumers find it convenient to buy all their requirements in one shop. Regular buyers are also offered home delivery services and credit facility.

3 Speciality **Shops** : Small retail shops which deal in only one or two special types of goods are known as speciality shops. The goods dealt with may be only electrical fittings of different kinds, or medicines, or motor parts, or books and stationery, or bread and confectionary items, or ready-made garments, or toys, etc. People often find it convenient to buy their requirements from these shops due to the availability of different grades and sizes in the same product line.

11.11.2 Large-scale Retail Shops

Large-scale retail shops are so called because they deal in a large variety of goods, and have large volume of business. The types of fixed shops in this category include the following: '

1 Departmental stores
2 Super-market
3 Multiple shops or chain stores
4 Mail order house
5 Consumer cooperative stores
6 Hire purchase traders
7 Discount houses
8 Super bazars
9 Automatic vending machines

We shall now discuss briefly the characteristics of each of these types of retail shops.

Departmental **Store** : A departmental store is a large-scale retail store in which there are several departments each selling a particular type of product. The departments are like separate retail shops operating in the same building. The idea behind a departmental store is to offer as many different products as possible to each customer. Thus, a wide range of products is sold under the same roof, and in each department there are varieties of a particular product available for sale. This type of stores can be regarded as a retail market in which the shops are owned and controlled by a single business firm. The departmental stores are generally established in central locations in cities so that they are within short distance of residential localities.

All kinds of consumer goods are sold in departmental stores. But perishable goods, like vegetables, fruits, bread, butter, milk, etc., are not sold in these stores. To attract customers, the departmental store also provides a number of services and facilities like hair-cutting saloon, beauty parlour, restaurant, reading room, telephone, toilets, and even recreation facilities. These stores are very popular in USA and European countries. In India departmental stores have been established in cities like Bombay, Calcutta, Madras, Delhi.

Super-market: **A** Super-market is a large-scale retail store which offers for sale a wide variety of consumer good of regular use. The articles may include stationery, toiletry, dress materials, ready-made garments, toys, grocery items, crockery, kitchen utensils, medicines, as well as bread, butter, meat, eggs, fruits, vegetables, etc. The items are placed in separate stalls in the same building, or kept on shelves or tables in a hall, The customers are to pick-up the items they need and then pay for the articles at the cash counter. It works on a self-service basis though one or two salesmen are there to help the customers.

The super-market, like the departmental store, deals in a large variety ol'goods, But there are certain differences between the two types of stores:

i) In **a** super-market the products sold are generally low priced, fast-moving items of daily need. Durable goods like refrigerators,electric fans, radio, television, etc., are not available in super-markets. A departmental store mostly concentrates on consumer' durables and fashion goods.

ii) In a departmental store there are separate counters served by salesmen, whereas super-market operates on a self-service basis.

iii) Customers are not provided with services and facilities like hair-dressing recreation, etc., in a super-market. These **may be available** in **large departmental** stores, although not in **every such store.**

Now-a-days the departmental stores and the super-markets have started dealing in similar products and the difference between the two is fast fading.

Multiple Shops or Chain Stores: Multiple shops are retail stores located at different places under the same ownership and management, and deal in similar products. It is **a** system of large-scale retailing through stores located as near as possible to the residential areas. Since the stores are owned and managed by the same organisation, they are also known as **chain stores.** These stores may be established by manufacturers or trading companies. The more important features of the multiple shop system are as follows:

i) **A** limited range of products are sold through the shops.

ii) The same tvpe of products are sold by every shop.

iii) Goods are centrally purchased or produced and supplied to each store which is run by a manager.

iv) There is uniformity in the setting and outward appearance of the stores and interior display of goods.

v) Prices are fixed by the central office and the same price is charged in every store.

In India, chain stores have been established by **a** number of manufacturing companies like Delhi Cloth Mills, National Textile Corporation, Mafatlal, Bata Shoes, Jay Engineering Works (Usha Brand products).

Mail-order House: Retail trading which consists of receiving orders by mail and delivery of goods by parcel post is known as mail order business. The mail-order house is thus a retail trading organisation which uses the post office as its channel of distribution. Standard consumer goods with trade marks or brand names are generally dealt with by mail order houses. This is because customers are to place orders without physically checking the items. Bulky goods which cannot be delivered by post, and those for which delivery costs are relatively higher, are not included in the items traded. Orders from customers may be secured by advertising in newspapers or journals. Sometimes circular letters are issued by mail to certain categories of customers. For this purpose, a mailing list may be prepared from the telephone directory, or from the list of members of a club, or traders' association. The mailing list contains the names and addresses of persons likely to be interested in the particular goods. Customers are invited to send their orders by post to the address of the mail order house. Delivery is made by V.P.P (Value Payable Post). Goods are thus available to the customers on payment of the price which is remitted by the post office to the sender of goods.

Mail-order business helps customer; to get their requirements at their own place and save the time and expense of shopping. The mail-order house, on the other hand, is also benefited in a number of ways. Goods can be procured according to the orders received. The business can thus be started with a small amount of capital. Payment for goods is assured through the post office. A wide market can be covered by means of postal communication. However, mail order business has not developed in India mainly due to the existence of retail trading shops in every locality. Besides, illiterate people cannot be approached through the mailing list.

Consumer's Cooperative Stores : Retail stores run by Cooperative societies formed by consumers are known as consumers' cooperative stores. The society enlists members from among the public or a particular group such as employees of an organisation. These stores offer goods on sale which are procurrd from wholesalers or manufacturers. Consumers can buy goods at a relatively lower price because middlemen's margin of profit is not added to the price. The margin of profit earned by the cooperative store is distributed among its members as dividend after meeting the expenses of running the store. They may deal with all types of consumer goods of day-to-day use such as stationery, grocery, dress materials, utensils, medicines, paper, etc. Since the store is under the control of its members, articles needed by a majority of them are always available in the store.

Hire-purchase Trading: Hire-purchase trading consists of supplying durable goods for use by customers who agree to pay the price by instalment at regular intervals. The buyer acquires ownership of the goods only after the total price has been paid. In other words, in hire-purchase trading, the buyer takes possession of the goods, but does not get the ownership until the last instalment has been paid. The instalments are regarded as hire charges. If there is default in paying an instalment, the seller has the right to recover the goods or sue the buyer for the balance amount due. Durable goods like refrigerators, television sets, radio, sewing machines, electric fans, automobiles, industrial machinery, air-conditioners etc. can be sold by hire-purchase trading houses. The instalments payable by the buyer includes interest on unpaid balance. Hence, the total price paid is relatively higher than in the case of outright cash purchase. But the customers get the advantage of deferred payment, as in the case of purchase on credit, and is also able to use the goods meanwhile. Hence, hire-purchase becomes attractive as a means of saving large initial payment required foi outright purchase of goods.

Discount Houses : Large scale retail establishments which offer discounts on the prices are known as 'Discount Houses'. Durable goods like household appliances (cooking ovens, electrical gadgets, etc.) camera, binoculars, etc., are generally available through discount houses at a relatively lower price as compared with the price charged by other retail stores. This is possible as the discount houses directly purchase from manufacturers and operate the business on a low margin of profits. They expect to cover expenses and make substantial profits through larger volume of sales.

Super-bazars : These are large retail stores organised by cooperative societies which sell a variety of products under a single roof. The goods traded by super-bazars include consumer goods which are procured at wholesale rates from manufacturers or wholesalers. The stores are operated either on the principle of self-service or with sepdrate counters served by salesmen. The difference between a super-bazar and super-market is that the former is organised by cooperative society whereas the latter is generally established as a private sector organisation. Similarly, the difference between a consume; cooperative store and super-bazar is that a consumer cooperative store is usually run on small scale, while the super-bazar may be a large-scale establishment.

Automatic **vending** machines: Retail sale of articles with the help of coin-operated automatic machines is known as automatic vending. Retailing on a large scale is possible in this way by placing machines at convenient locations like bus terminals, railway stations, airports, shopping centres, etc. This method of retail selling is very popular in western countries. Cigarettes, razor blades, postage stamps, milk, ice-cream, soft drinks, soup, paper-back books, newspapers, etc., are sold in cities through vending machines. Customers are required to insert necessary coins in a slot and press a button whereby the article is released 'automatically. The coins are collected from the machine periodically, and articles are put in as needed. Automatic vending facilitates buying of small items round the clock. There is no necessity of salesmen's services. However, the stocking capacity of machine is limited and there are risks of mechanical failures irritating the customers. Moreover, paper currency may not be used and coins of exact value are required to operate the machine.

In India, automatic vending has been used for limited purpose like selling postage stamps, flight insurance, milk, etc. It is not a popular retailing device in India due to the existence of a large number of small retail shops.

Check Your Progress D

1 Fill in the blanks.

i) A departmental store is like a retail market in which shops are owned by a single ____.

ii) Small-scale retailers generally deal in a______ range of products.

iii) Retail traders who move from place to place are known as ____ retailers.

iv) Retail shops selling one or two special types of goods are known as _____ shops.

v) Super-markets do not have _____ to serve each and every customer.

vi) All branches of a chain store offer _____ products for sale.

vii) Mail order houses generally sell ______goods.

viii) The profits earned by consumer cooperative stores are distributed among _____.

ix) In hire-purchase trading price is paid in ________

x) Super-bazars procure goods at ______ rates.

2 Which of the following statements are True and which are False?

i) Small scale fixed shop retailers sell many different products.

ii) Departmental stores are established in central locations of cities.

iii) Super-markets are exactly like departmental stores.

iv) Mail-order houses secure orders from customers only through post office.

v) Consumers' cooperative stores are run on no-profit no-loss basis.

vi) In hire-purchase trade, customers have ownership rights after all the instalments are paid.

vii) There is no difference between super-bazars and super-markets.

11.12 LET US SUM UP

In a broad sense business firms which sell goods in large quantities may be called wholesalers. In a more specific sense, wholesalers are defined as merchant middlemen who are engaged in buying and reselling goods to retailers, other merchants, industrial and commercial users, but not to ultimate consumers. Wholesalers facilitate distribution of goods to small retailers.

Wholesalers may be classified on the basis of merchandise dealt with, as general merchandise wholesalers, general line wholesalers, and single line or speciality wholesalers. On the basis of methods of operation, they may be classified into service wholesalers and limited function wholesalers. Based on the geographical coverage of their dealings, wholesalers may be classified as local wholesalers, district wholesalers, and regional or national wholesalers.

The Functions performed by wholesalers include: assembling goods, arranging the storage of goods, grading and packaging, transportation and distribution of the goods, financing retail traders, and making advances to manufacturers. The wholesalers also undertake the task of price-fixing and bear the risks associated with holding large stocks of goods. Wholesalers render valuable services to manufacturers as well as retail traders.

Retailing refers to sale of goods to the ultimate users. A retailer is one whose business consists primarily of selling goods to customers for their own use, not for use in their business. If manufacturers sell goods to consumers, they are not treated as retailers as retailing is not the major activity of a manufacturer. Retailers form a vital link in the channel of distribution of goods. They act as a link between the producers or wholesalers on the one hand and consumers on the other.

The retailers perform several functions such as estimating demand, procuring goods, arranging transport, holding stocks, grading and packaging of the goods dealt with, and selling goods in stock so as to satisfy consumer needs. They render valuable services to consumers, wholesalers and indirectly also to the producers of goods.

Retailers may be divided into two broad categories: itinerant retailers and fixed-shop retailers. Itinerant retailers either move from house to house or change their place of business according to convenience. Hawkers, pedlars, pavement traders, and market traders are included in this category.

Fixed-shop retailers locate their stores at fixed places where customers can easily come and make their purchases. Fixed shop retail trading may consist of small-scale retailing or large-scale retailing. Small scale retailers deal in a limited range of products. Stall-holders, general merchandise shops, speciality shops, and second-hand goods sellers belong to this category. Large-scale retailers establish stores which deal in and stock a wide range of products and cater to the needs of a large number of customers. Large-scale retailing may be of the following types: departmental stores, super markets, multiple shops, mail-order house, consumer cooperative stores, super-bazars, hire-purchase trading, discount-houses, and automatic vending.

11.13 KEY WORDS

Automatic Vending : Sale of small articles of regular use by installing coin-operated automatic machines at different places.

Consumer Cooperative Stores : Retail stores run by cooperative societies organised in the interest of consumer groups.

Departmental Stores : Large retail stores consisting of separate departments selling different types of products.

Discount Houses : Retail stores engaged in selling durable consumer goods at a discount.

Hire-Purchase Trading : Supply of durable goods on hire against the payment of periodical instalments with ownership transferred to the buyer, after all instalments have been paid.

Itinerant Retailers : Retail traders who sell goods moving from house to house or change their plate of business frequently.

Mail-Order House : Receiving orders by mail and delivering goods through the post office.

Multiple Shops I Chain Stores : Retail stores under the ownership and management of a single firm dealing in similar products at-uniform prices and located at different places,

Retailer : One who is engaged in wholesale trading.

Retailing : Purchasing goods from wholesalers or manufacturers and selling them to consumers for their personal non-business use.

Speciality Shops : Small retail shops dealing in one or two special types of goods.

Super-Markets : Retail stores selling consumer goods of regular use and operating on self-service basis.

Wholesaler : One who is engaged in wholesale trading:

Wholesaling : Purchasing and reselling of goods to retailers and merchants.

11.14 SOME USEFUL BOOKS

Amarchand D. and B. Varadarajan, 1983, *An Introduction to Marketing,* Vikas Publishing House : New Delhi. (Chapter 2)

Bhushan Y. K. 1987. *Fundamentals of Business Organisation and Management,* Sultan Chand; New Delhi. (Part 7, Chapter 3)

Kotler, Philips 1986. *Marketing Management,* Prentice-Hall of India: New Delhi. (Chapter 18)

11.15 ANSWERS TO CHECK YOUR PROGRESS

A 2 (i) False (ii) True (iii) False (iv) False

3 (i) small (ii) consumers (iii) manufacturers (iv) varieties

B 1 (i) large (ii) packaging *(iii)* storage (iv) credit

2 (i) False (ii) True (iii) False (iv) True (v) False

C 1 (i) False (ii) True (iii) False (iv) True (v) False (vi) False

2 (i) personal (ii) wholesalers (iii) displayed

D I (i) firm (ii) limited (iii) itinerant (iv) speciality (v) salesmen (vi) similar (vii) standard (viii) members (ix) instalments (x) wholesale

2 *(i)* False *(ii) True (iii)* False (iv) True (v) True (vi) False (vii) True (viii) False

11.16 TERMINAL QUESTIONS

1 What do you understand by wholesaling? How does it differ from retailing?

2 Discuss the importance of wholesalers in marketing manufactured goods.

3 What are the functions performed by wholesalers? Explain briefly,

4 Enumerate the services of wholesalers to manufacturers and retailers.

5 What are the services rendered by retailers to consumers?

6 Distinguish between different types of small-scale retailers.

7 Explain briefly the important characteristics of the following:

i) Departmental Stores
ii) Mail-Order House
iii) Super-Markets

8 What are the characteristics of consumer cooperative stores and the super bazars? Bring out the difference between these two types.

9 Write explanatory notes on:

i) Hire-purchase Trading
ii) Discount Houses
iii) Automatic Vending

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

UNIT 12 PROCEDURE FOR IMPORT AND EXPORT TRADE

Structure

12.0 Objectives
12.1 Introduction
12.2 What is Foreign Trade?
12.2.1 Types of Foreign Trade
12.2.2 Importance of Foreign Trade
12.2.3 Problems in Foreign Trade
12.3 India's Foreign Trade Performance
12.4 Regulations Governing Foreign Trade
12.5 Export Trade Procedure
12.6 Import Trade Procedure
12.7 Let Us Sum Up
12.8 Key Words
12.9 Some Useful Books
12.10 Answers to Check Your Progress
12.11 Terminal Questions

12.0 OBJECTIVES

After studying this unit, you should be able to:

- describe what foreign trade is
- identify the types of foreign trade
- explain the importance and problems of foreign trade
- describe the growth of India's foreign trade
- explain the regulations governing foreign trade
- identify the documents used in foreign trade
- describe export trade procedure
- explain import trade procedure

12.1 INTRODUCTION

In the previous two units you have leamt what home trade is and how goods reach the consumers from producers through various intermediaries or channels of distribution. In thi: unit, we shall discuss the nature of foreign trade, how it is different from home trade, the importance of foreign trade, documents used in foreign trade, and the procedure to be followed by importers andexporters while importing or exporting goods.

12.2 WHAT IS FOREIGN TRADE?

Nations, like individuals, do not possess everything they need to fulfil their requirements, Even countries like the USA, USSR and China, which are rich in natural and human resources have to look to other countries for supply of some of their requirements. For instance, consumers in USA obtain their supply of sugar and coffee from other countries. Moreover, different countries posses's different types of resources. Those which have a surplus of certain resources find it beneficial to sell the surplus items to some other countries, and buy other items which they need. Such exchange of goods and services between people across national boundaries is called 'foreign trade' or 'international trade*.Foreign trade can be bilateral or multilateral. When there is trade between people of any two nations, it is **bilateral:** foreign trade is **multilateral** when people of any country buy from and sell to people of more than one country.

You will notice that the main difference between home trade and foreign trade is that while home trade takes place within a country among people who are 'citizens of that country, the foreign trade takes place beyond the national boundaries of two or more countries. Besides this, there are other differences which may be stated as follows:

i) There is little restriction on trade between people within a country. But in case of foreign trade the restrictions are numerous. A firm requires permission from Govemment authorities before goods can be imported or exported.

ii) In domestic trade payment made by the buyer and received by the seller of goods is in the same units of money. In foreign trade, what the importer pays in his national currency has to be converted into foreign currency acceptable to the exporter.

iii) Payment can be made either in cash or by cheque on a national bank in the case of home trade. Payment can be made only through bank in the case of foreign trade.

12.2.1 Types of Foreign Trade

Foreign trade can be divided into three categories. They are:

i) Import Trade
ii) Export Trade, and
iii) Entrepot Trade

When goods are sold to a trader in any foreign country, they are said to be exported to that country and it is known as 'export trade'. When purchases are made from a foreign country, goods are said to be imported into the country and it is called import trade. Many a time goods are imported from one country with the objective of exporting them to some other country or countries; This is known as entrepot trade. City states like Singapore and Hongkong are important entrepot trade centres.

12.2.2 Importance of Foreign Trade

Production of goods and services requires different resources like men, materials, money, machines and management. If we compare the resources possessed by nations it will be found that no country is self-sufficient and there are differences in the quality and quantity of domestic resources available in different .countries. Indeed, it is this difference in the relative abundance or shortage of resources in different countries that has given rise to foreign trade involving exchange of goods and services between countries. Through international trade, it is possible for a country to avail of goods which it cannot produce or cannot produce as economically as other countries. Hence, a country's well-being is determined to a great extent by the nature and extent of its foreign trade. Let us discuss the importance of foreign trade to people in different countries.

1 Specialisation and **efficiency** of production: Foreign trade leads to specialisaiton in productive activities undertaken by different countries. Depending on available natural resources, and development of science and technology, every country can produce only those goods and services for which it has the greatest relative advantage and efficiency. No country has facility and resources within its own boundaries for economical production of all its requirements: Some countries are more suitably placed to produce certain goods/services economically and sufficiently than other countries. Therefore, they can specialise in the production of such goods and get the goods they need in exchange for those goods, For example, India has comparatively greater advantages for the production of agrobased products such as coffee, tea, sugar, textiles, etc. Similarly some developed countries such as USA, Japan, Britain, etc. have greater advantages for the production of industrial machinery, automobiles etc. Some gulf countries such as Iran, Libya, Iraq, Saudi Arabia, etc. produce crude oil, petroleum, etc. in abundance.

2 **Utilisation of** resources: Every country possesses some natural resources. The economic development of a country heavily depends upon exploitation of these resources. For example, India has adequate off-shore oil resources. But, it requires exploitation through sophisticated machines, technology, etc. which we do not have. Machinery and technology can be imported from the developed countries like USSR, USA, Japan, etc. This leads to best possible use of natural resources.

3 Facilitates economic development: Rapid economic development and growth of national income can be facilitated on the basis of exports and imports. Indeed, it is on the basis of imports of raw materials and export of manufactured goods that countries like U.K., Japan etc, have achieved a high rate of economic growth.

4 Equalisation **of** prices: International trade equalises prices of goods throughout **the** world. Whenever the prices of commodities tend to rise in a country, it can increase the

level of its imports to check the rise in prices. Similarly, whenever prices of products decline, the trend may be coùnteracted by exporting the same.

5 Employment ppportunities: Foreign trade facilitates the growth of agricultural as well as industrial activities which in turn generates more employment in the country.

6 Harmonious relationship between countries: Because of foreign trade every country may have access to goods that it does not produce at home. Similarly, a country with a surplus of certain goods can make them available to other countries experiencing shortage of those goods. This promotes harmonious and cordial relationship among various countries.

12.2.3 Problems in Foreign Trade

Because of cultural and other environmental differences between various countries and the distance involved, foreign trade involves certain problems which do not arise in connection with home trade. Let us examine these problems in detail.

1 Suitability of the product for the market: Securing information about the suitability of products in the foreign market is a challenging task for every international marketer. This involves heavy expenditure and requires special skill and knowledge. Besides, the quality and price of goods must be more attractive as compared with similar products manufactured abroad. This requires intensive market research on the potential sale of goods to be exported.

2 Changes in supply and demand conditions: International markets are often subject to changes in the supply and demand for particular products due to the entry of new competitors, or increased competition of local producers, or because of changes in buyers' preferences. These changes cannot be easily anticipated by the exporters.

3 Frequent price changes : The price of products in the international market may be affected by different factors. The changes may be due to changes in exchange rates of the currencies of importing and exporting countries, higher import duties, or freight rates. These factors increase the risks of foreign trade a great deal.

4 Credit risk: International trade which is generally on a large scale involves heavy amounts to be paid by the importer. The exporters often sell their products on credit and therefore have to bear the credit risk arising from the buyer's default, bankruptcy, etc.

5 Changes in exchange rate: An additional risk of foreign trade is the risk of changes in exchange rates. The rate at which the currency of importing countries can be converted into the currency of exporter may cause losses to the exporter or the importer.

6 Rules, regulations and procedures: Every country imposes certain restrictions in the export and import of goods to protect its economic and political interests, Besides, the rules and regulations differ from country to country°and are changed from time to time. For example, the provisions of Imports and Exports Control Act, 1947 changes in export import'policy and the restrictions on trade often create complications and problems for importers and exporters.

7 'Credit worthiness of importer and reliability of exporters: The value of goods involved in external trade is fairly high and the exporter has to grant credit facilities to the importer. Since there is no direct contact between exporter and importer, it is necessary that the exporter must take steps to verify the credit worthiness of the importer and importer should check the reliability'of the exporter for supply of goods. This may take a long time and cause delay in the availability of goods.

8 Transportation and cargo risks: International trade takes place either by land, air or water transport, and goods have to be transported over long distances. Water transport occupies a predominant place in transporting goods across the national boundaries because ships can carry large volumes of cargo at low cost. In spite of all developments in transportation, the risks of loss or damage to cargo by fire, storm, collision, leakage, explosion, spoilage, etc. exist.

9 Time gap: The distance involved is usually greater in transporting goods from one country to another country, and hence the transit time is longer. This time gap involves exporter's capital being locked up over a long period.

10 **Political and legal** problems: Political risks may arise as a result of changes in governments or capture of cargo by enemies, etc. Commercial laws may be different between the trading countries. Moreover, conducting legal proceedings in a foreign country is complicated and expensive.

12.3 INDIA'S FOREIGN TRADE PERFORMANCE

The pre-independence scene of India's foreign trade was characterised by heavy dependence of exports of traditional items. Nearly 85% of exports before independence were made up of raw materials and semi-manufactured products like foodstuffs, raw cotton, tea, spices, tobacco, Rides **and** skins and jute nianufactures. The import consisted of consumer goods and manufactured products.The major parts of India's trade was confined to Britain and its colony. Since the post independence period, the foreign trade has undergone **a** radical change in the composition and market. The exportable items are shifted from traditional commodities to new commodities. The major items of exports are gems and jewellery, readymade garments and cotton fabrics, agro-based products, machinery and metal manufactures, chemicals , etc. On the import front the major items are petroleum oil, capital goods, chemical elements, etc. which are essential for country's economic development. The markets for India's export include USA. Japan, Germany, UK, Belgium and other developed, developing and least developed countries. Look at Table 12.1 which shows the growth of India's foreign trade.

Table 12.1

The Growth **of India's** Foreign Trade

(Rs. in Crores)

Year	Exports	Imports	Balance of Trade
1950-51	606	608	-2
1960-61	642	1122	480
1970-71	1535	1634	-99
1980-81	6711	12549	-5838
1990-91	32553	43198	-10645
1991-92	44041	47851	-3810
1992-93	53688	63375	-9687
1993-94	69751	73101	-3350
1994-95 (Provisional)	82674	89971	-7297
1995-96 (April-Dec) (Provisional)	74493	86064	-11571

Source: Economic Survey (1995-96), Government of India, New Delhi.

Note: The difference between the total value of goods exported and imported is called balance of trade.

Check Your Progress **A**

1 State whether the following statements are True or False.

i) 'selling goods within the national boundaries is called home trade

ii) Exchange of goods between two countries is called internal trade.

iii) Exchange of goods and services across national boundaries is called foreign trade.

iv) Foreign trade generates resources and employment

v) External trade is an 'engine' for the development of economy of a nation

vi) The element of risk involved in foreign trade is much less than that of home trade.

vii) India imports goods from USSR and pays its own currency to settle trade balances

viii) Exporters export goods without knowing the credit worthiness of the importers.

ix) International trade locks up huge amount of capital in products for a long period

x) Before Independence the major part of India's foreign trade was with Britain and its colonies.

2 India purchased Rs. 100 crores of machinery and equipment from the USSR. Equipment worth Rs. 20 crores was exported to Bangladesh.

a) Tick the correct alternatives from the following after going through the above statement.

i) Which one is the exporting country?
1 India
2 Bangladesh
3 USSR

ii) Which one is the importing country?
1 USSR
2 Bangladesh
3 India

iii) Which one. is the re-exporting country?
1 Bangladesh
2 USSR
3 India

b) Fill in the blanks after identifying the form of trade:

i) From USSR to India is called .... for India.
ii) From India to USSR is called................... for India.
iii) From India to Bangladesh is called .... for India.
iv) Trade among the above nations is called ....

12.4 REGULATIONS GOVERNING FOREIGN TRADE

In India, Foreign Trade is mainly governed by Foreign Trade (Development and Regulation) Act 1992, Foreign Exchange Regulations Act 1973, and the Quality Control and pre-shipment Inspection Act 1963. To export goods from India and to avail of the export benefits, exporters have to comply with certain formalities. First of all, let us discuss some of the important steps required to be taken by businessmen to undertake export-import business. They should (i) obtain the Reserve Bank Code Number, (ii) Register with Export Promotion Council. etc. and (iii) Obtain the Import-Export Code Number.

i) Reserve **Bank** Code Number: Commercial exports can be undertaken by a firm in India only after it has obtained the Reserve Bank Code Number. This is a requirement under the Foreign Exchange Regulation Act (FERA). For obtaining the code number, the firm has to apply to the Divisional Office of the Reserve Bank having jurisdiction over the area where the firm is located. There is a prescribed form of application for this purpose which is to be submitted in duplicate along with the report from the bank where the firm has opened a current account. The firm is to furnish details about the nature of the organisation and products intended to be exported. Besides, it requires the permanent income-tax account number to be given. In case the firm does not have an income-tax account number, it will be required to apply for the same. The Reserve Bank is to be intimated within 15 days of the allotment of the income tax account number. On completion of these formalities, the Reserve Bank will allot the code number to the firm, if the application is in order. The code number is permanent and there is no need to renew it. The number is to be cited invariably on export forms used for declaration of exports.

ii) Registration with Export Promotion Council etc.:The Export-Import Policy, 1992-97 makes it compulsory for exporters to get registered with any Export Promotion Council (EPC) or specified Commodity Boards, APEDA, MPEDA or FIEO etc. This registration is required for any person wishing to apply for a licence to export or for any other benefit or concessions available under the policy. An application for membership is made to concerned authority in the prescribed form.

Once an exporter has been registered, the registration remains valid for five years. Export of the registered exporters having valid RCMC will only qualify for the benefits provided in the EXIM policy. Registered exporters have to submit monthly reports about exports made by them.

iii) Import Export Code' Number : Every person importing goods for commercial purposes is required to obtain an Import-Export code number from the Regional Import-Export Licensing Authority. Customs authority do not allow clearance of goods to an importer, unless he possesses a valid import-export code number. Application for allotment of the code number has to be made in duplicate, in the prescribed form to the Regional Import-Export Licensing Authority. The Code number allotted to a person is valid for import of any commodity by the person subject to restrictions announced from time to time.

12.5 EXPORT TRADE PROCEDURE

When goods are exported to a foreign country, the exporter has to follow the procedure prescribed by the government. The procedure involved in exporting goods differs from country to country and depends on the existing policy of that country. The general procedure for exports from India involves the following stages:

1 Receives enquiry
2 Receives 'and scrutinises the order from importer
3 Obtains export licence
4 Manufactures/procures goods
5 Fulfils exchange regulations
6 Books shipping space
7 Gets excise clearance and pre-shipment inspection
8 Backing and marking
9 Appoints clearing and forwarding agents
10 Customs formalities
11 Insurance of goods and ECGC cover
12 Places the goods on board the ship
13 Obtains bill of lading
14 Collects necessary documents and despatches shipment advice to the importer
15 Secures payment
16 Claims the incentives

Receives an Enquiry

The first stage in the export trade is the receipt of an enquiry by the exporter from an importer or his agent. An enquiry is a request by a foreign buyer for information regarding the specifications and the price of the goods he intends to purchase. The reply to an enquiry is in the form of a quotation or proforma invoice which contains particulars like name and address of the buyer, full description of the goods offered, price, and terms of sale, and other details such as validity period of the offer, delivery schedule, payment terms, etc.

Receives and Scrutinises the Order from the Importer

When the importer accepts the quotation, he places an order (also called indent) with the exporter. The exporter should take care to scrutinise the terms and conditions of sale as they determine all subsequent actions with regard to the export transaction. It should be ensured that the contract has been entered into in accordance with the prevailing export policy and foreign exchange regulations of India, Particular attention has to be paid to the terms of payment. If the terms and conditions of the order are acceptable, a confirmation in writing giving the details of the order, terms and conditions, etc, should be forwarded to the buyer at the earliest.

Obtains an Export Licence

The development and regulation of foreign trade in India is governed by the Foreign Trade (Development and Regulation) Act, 1992, This act helps in facilitating imports into and augmenting exports from India. Goods subject to control can not be exported without a valid export licence. In order to obtain an export licence, the exporter has to apply to the Director General of Foreign Trade (DGFT) or Regional Licensing Authority on the prescribed form. After the Licensing Authority is satisfied; the exporter will be issued an export licence.

Manufactures/Procures Goods

As soon as the export order is confirmed, preparations for the production/procurement of the goods are started. In the case of manufacturer-exporter, a delivery note (in duplicate) is sent to the works manager or the factory manager. The note should contain the description of the goods as has been given in the export order, and a copy of the instructions given by the importer. The dates by which the goods must be manufactured. the date by which necessary formalities are to be completed, and the date of shipment must be clearly intimated to the works manager. A merchant exporter has either to obtain the required goods from the market or has to get them from other manufacturers. The specifications and instructions to be intimated to the supplier of goods must be in accordance with those given in the export order.

Fulfils Exchange Regulations

Every exporter precedent to export of any goods directly or indirectly to any place outside India other than Nepal and Bhutan has to furnish a declaration on the prescribed form to the Reserve Bank of India. The declaration is made about the full value of exportable goods or the prevailing market value of the goods. The full value of exports should be realised on due date for payment or within 180 days from the date of shipment, whichever is earlier. The documents for foreign exchange formalities include, GR form in all shipments other than by Post, VP/COD form used for postal channel and SOFTEX form for Computer Software.

Books Shipping Space

It is the responsibility of the exporter to arrange transport by entering into an agreement with a shipping company for transporting the goods to the importer. Usually this responsibility is given to a freight broker or agent who specialises in this job. He possesses full knowledge of the various shipping lines operating on the specific route and is in a position to obtain the lowest possible freight rates. The shipping agent on behalf of the exporter gets shipping order from the Shipping Company. The shipping order contains instructions to the captain of the ship to receive the specific quantity of goods from the exporter mentioned therein. If-the consignment is very big, the exporter may charter a whole ship or a major part of the ship. The agreement with the shipping company is then known as Charter Party. If it is the buyer's responsibility to arrange transport, he should be advised of the dates the goods would be ready for movement.

Gets Excise Clearance and Pre-shipment Inspection

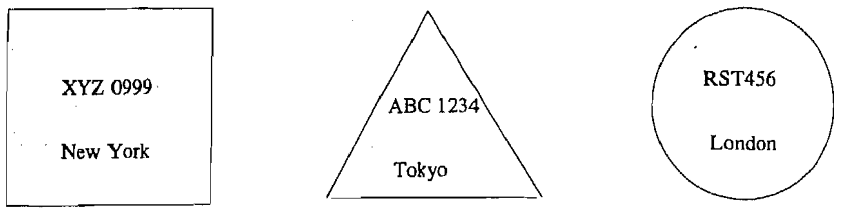
As soon as the goods have been manufactured or procured, steps should be taken by the exporter to obtain clearance from the excise authorities. This can be done in two ways: (i) he can pay the excise duty at the time of removing the export consignment from the factory and then file a claim for refund of the duty after the goods have been exported; (ii) he can secure clearance by executing a bond on such terms and conditions as the collector of excise may decide.

At this stage the exporter has to arrange for pre-shipment inspection to ensure conformity with the prescribed specifications. An Inspector is deputed by the Inspection Agency to inspect the export consignment. If the goods conform to the prescribed specifications, an inspection certificate is issued.

Packing and Marking

Packing for exports is a highly specialised job. It provides adequate protection for the goods.

Packed goods must be in accordance with requirements of the buyer, shipping company and the customs authorities. Packed goods should be marked as per the instructions of the importer. Each package should have distinct shipping marks to identify the consignment easily. In addition, the gross weight, the tare (the weight of the package itself) and the net weight along with the measurements should be marked on the package. The marking may be done in the form of a rectangle, a square, a triangle or a circle as given below:



The package should also have suitable lables for different classes of goods to facilitate the handling of goods. For fragile goods, handling instructions like handle with care or this side up could also be marked on the package.

Appoints Clearing and Forwarding Agents

Sometimes, exporters appoint clearing and forwarding agents to look after all shipping and customs formalities and actual loading of the goods on board the ship. The forwarding agents are experts in their line of business and offer valuable services to the expoiter on payment of reasonable charges. In particular, they perform the following functions: (i) negotiation of shipping contract, (ii) customs formalities, and (iii) loading of goods in the ship and securing the Bill of Lading. They may also undertake packing and marking of goods and help in getting the goods insured.

Customs Formalities

The clearing and the forwarding agent takes delivery of the consignment from the railways and arranges for its storage in the warehouse. Thereafter, he takes necessary action to comply with the customs formalities. He has to prepare the shipping bill which is the main document required by the customs authorities for the purpose of granting permission for exports. The shipping bill is a document showing the exporter's name and address, description of goods such as marks, numbers, quantity and value, etc., the country from which they are exported, the name of the vessel and the port where goods are to be discharged. There are three types of shipping bills: (i) for duty free goods a white shipping bill, (ii) for dutiable goods, a yellow shipping bill and (iii) When duty drawback is allowed, a green shipping bill.

Besides the shipping bill, the following other documents are also required to be submitted for customs clearance: **AR-4** form (regarding excise duty payment), G.R. form (declaring value of goods), original order or letter of credit, commercial invoice, packing list (needed for inspection of goods), and declaration form (a formal announcement by the exporter that the particulars entered in the shipping bill are in conformity with the export order).

'The exporter or the clearing and forwarding agent in his belialf'is required to present the required documents. The exporter will be asked to pay the export duty, if any. The customs house will then direct the examining office or the appraiser to carry out the physical examination of the goods at the dock. After the exporter has gone through all formalities to the satisfaction'of the customs authorities, a customs export pass or an endorsement 'let ship' is issued to the exporter on the duplicate copy of the shipping bill.,Then the loading of goods will take place on the board.

Insurance of Goods and ECGC cover

Generally, the shipping companies refuse to carry the goods unless they are insured for loss or damage in course of transit. Similarly, the commercial banks refuse to finance.or discount the bills of exchange, unless they are accompanied by the insurance policy. Hence, before the goods are despatched, they must be insured for the various types of risks involved in' transit by the exporter. Usually goods are insured for an amount which covers not only the value of the goods but also a reasonable profit. The commercial and political risks, like insolvency of the buyer, rebellion .or civil war in the importing country can be covered by insuring the shipment with the Export Credit Guarantee Corporation (ECGC). This will help the exporter in securing export finance from banks.

,Places the Goods on Board the Ship

Once the customs export pass is secured, the exporter may deliver his goods directly to the dock or the ship. If the exporter delivers goods to the dock, a dock receipt is given for the goods. When goods are loaded directly in the ship, the Mate (captain's assistant) of the ship issues a receipt in acknowledgement of the goods after examining the packing and counting of the packages. This receipt is called the 'mate's receipt'. The mate issues a clean receipt if he is satisfied with the packing of the goods. If he is not satisfied he will make a remark to the effect of the mate's receipt. A mate's receipt with such a remark is considered a 'foul' or 'claused receipt'. This remark is transferred to the bill of lading when the exporter gets it in exchange for the mate's receipt. The exporter should, therefore, take proper care in packing the goods so as to avoid any remarks on the mate's receipt.

Obtains Bill of Lading

A bill of lading is a document by which the shipping company acknowledges the receipt of goods on board the ship. It contains the terms and conditions on which goods are to be delivered to the port of destination. It serves as an evidence of the terms of the contract of afreightment between the exporter and the shipping company. The bill of lading is the document of title to the goods, without which goods cannot be claimed. Thus, when the goods arrive at the foreign port, the bill must be produced before they can be claimed. The bill can be made out to a certain person only, or, to order, when it can be endorsed and passed on, to transfer ownership of the goods to another. However, it is not negotiable, because the bearer's claim to the goods can never be better than the claim of the person who passed on the bill to him. If a bill were stolen before being passed on, it would not confer a legal right to the goods.

The bill of lading mentions whether the freight has been paid or yet to be paid. When the freight is paid by the exporter, the bill of lading is marked freight paid. When the freight is payable by the importer of the goods, the bill of lading is marked **freight forward**.

Collects Necessary Documents and Despatches Shipment Advice to the **Importer**

After the goods are placed on board, the forwarding agent returns the following documents to the exporter: (i) A set of 'clean on board' bill of lading, (ii) a copy of invoice duly attested by the customs authorities, (iii) copies of the shipping bill, (iv) export order in original (v) letter of credit in original (vi) duplicate copy of the AR-form and (vii) duplicate copy of GR form,

As soon as the exporter receives the above documents, he sends a shipment advice to the importer, along with the following documents: (i) commercial invoice (ii) insurance policy, (iii) copies of the bill of lading which are not negotiable, and (iv) the packing list.

Taking the possession of these documents, the importer or his clearing agent arranges for the clearance of goods from the customs office in whose custody the goods lie after being unloaded from the ship. The importer or his clearing agent approaches the shipping company, pays the dues, if any, and gets the possession of goods after submitting the bill of lading and other documents needed by the shipping company. The commercial invoice is the bill stating what goods have been sent, their weights, markings, prices and values. The importer needs the invoice to see what he owes and to check it with his copy of the indent. He must have the bill of lading to claim the goods and insurance policy to enable him to claim from the insurance company the value of damage, if any, suffered by the goods during the voyage.

Secures Payment

There are a number of alternative methods of securing payment of export dues from the importer. The method of payment is however, determined by the contract between the exporter and the importer. The two most common methods are described below:

i) Documentary bills of exchange: By drawing a**'bill** of exchange' on the importer, the exporter gets a promise of payment. The exporter sends the necessary documents to the importer along with a bill of exchange drawn on him with specific ihstructions that the documents would be released to the importer only when he accepts the bill of exchange or pays it. If the documents are released against payment, the arrangement is known as documents against payment (DIP). If the documents are to be released against acceptance of the bill, the arrangement is known as documents against acceptance (D/A). Normally, under the D/A bills the exporter waits for payment till the bill is finally paid for. This may take time. But the negotiating banks are very often willing to discount the bills. This enables the exporter to receive payment immediately after shipment of goods.

If the exporter wants to get the amount immediately, he can discount the documentary bills with the local branch of his bank. For this purpose, he has to issue a letter of hypothecation to the bank. A letter of hypothecation is a letter addressed to a bank along with the bill drawn on the importer, by an exporter for the goods shipped by him. The exporter authorises the bank to sell the goods in case of dishonour of the bill by the importer.

ii) **Documentary credit** under letter of credit: A safer and quicker method of obtaining payment is that of documentary credit whereby the importer arranges for a bank to open a letter of credit in favour of the exporter. In a letter of credit, the importer's bank branch gives a written undertaking to the exporter that if the exporter presents certain documents relating to the shipment of the goods within a fixed period, the bank will honour the bill of exchange drawn under the credit upto the amount specified in the letter of credit. In both the cases, the necessary documents along wifh the bill of exchange drawn on the importer are sent to the importer through the exporter's bank. The negotiating bank scrutinises the documents and thereafter sends the bill of exchange, bill of lading, insurance policy and other documents to the importer's bank for discharge of payment. If the bill is payable at sight, the exporter receives his money immediately. If it is payable certain number of days after sight or date, the bank accepts it and the exporter discounts it.

Claims the Incentives

An exporter is entitled to claim certain benefits like duty drawbacks, excise rebate; special import licences; tax concessions etc. These incentives are offered by the government to promote exports. The last step in export procedure is to claim these incentives from the government.

Check Your Progress B

Fill in the blanks.

i) Export of goods from India is subject lo control under the ....

ii) Taking the whole ship or major part of the ship from the shipping company to export the goods is called ....

iii) The Mate issues .... when he is satisfied with packing, etc. of the goods to be exported.

iv) .... is given when an exporter delivers goods directly at the dock.

v) Preshipment inspection and quality control of the goods are done by ....

vi) When the freight is paid by the exporter the bill of lading is marked ....

12.6 IMPORT TRADE PROCEDURE

Import trade procedure differs from country to country depending upon the satisfactory requirements and trade practices in force. The general procedure of import trade in India involves the following stages:

1 Trade Enquiry
2 Obtains an Import Licence
3 Obtains Foreign Exchange
4 Places the Orderllndent
5 Arranges Letter of Credit

6 Gets Shipping Documents
7 Clears the Goods
8 Makes Payments

Trade Enquiry

The intending importer makes trade enquiry from the possible exporters. His enquiry is based on the details of the goods required by him viz., quality, design, size, etc. and seeks information regarding the availability of goads, the price at which they would be available and the terms and conditions regarding delivery and payment. In response to his enquiry, the importer may receive a number of quotations which will contain particulars as of the goods available in ready stock, their quality, size, design, etc. The different quotations will also specify the price at which the goods should be available and the terms and conditions of sale. Once quotations from different suppliers have been received, a thorough comparison should be made of the various quotations before taking the decision to import.

Obtain an Import Licence

In order to obtain an import licence, the intending importer makes an application in the prescribed form, to the Licencing Authority. When the licensing authority is satisfied with the claims, he issues the licence. The import licence is issued in duplicate. The first copy is presented by the importer to the customs authority at the time of clearance of goods and the second copy is used for obtaining foreign exchange from Reserve Bank of India. Although raw materials, intermediates, capital goods and other items announced by the central government may be imported freely under Open General Licence (OGL) scheme.

Obtains Foreign Exchange

After obtaining the import licence, the importer makes arrangements for obtaining the necessary amount of foreign currency. In India, the Reserve Bank of India (RBI) is authorised by the Government to regulate the use of exchange. Every importer has to produce import licence along with the prescribed application form under the Exchange Control Act. The exchange bank of the importer endorses and forwards the application to the Exchange Control Department of RBI. The RBI sanctions the release of the amount of foreign exchange to the importer after scrutinising the application on the basis of the existing Government policy.

Places the Order/Indent

After obtaining the import licence and requisite amount of foreign exchange, the next step is to place the order or indent for import of the goods. An indent is a form of order sent abroad for goods to be imported. The indent contains Full details regarding the goods to be imported and the terms and conditions regarding price, shipment, delivery, the method of payment, etc. An indent may be 'open', 'closed' or 'confirmatory'. When the selection of goods and other details are left to the agent's discretion in the foreign country, it is called an 'open indent'. **A closed indent** contains full particulars of the exact goods required. When an order is placed subject to the confirmation by the importer's agent, it is called confirmatory **indent.** Every importer is free to place the order directly or through the intermediaries, specialised in such trade. These specialised agencies are called **indent** houses. An indent house refers to an import agent or import firm, which impons goods on orders received from importers. The indent house serves as middlemen between the importers and exporters. They charge certain percentage of commission for their services from the importer. If the importer wants to make use of services of an indent house, he has to enter into an agreement with the indent house for the supply of specified goods. For this purpose there are certain special forms which the indent house fills up and the importer signs, In India many of the big indent houses have their offices in port'towns like Bombay, Madras, Calcutta, etc.

Arranges Letter of Credit

Depending upon the terms of payment, the importer may have to arrange a letter of credit to be issued by his bank in favour of the exporter. All the terms and conditions agreed upon between the importer and exporter are generally spelt out in the letter of credit. The importer's bank issues the letter of credit authorising the correspondent bank in the exporter's country to buy the bill drawn by the exporter on the importer, or to accept the bill drawn on the bank itself. The importer's bank may require adequate amount to be deposited by the importer so as to cover the amount for which the letter of credit is issued. But such a deposit may not be insisted upon if the importer is an established person or a firm well known to the bank or it maintains a satisfactory deposit account with the bank.

A bank may issue any of the following types of letter of credit.

i) Revocable letter of credit: It can be withdrawn or altered or revoked at the diseretion of the issuing bank without the prior consent of the exporter.

ii) Unconfirmed irrevocable letters of credit: It cannot be cancelled or altered or withdrawn by the issuing bank prior to the date of expiry, without the consent of the exporter and is thus much safer.

iii) Confirmed irrevocable letters of credit : The irrevocable letter of credit shall be more safe if it is confirmed or guaranteed by a bank. With a confirmed irrevocable credit, the bank must pay the exporter, whatever happens to the importer or the foreign bank.

Gets Shipping Documents

After receiving order and the letter of credit, the exporter ships the goods and intimates the importer that the goods have been despatched. The exporter draws a bill of exchange on the importer's bank for the full value of goods payable to him. The bill of exchange, accompanied by all the shipping documents viz. commercial invoice, bill of lading, insurance policy, and the certificate of origin (if needed), are forwarded to the importer's bank by the exporter's bank. Under the letter of credit arrangement, the importer's bank will handover the documents to the importer who would take steps for getting the goods cleared from the customs authorities. In the absence of a letter of credit, the bank will follow the instructions of the exporter in the matter of delivering the documents to the importer. If the bill of exchange is marked D/A (documents against acceptance), the documents will be delivered to the importer on the acceptance of the bill. If the bill is marked D/P (documents against payment), the documents will be delivered to the importer only on payment of the amount of the bill.

Clear the Goods

After taking possession of the documents of title to the goods, the importer waits for the arrival of the ship. When the ship arrives at the port of destination, the importer arranges clearance of the goods from the customs office in whose custody the goods lie after being unloaded from the ship. This requires a number of formalities to be completed. The importer may appoint a clearing agent for that purpose. Clearance of goods requires the following steps to be taken: (i) get the bill of lading endorsed by the shipping company for delivery of the goods or a delivery order issued by the shipping company (ii) pay the necessary amount of port trust dues representing the cost of services rendered by the dock authorities in connection with the loading of goods (iii) fill up a 'bill of entry' containing all particulars relating to the imported goods and the customs duty to be paid. After import duty has been paid, the importer has to submit the 'bill of lading ' 'port trust dues receipt' and 'bill of entry' to the shipping company for release of the goods. In case the importer is not in a position to pay the customs duty in full immediately, he may apply to the customs authorities to get them placed in the bonded warehouse. The importer can pay duty for part of the goods as and when he wants to get delivery.

Makes Payments

The mode of payment for import depends upon the agreement between the importer and the exporter. If the documents have been received against acceptance (D/A bills), the importer has to honour the bill of exchange on the due date. After the bill is paid, the importer transaction comes to a close. In case of documents against payment (D/P bills), the importer pays immediately or within a short period after presentation, because the importer gets possession of the documents of title to the goods only on payment of the bill.

Check Your Progress C

1 State whether the following statements are True or False.

i) Import,trade procedure does not differ from country to country.

ii) RBI issues foreign exchange in our country.

iii) An indent is an order to import goods.

iv) An indent house serves as middleman between the importer and exporter.

v) Letter of credit is issued by the bank only when bill of exchange is produced.

vi) In the absence of letter of credit, the bank follows the instructions of the exporter to deliver the documents.

vii) On dutiable goods, the duty is paid immediately and on bonded goods the duty is not paid in instalments.

viii) Certificate of origin is sent to the importer to take the possession of goods imported.

ix) Revocable letter of credit cannot be altered or cancelled without the consent of the exporter.

x) Clearing agents and indent houses perform similar functions.

12.7 LET US SUM UP

Exchange of goods and services across national boundaries is called 'foreign trade' or 'international trade'. The main difference between home trade and foreign trade is that the people involved in the former are citizens of the same country, whereas those involved in the latter are of different nationality. Besides, there is little restriction on trade between people within a country. But there are numerous restrictions on foreign trade. In domestic trade, payment is made and received in the same units of money. In foreign trade, what the importer pays in his national currency has to be converted into the currency acceptable to the exporter. Moreover, payment can be made in hometrade either in cash or by cheque or a national bank. In foreign trade payment can be made only through a bank,

Foreign trade can be divided into three categories: Import trade (purchase made from a foreign country), Export trade (goods sold to a foreign country), and Entreport trade (goods imported from one country for export to other countries).

The importance of foreign trade to people in different countries may be attributed to (i) specialisation and efficiency of productive activities of different countries (ii) utilisation of natural resources in different countries, (iii) economic development on the basis of exports and imports (iv) equalising the prices of goods all over the world (v) creating employment opportunities and harmonising relationship between different countries.

The problems of foreign trade are (i) difficulty of securing information about the suitability of products in the foreign market, (ii) difficulty of anticipating changes in supply and demand conditions abroad, (iii) risks of frequent changes in prices in international markets, (iv) credit risk to be borne by the exporter, (v) risk of fluctuation in exchange rates (vi) differences in the rules, regulation and procedures in different countries, (vii) ensuring the credit worthiness of importer and reliability of exporter, (viii) risks of loss or damage to cargo in course of transportation, (ix) time gap between export and receipt of payment, and (x) political and legal problems.

Before Independence, India was largely an importer of manufactured goods and exporter of raw materials. With industrial development since Independence India's foreign trade has undergone a radical changd in its composition and is no longer confined in Britain and its colonies.

To export goods from India and to avail of the export benefits, exporters were to comply with certain formalities like: obtaining the Reserve Bank Code Number, registration with Export Promotion Council, and obtaining the Export-Import Code Number.

The general procedure involved in connection with exports from India are: receiving enquiry; receipt and scrutiny of the order from the importer; obtaining export licence; manufacturing or procuring goods; fulfilling exchange regulation; booking of shipping space; getting excise clearance and pre-shipment clearance; packing and marking;

appointing clearing and forwarding agents; completing customs formalities; insurance of goods and ECGC cover; placing goods on board the ship; obtaining the bill of lading; collection of necessary documents and despatch of shipment advice to the importer; securing payment either by means of documentary bills of exchange or documentary credit under letter of credit; and claiming the incentives for export from government authorities.

The procedure for import trade in India consists of: making trade enquiry from exporters; obtaining import licence; securing sanction and release of foreign exchange; placing the order or indent; arranging letter of credit; receipt of shipping documents; clearing the goods after getting the bill of lading endorsed by the shipping company and delivery order issued, payment of port trust dues etc. filling up the bill of entry; and making payment against the exporters bill and accepting the bill to obtain the documents of title to the goods.

12.8 KEY WORDS

Bill of Entry: A document showing the details of goods imported. The custom authorities determine the amount of import duty on this basis.

Bill of Lading: A document issued by the shipping company acknowledging the receipt of goods on board the ship and containing the terms and conditions on which goods are to be taken to the port of destination.

bonded Warehouse: An agreement between shipping company and the exporter for transportation of goods to another port.

Certificate of Origin: A document showing place of origin sent to the importer in order to enable him to take advantage of preferential treatment as regards customs duties.

Commercial Invoice: The bill prepared by the exporter showing details of their weights, markings, prices and values, despatched viz., together with any other charges that may be due to the exporter such as freight and insurance premiums paid by him.

Charter Party: A contract of affreightment for chartering a whole ship or a major part of it.

Contract of Affreightment: An agreement between shipping company and the exporter for the transportation of goods to another port.

D/A: A method of receiving payment from the importer whereby the documents are released to the importer on acceptance of a bill of exchange.

Documentary Credit: A method of receiving payment from the importer whereby the importer arranges for a bank to issue a letter of credit in favour of the exporter.

D/P: A method of receiving payment from the importer whereby the documents are to be released by the bank to the importer on payment of the account due.

Dock Receipts: A document issued by the dock authorities when the exporter delivers goods directly to the dock.

Drawback: Getting refund of import duty.

Entrepot Trade: Import of goods by one country for exporting to another country.

G.R. Form: A form prescribed by Reserve Bank of India to ensure that the foreign exchange receipts in respect of exports are received in India within 180 days of the shipment.

Indent: An order sent abroad for the import of goods.

Indent House: A firm which arranges the import of goods on behalf of various importers.

Letter of Credit: A document or order issued by a banker authorising some other banker to pay upto the amount stated in the letter to a party named therein or his order.

Letter of Hypothecation: A letter signed by the exporter authorising the bank to deal with the goods in case the importer fails to accept or honour the bill.

Mate's Receipt: A document issued by the captain/mate (captain's assistant) when an exporter loads goods directly in the ship.

Shipping Bill: A document showing the description of goods, the country from which they are exported, the name of the vessel and the port where goods are to be discharged.

Shipping Order: A document issued by the shipping company containing instructions to the captain of the ship to accept goods mentioned therein for shipping from the exporter.

12.9 SOME USEFUL BOOKS

Mathew, M.J. 1985. ***International Trade, Policies and Prospective in Developing Economy,*** Sri Ram Book Company: Jaipur.

Verma, M.L. 1988. ***Foreign Trade Management in India,*** Vikas Publishing House Private Limited: New Delhi.

Varshney, R.L. and B. Bhattacharya. 1984. ***International Marketing Management: An Indian Perspective,*** Sultah Chand & Sons: New Delhi.

Trerarne, Williams D. 1985. ***Commerce.*** Longman: New Delhi.

12.10 ANSWERS TO CHECK YOUR PROGRESS

A 1 (i) True (ii) False (iii) True (iv) False (v) True
(vi) False (vii) False (viii) False (ix) True (x) True

2 (a) (i) 3 (ii) 3 (iii) 3
(b) (i) export trade (ii) import trade (iii) re-export trade
(iv) foreign trade

B (i) Import Export Controls Act (ii) Charter Party
(iii) clean receipt (iv) dock receipt (v) inspector from the inspection agency
(vi) freight paid

C (i) False (ii) True (iii) True (iv) True (v) True
(vi) True (vii) True (viii) False (ix) False (x) False

2 1 TERMINAL QUESTIONS

1 Define foreign trade. How does it differ from home trade?

2 "Foreign trade is an engine of economic growth in a country." Discuss this statement keeping in view the Indian context and state other advantages of the foreign trade.

3 India's foreign trade has undergone a radical transformation since Independence. Do you agree with this view? Substantiate your view with facts.

4 What is a Letter of Credit? How does it help'in financing foreign trade? Name the shipping documents required to be submitted along with a documentary letter of credit?

5 What documents must accompany an export shipment? Describe them briefly.

6 Distinguish between
a) Bill of Lading and Shipping Bill
b) Bill of Lading and Charter Party
c) Mate's Receipt and Shipping Order

7 Explain the stages through which an export transaction has to pass and describe the various documents involved.

8 Describe the procedure for import of goods.

9 State the functions performed by clearing and forwarding agents in relation to import and export of goods.

10 Write **short** notes an:

a) Bill of Entry

b) Documents against Payment .

c) Documents against Acceptance

d) Certificate of Origin

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

NOTES

UNIT 13 BANKING

Structure

13.0 Objectives

13.1 Introduction

13.2 What is a Bank

13.3 Types of Banks

13.4 Role of Commercial Banks

13.5 Banker and Customer

- 13.5.1 Who is a Customer
- 13.5.2 Relationship between Banker and Customer
- 13.5.3 Duties of a Bank
- 13.5.4 Rights of a Bank

13.6 Types of Bank Accounts

- 13.6.1 Fixed Deposit Account
- 13.6.2 Current Account
- 13.6.3 Savings Bank Account
- 13.6.4 Recurring Deposit Account

13.7 Modes of Making Payments

- 13.7.1 Cheques
- 13.7.2 Drafts
- 13.7 3 Standing Instructions

13.8 Advances

- 13.8.1 Loans
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- 13.8.3 Cash Credit
- 13.8.4 Discounting of Bills

13.9 Modes of Creating Charge

- 13.9.1 Pledge
- 13.9.2 Hypothecation
- 13.9.3 Mortgage

13.10 Other Bank Services

13.11 Let Us Sum Up

13.12 Key Words

13.13 Answers to Check Your Progress

13.14 Terminal Questions

13.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of a bank
- describe the types of banks
- explain the relationship between banker and customer
- list the duties and rights of banks
- describe the types of accounts and their operations
- enumerate the methods of making payments through banks
- explain the methods of advance and loans
- describe the role of credit cards.

13.1 INTRODUCTION

You have already studied that all those activities which facilitate the trade are called 'aids to trade' or "auxiliaries to trade'. Aids to trade eliminate the hindrances and facilitate the flow of goods from producer to consumers. They are classified into five categories: (1) advertising, (2) banking, (3) insurance, (4) transportation, and (5) warehousing. You have already studied about advertising in Block 3. You will study the remaining four aids to trade in this block. This unit is devoted for banking. In this unit, you will learn the meaning and classification of banks, the different types of accounts that can be opened in a bank and their operations, various types of bank and various methods of payments through banks. You will also learn about electronic banking and credit cards.

13.2 WHAT IS A BANK

In simple words, bank is an institution which deals in money. Banks accept surplus money from those who are not needing it immediately and lend it to those who need it. Let us see the various definitions of bank given by different authors and understand the main features of a bank.

"A banker is one who in the ordinary course of his business honours cheques drawn upon him 'by persons from and for whom he receives money on current accounts"
- Herbert L. Hart

"The function of receiving money from his customers and repaying it by honouring their cheques as and when required is the function above all other functions which distinguishes a banking business from any other kind of business". - H. P. Seldon

"Banking means the accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise". - Banking Regulation Act [Sec.5(1)(p)]

"No person or body corporate or otherwise, can be a banker who does not take deposit accounts, take current accounts, issue and pay cheques and collect cheques, crossed and uncrossed, for his customers". - Sir John Paget

If you go through the above definitions of a bank, you will notice that a bank must perform two essential functions: 1) acceptance of deposits from public, and (2) lending or investing the same. It is also provided that the bank is under the obligation of repaying money on demand to respective depositors. You should note that the banker does not refund the money on his own accord, even if the period for which it was deposited expires. Thus, the depositor must make a proper demand for refund of money.

Acceptance of deposits,of money is an essential function no doubt, but simply because a company is accepting deposits of money from the public, does not make it a banker. It is necessary that the deposits accepted should be used for lending or investment. The banks mobilise the resources by accepting deposits and utilise such funds by employing them profitably. The banker is, thus, an intermediary and deals with the money belonging to the public.

In the modern days, industrial units and commercial undertakings also accept deposits of money from the public with the facility to withdraw them when required or after the expiry of a certain agreed period. But such institutions cannot be termed as bankers because acceptance of deposits is their subsidiary business, while the main function is manufacturing or trading.

Besides receiving deposits and lending or investing funds, the banks also perform various subsidiary services such as collection of cheques, drafts and bills, collection of interests and dividends on securities, making payment on behalf of his customers, remittance of funds, discounting the bills of exchange, acceptance of valuables for safe custody, etc.

From the above discussion, you identify the distinguishing features of a bank as follows:

Acceptance of deposits of money from the public

Profitable employment of such funds

Obligation to refund deposits on demand

- Lending or investing money
- Banking as the main business.

Thus, if a concern carries on banking business only as an ancillary to some other main business, it cannot be considered as a bank.

13.3 TYPES OF BANKS

There are different institutions who conduct their operations in a different manner. On the basis of their functions, we can classify banks as follows:

Commercial Banks: Commercial banks are the oldest institutions having a wide network of branches throughout the country. A commercial bank is a monetary institution which serves the interest of its depositors by utilising their funds in profitable ventures and provide a variety of services to its customers. Commercial banks may either be owned by the Government or may be run in the private sector. Besides deposit mobilisation, the commercial banks provide not only short-term loans but also medium and long term loan to trade and industry.

2, Co-operative Banks: Cooperative banks are private sector banks. A cooperative bank is a voluntary association of members for self help and caters to their financial needs on a mutual basis. These banks are also subject to control and inspection by the Reserve Bank of India. Such banks get their resources from their shares, public deposits and also loans from the state cooperative banks. They also get short and medium term loans from the Reserve Bank of India. To enhance public confidence in cooperative banks, the Reserve Bank of India has extended the Credit Guarantee Scheme to cooperative banks.

3. Land Development Banks: These banks provide long term credit to agriculture for purposes such as pump sets, tractors, digging up wells, land improvement, etc. These banks raise their resources mainly by flotation of debentures, subscribed by the ***State*** Bank ***Group,*** commercial banks, LIC and by RBI. These banks grant loans to farmers against the security of their land. The land development banks cannot be strictly called banking institutions because they are not required to mobilise deposits and not to maintain cash reserve ratio.

4. Regional Rural Banks: The main objective for setting up of the RRB's was to provide credit and other facilities, especially to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in rural areas. The RRB's are sponsored by scheduled banks, usually a nationalised commercial bank.

5. Industrial Banks: These banks have come up to promote rapid industrial development. Such banks provide medium and long term loans to industrial sector. They also do underwriting of public issues by corporate sector and guarantee. They render other services like identification of suitable projects, preparation of project reports, providing technical advice and managerial services, raising standards of management, etc. We have a number of such banks in India, namely, Industrial Development Bank of India (IDB), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India Ltd. (ICICI), Industrial Reconstruction Bank of India (IRBI), etc.

6. Central Bank: Every country has a Central Bank of its own. It is called a Central Bank because it occupies a central position in the monetary and banking system of the country and is the highest financial authority. It is the apex bank and the statutory institution in the money market of a country. In India, Reserve Bank of India is the central bank. The main function of this bank is to regulate and supervise the whole banking system in the country. It is a banker's bank and controller of credit in the country. It has the sole right of note issue. It is a lender of last resort and custodian of foreign exchange of the country.

13.4 ROLE OF COMMERCIAL BANKS

Commercial banks play a very important role in the economic development of the country. Banks are the nerve centre of trade, commerce and business in any country. We can discuss the role of commercial banks by examining the services provided by them as under:

1. Collection of Deposits: Accepting deposits from the customers is one of the main function of the banks, By mobiling deposits the commercial banks help in the developinent of savings habit in the public. Bank deposits are not only safe but bank also earn interest on it.
2. Facilitate Payments: Banks facilitate Payments through cheques which is a very convenient and safe mode of making payments. Cheques serve as a ready proof of the fact that the payment has been made. When payments are made by cheques, there is no need of carrying large amounts of cash and the trouble of counting is avoided.

3. Provide Loans and Advances: Commercial banks grant loans and credit facilities to the public. Banks also allow overdraft facilities to its customers, thus providing them instant credit. Banks issue letters of credit, thus enabling businessmen to deal with strangers because payment is guaranteed.

4. Provide Credit Information: Commercial banks provide vital information relating to the credit worthiness of their customers. Whenever a businessman deals with another businessman for the first time, he would like to know the financial position of the other person. In such case if he refers it to his banker, who provides the necessary information.

5. Discounting of Bills: The banks lend money by discounting bills. Discounting a bill of exchange means the advancing of a loan against a promise to pay in future. This is a very popular method of lending as the loans are self liquidating.

6. **Collection of** Cheques, etc.: Banks also undertake to collect the amount of cheques, drafts, bills of exchange etc. on behalf of its customers.

7. **Safety of** Valuables: The banks provide safe deposit vaults (lockers) wherein valuables such as jewellery, ornaments, documents, etc., can be kept safely.

8. **Remittance** of Money: If money is to be remitted to any other place, it can be done quickly through banks, Now some of the banks provide 24 hours service, wherein by giving your personal identity number, you can withdraw money at any hour of the day.

From the above you must have noted that the commercial banks play a very important role in the business world. We cannot think of a modern society without banks. The banks are playing a pioneering role in lending, particularly to the priority sector, constituting agriculture, small scale industries and small business. The emerging environment offer ample opportunities to banks to venture into new and profitable areas.

13.5 BANKER AND CUSTOMER

You have learnt the meaning and functions of a bank. Now let us discuss the meaning of a customer of a bank.

13.5.1 Who is a Customer ?

Ordinarily, the customer of a bank means a person who has an accpunt with a bank. According to Sir John Paget, "To constitute a customer there must be some recognisable course or habit of dealing in the nature of regular banking business. It is difficult to reconcile the idea of a single transaction with that of a customer". According to this view, to constitute a customer of a bank it is necessary to satisfy two conditions, (i) there must be regular transactions or that the customer must have the habit of dealing with the bank, and (ii) the transaction between them must be of a banking nature.

The first condition means that a single banking transaction will not make a person a customer of a bank. He must maintain his account with the bank for a reasonable duration, and must deal with the bank quite frequently. But now this view has been discarded. In *Ladbroke vs. Todd,* it was held, "the relationship of banker and customer begins as soon as the first cheque is paid in and accepted for collection". According to this decision, a person becomes a customer of a bank as soon as the bank account is opened. In the case of ***Commissioners of Taxation vs. English, Scottish and Australian Bank,*** it was held, " duration is not the essence to signify the relationship between a banker and customer." In a recent case of The Central Bank of India vs. Gopinathan Nair & Others the Kerala High Court observed', "broadly speaking, a customer is a person who has the habit of resorting to the same place or person to do business. So far as banking transactions are concerned, he is a person whose money has been accepted by the banker on the footing that the banker will honour drawings upto the amount standing to his credit, irrespection of his connection being of short or long standing." From the above, it should be clear to you that as soon as an account is opened in a bank and the first transaction takes place, the person becomes a customer of that bank. You should remember that casual transactions carried on through a bank, without having a bank account, will not make a person a customer of the bank, even if they are carried on for a long duration.

13.5.2 Relationship between Banker and Customer

You have learnt what is a bank and who is a customer. Now let us understand the relationship between the two. The relationship between a banker and a customer is as follows:

1. Contractual Relationship: The primary relationship between a banker and a customer arises from'a contract between the two, so it is a contractual relationship. The contract takes place the moment an account is opened by a customer with a bank and this contract remains valid till the customer operates his account as per the terms and conditions agreed between them.

2. Debtor and Creditor Relationship: The relation of a banker and customer is primarily that of a debtor and creditor. When a customer opens an account with a bank and maintains a credit balance, the banker assumes the position of a debtor and the customer assumes the role of a creditor. Money deposited with the bank becomes a debt due from him to the customer. The banker can use the money deposited with him by the customers in any manner according to his discretion, his only obligation being to repay the debt as and when demanded by the customer.

3. Bailee and Bailor Relationship: When a bank accepts deposits of money, he does not act as a bailee. This is so because a bailee accepts the bailment of goods on the condition that the things bailed will not be utilised by him and the identical goods will be returned. But a bank does not accept money from customer on the condition that it will not utilise the money and that the identical money (the same currency notes or coins deposited by customer) will be returned.

   A banker provides for safe deposit vaults and accepts documents and valuables for safe custody. Here the bank is acting as a bailee and the relationship is that of bailee and bailor.

4. Trustee Beneficiary Relationship: Banks also act as trustees and executors of will of customers. A trustee is required to hold p.:operty and money and use the trust money in accordance with the trust deed and use it for the benefit of some other person known as beneficiary. A customer may deposit some money with the bank for a specific purpose with specific instructions to the bank regarding its use. In such cases, the banker is the trustee of the customer's money, and the banker cannot employ them for any other purpose other than the purpose specified by the customer. You should note here that the money held under trust is different from the money received as deposits.

   The legal position of a banker as a trustee is different from that of a debtor to the customer. The relationship is determined by the particular circumstances in each case. For instance, when a bank receives a cheque from the customer for collection from another bank, the bank becomes a trustee till the amount of cheque is realised. Once the amount is credited to the customer's account, the banker assumes the position of a debtor.

5. Principal-Agent Relationship: Banks perform many agency functions such as collection of cheques or drafts or bills, collection of interest and dividends on securities, arranging for remittances and payment of insurance premiums, etc., as per the instructions of the customers. In all such cases, the bank is acting as an agent of the customer. In these cases the position of a customer is that of the principal and the position of the banker is that of the agent. Here the bank has to act according to the instructions of the customer.

13.5.3 Duties of a Bank

The relationship between the banker and customer creates some obligations on the part of a bank. The main obligations of the banker towards the customer are as follows:

1. Obligation to Honour Cheques: You know that a bank is the debtor of his customer. The . bank has a statutory obligation to honour the cheques of its customers upto the amount standing to the credit of the customer's account. If a bank wrongfully refuses to honour the cheque of its customer, the bank shall be liable to compensate the customer. This obligation is subject to some conditions, namely:

a) There must be sufficient funds of the customer in the hands of the bank.
b) The funds must be properly applicable for the payment of the customer's cheque.
c) The cheque must be properly drawn up i.e., it should be complete in all respects.
d) The cheque must be presented for payment within a reasonable time.
e) There must be no legal bar preventing the payment of such cheques. If the bank has received any order from a court or any other competent authority prohibiting payment, it is the duty of the bank to obey such orders.

2. **Obligation to** Maintain Secrecy: The relationship between the banker and customer is of a confidential nature. The bank must not disclose to any outsider the details concerning the customer's account, as such disclosures may adversely affect the credit and business of the customer. However, a disclosure can be made under the following two situations : (a) when the law requires such disclosures to be made, and (b) when the practices amongst the banks permit such disclosure.

3. **Obligation** to Follow Customer's Instructions: The banker is under a legal obligation to follow the instructions of the customer. This is so because there is the contractual relationship between the bank and the customer.

4. **Obligation** to Maintain Proper Records: The banker is under an obligation to maintain accurate record of all the transactions of the customers made with the bank.

5. **Obligation** to give Notice before **Closing** the Account: If a bank wishes to close the account of a customer, it must give a reasonable notice to this effect to the customer. Thus, a bank cannot close the account of a customer on its own, because it may have serious consequences to the customer.

13.5.4 Rights of a Bank

For fulfilling the obligations towards the customers, bankers enjoy the following rights:

I. Right of General Lien: One of the most important rights enjoyed by a bank is the right of general lien. Lien is a right of a person to retain goods belonging to another, until the demands of the person in possession are satisfied. Section 171 of the Indian Contract Act confers the right of general lien on the bankers. General lien entitles the banker in possession to retain goods and securities till all its claims against the customer are satisfied. You should note that the banker can exercise his right of general lien only as a banker and not as a bailee. Banker's lien is an implied pledge in the sense that if a default is made by the debtor, the banker can, after giving a reasonable notice to the customer, sell the goods in his possession and recover the amount. If some valuables are deposited with a bank for safe custody, then it is bailment and the bank cannot exercise the right of general lien.

You should note that the right of general lien cannot be exercised in the following cases:

a) When valuables are deposited for safe custody,
b) When money or documents are deposited for a specific purpose,
c) When some securities are left with the bank by mistake,
d) When the property is held by the customer as trustee and the bonk has the notice of trust, and
e) When there is an express agreement that the bank shall not exercise the right of general lien.

2. The Right of Set-off: Right of set-off is the right of a debtor to adjust the amount due to him from a creditor against the amount payable by him to the creditor to determine the net balance payable by one to another, Like any other debtor, a bank also has a right of set-off. When a customer has two or niore accounts in the same name and capacity in a bank, the bank has the right to adjust the amount standing to the credit of the customer against the debit balance in the other account. The bank has a right to combine the two accounts. For example, Mı X has overdrawn his current account to the extent of Rs.10,000 and he has a credit balance of Rs.8,000 in his savings account. The bank can combine these two accounts and claim the balance of Rs.2,000 after adjusting the credit balance of savings account against the debit balance of current account.

3. Right of Appropriation: A customer may owe several distinct debts to the bank. When the customer deposits some money in the bank without specific instructions and the amount is not sufficient to discharge all debts, then the problem arises as towards which debt this amount should be adjusted. In the absence of any specific instructions, the bank has the right to appropriate the deposited amount to any loan, even to a time barred debt. But the banker must inform the customer about the appropriation.

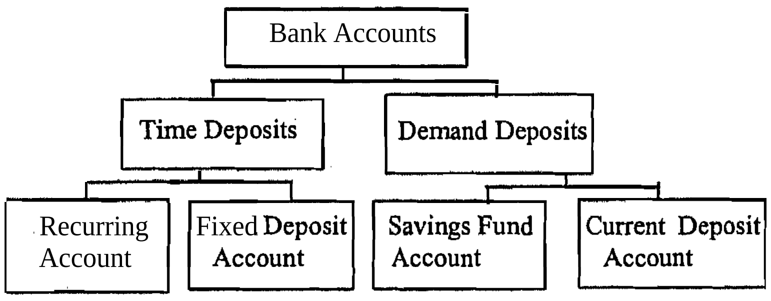
4. Right to Charge Interest and Commission: The bank has the implied right to charge interest on loans and advances, and also to charge commission for services rendered by the bank. The bank can debit such charges to the customer's account.

5. Right to Close **the** Account: If the bank is of the opinion that an account is not being operated properly, it may close the account by sending a written intimation to the customer.

13.6 TYPES OF BANK ACCOUNTS

You have studied that one of the main function of a commercial bank is to accept deposits of money from the public. The deposits accepted by a bank may be classified into two broad categories: (a) time deposits and (b) demand deposits. ***Time deposits*** are repayable on the expiry of a fixed period of time, while ***demand deposits*** are repayable on demand. Therefore, as shown in Figure 13.1 the main type of accounts in a bank are fixed deposit account and recurring account (for time deposits), savings bank account and current account (for demand deposits). Let us now see how these accounts are opened in a bank and how are they operated.

Figure 13.1 : Classification of Bank Accounts



13.6.1 Fixed Deposit Account

The fixed deposits are the most popular form of deposits raised for the banks. This type of account is most suitable for persons who have spare money to invest for long duration but do not want to **invest** in risky securities.

The term 'fixed deposit' means the money or deposit is made for a fixed period of time at a fixed rate of interest. This period may vary from forty five days to several years. This period is decided by the customer according to his convenience. The rate of interest is usually higher than other types of deposits. The reason is very clear, because the bank knows that the deposit money is repayable only after a certain period. So the bank need not keep cash reserves more than the statutory requirement against these, thus, the bank can utilise this money more profitably. The rate of interest on fixed deposit depends on the period of deposit, the longer is the period of deposit, the higher will be the interest **rate.** The interest rate is decided by the Reserve Bank of India **from** time to time and all banks have to follow that rate structure.

Opening the account: For opening a fixed deposit account, the depositor has to fill in an application form available with the bank. The form contains particulars such as name of depositor, the amount of deposit, the period of deposit and the specimen signature. The bank records the rate of interest payable and the due date of repayment, As cheques are not drawn against a fixed deposit account, the banker need not ask for any introduction or reference as to the integrity and respectability of the depositor. After the deposit is received by the bank, an account is opened in the name of depositor in the ledger of the bank **and** the bank issues a fixed deposit receipt to the depositor. The receipt is an acknowledgment of the receipt of deposit by the bank. A deposit receipt is not a negotiable instrument and cannot be treated as a cheque.

Operation of the **Account:** Since the money is deposited for a fixed period of time, the amount cannot be withdrawn before the due date. In this type of account no cheque book and pass books are issued. The bank issues only a deposit receipt.

In practice, the banks allow the depositors to withdraw their deposit before the due date. In such cases interest is paid at the rate applicable to the period for which the deposit has already run with the bank less one per cent penalty for premature withdrawal. The depositor can borrow money against the security of fixed deposit receipt.

The fixed deposit receipts are marked 'Not Transferable'. So they cannot be transferred by endorsement. However, it can be assigned in favour of a third party and such an assignee can receive the amount provided the receipt is duly discharged and a proper letter of assignment is given to suchperson asking the bank to pay the deposit to the assignee on the due date.

When the depositor does not take repayment on the due date, the interest ceases to incur from that date, but the banks may, at their discretion, allow interest thereafter if the deposit is renewed from the date of its maturity till some future date.

If the depositor loses his fixed deposit receipt, he can ask the bank to obtain an indemnity bond from the customer and a note to this effect should be made in the ledger.

13.6.2 Current Account

Current accounts are intended for businessmen, joint stock companies, public institutions, etc., whose banking transactions happen to be numerous on every working day. A current account is a running and active account which may be operated upon any number of times during a working day. There is no restriction on the number and the amount of deposits or withdrawals from this account. Since the amount from this account is repayable on demand, the banks are required to keep sufficient cash to meet such demands. Therefore, the banks pay no interest on current account deposits. The banks charge incidental charges on an unremunerative current account for the work and expenses involved in its maintenance.

The main advantage of current account is that the customers are relieved from the botheration of handling cash. Third party cheques with endorsements can be deposited in the current account for collection and credit to customer's account. Overdraft facilities are given in this **type** of account and loans and advances are granted by the bank.

Opening **of** a Current **Account**

Whenever any person or a grNotoup of persons or a firm wants to open a current account with a bank, they have to make a written request in the prescribed form. The forms contain the particulars about his name, his address, his trade or profession, his specimen signature and references etc. Before opening a current account in the name of a person, the bank should satisfy itself regarding the customer's character, integrity and respectability. For this purpose, the applicant must be introduced either by a respectable person known to the bank or known to the staff of the branch. If an account is opened without proper introduction, cases of fraud or misrepresentation may occur and the bank and the general public may suffer losses. After all the above formalities are over, the bank should receive the initial or first deposit from the customer. When an account is opened, the bank supplies to the customer a 'Pay-in slips book', a cheque book and a pass book. Now in place of the pass book, the banks send to their customers every month a statement of account showing therein the transactions that have taken place during the month.

Operation **of the Account**

A customer can deposit money or cheques in his account by filling up the requisite pay-in slip. Whenever he wants to withdraw money or wants to make payment to some one, it is done by issuing a cheque. The customer should check up the entries in the pass book or statement of account with the counterfoils in his possession.

13.6.3 Savings Bank Account

A savings bank account is opened and operated by people who wish to save a part of their income for his future needs and also earn some interest on his deposits. This type of account is intended to promote the habit of saving among depositors, therefore, some restrictions have been imposed on the number and the amount of withdrawals from this account. The banks allow interest on the minimum balance standing to the credit of an account during the period from the 10th day of the month to the last day of every month.

Opening a Savings Bank Account

The procedure of opening a savings bank account is similar to the procedure of opening a current account. For opening a savings bank account, the customer has to fill up the prescribed form, giving details about his name, address, occupation, etc. Before opening the account, the bank should seek proper introduction to satisfy himself about the integrity and respectability of the applicant. The bank should obtain specimen signature of the applicant. This account can be opened by depositing a minimum balance prescribed by the bank. The bank then opens an account in his ledger and provides the customer with a pay-in slip book, a cheque book (if customer wants) and a Pass Book.

Operating the Savings Bank Account

A customer operates this account through these documents - a pay-in slip (for depositing money in the account), a cheque or withdrawal form (for withdrawing or payment to others) and a pass book. When a cheque book is issued to a customer, he is required to maintain a minimum balance in his account. Interest is payable on the minimum balance according to the rates prescribed by Reserve Bank of India from time to time.

13.6.4 Recurring Deposit Account

Recurring deposit accounts are meant for people who have regular monthly incomes. This type of account is intended to encourage the habit of savings among depositors on a regular basis.

In this account, the depositor deposits a fixed sum of money every month for an agreed period and at the end of the specified period, he gets back the amount deposited together with the interest accrued thereon. The amount deposited in this account are in the multiples of Rs.10. The period for which a recurring account is opened varies from one year to ten years.

As there is a regular deposit of money into this account and as there is no withdrawal from this account before the expiry of the fixed period, the banks can utilise this money profitably. The rate of interest is higher than in a savings bank account,

The pass book is to be presented to the bank every month when a deposit is made, so as to enable the bank to record the deposit therein.

If a depositor is in need of money before the due date, the bank can on his discretion, repay the amount. Generally, instead of repaying the deposit amount, the bank grant a loan to the depositor against the security of his recurring deposit account. The bank charges interest on such loan at a rate which is one per cent. higher than the rate of interest applicable to the particular recurring deposit.

Check Your Progress A

1. What is a Bank ?

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2. List the main types of-banks.

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3. Define the term 'Customer'.

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4. What is the position of the bank in the following cases:
   (a) B deposits a bar of gold for safe custody.
   (b) B deposits Rs.10,000 with the bank, directing the bank to buy Units for him.
   (c) B deposits Rs.10,000 with the bank in fixed deposit account for one year.

5. Enumerate the important duties of a bank.

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6. What is banker's right of general lien ?

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7. List the types of accounts in a bank.

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8. State whether the following statements are True or False :
   i) Banks accept deposits for the purpose of lending or investment.
   ii) A company accepting deposits from the public to raise resources for its own use can also be called a bank.
   iii) The bank has an obligation to refund deposits on demand.
   iv) Reserve Bank of India has the sole right of note issue.
   v) The relationship between a banker and customer is primarily that of debtor and creditor.
   vi) Introduction is necessary for opening a savings bank account.
   vii) A bank can disclose the position of a customer's account to any one.
   viii) The rate of interest is the maximum in the case of current account deposits.

13.7 MODES OF MAKING PAYMENTS

You have learnt that money deposited in an account is repayable on demand. The bank shall make the payment only when a demand is made. A demand can be made by writing a cheque on the bank. Similarly bank drafts are also useful for payments. Banks perform another important function of remitting money from one place to another. Let us now study the meaning and rules relating to various instruments used for payments through banks.

13.7.1 Cheques

According to Section 6 of Negotiable Instruments Act, 1881, "A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand'. From this defmition it is clear that a cheque is an instrument in writing, containing an unconditional order to a bank to pay a certain sum of money on demand to a specific person or according to his order or it may be made payable to the bearer of the instrument. There are three parties to a cheque - drawer, drawee and the payee. A drawer is the person who has an account in the bank and who is writing the cheque. A drawee is one on whom the cheque is drawn, he is liable to make the payment. In case of a cheque paying bank is the drawee. A payee is the person to whom the amount of cheque is to be paid, If the cheque is made payable to "self", the drawer himself becomes the payee.

A cheque may either be a bearer cheque or an order cheque. A bearer cheque is one where the payment can be had by the person who is presenting the cheque to the bank for payment. A bearer cheque can be transferred from one person to another by mere delivery only i.e., just like cash payments. On the other hand an order cheque is one which is payable to a certain person or his order. In an order cheque, the payee must be named. An order cheque cannot be transferred from one person to another by mere delivery. It requires the endorsement of the payee.

A cheque is not meant for indefinite circulation. It must be presented for payment within six months of the date appearing on the cheque. If a cheque remains in circulation for a period exceeding six months from the date of issue, it is termed as a "stale cheque" and the bank must dishonour such cheques.

If a cheque bears a date which is yet to come is termed as a post-dated cheque'. A post dated cheque does not become invalid. It is valid and negotiable. But it is not payable until the arrival of the date written on it. The banks do not make the payment of a post date cheque because the written order is to be honoured on or after the date mentioned on the cheque.

In order to ensure the payment by cheque absolutely safe, the cheques are crossed. Crossing of a cheque means drawing across the face of the cheque two parallel transverse lines with or without the words "And Company" between the lines. Crossing can be hand written or stamped. When a cheque is crossed, its payment cannot be received at the counter but it is always deposited in the account of the payee.

The paying banker should make the payment of a cheque according to the instructions mentioned on the cheque. The paying banker should not deviate from those instructions. If the bank pays a stale cheque or pays a post dated cheque before the due date, the bank shall not receive the statutory protection. The paying banker should always make the payment in good faith and without negligence.

13.7.2 Drafts

Commercial banks are very useful for remittance of funds from one place to another through the network of their branches spread over the entire country. For remitting money from one place to another, banks issue demand drafts on their branches at the place where payment is to be made. It is issued on the request of a customer who has to make a guaranteed payment.

Section 85A of the Negotiable Instruments Act defines a bank draft as "an order to pay money drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand". A bank draft is, thus, a payment instruction similar to a cheque and is always drawn by one branch on another to pay a specified sum of money to the person named therein or his order. You must note that a draft is always payable on demand and it cannot be made payable to bearer. It can be crossed like a cheque.

A bank issues a draft for consideration received in advance. The person who intends to remit money has to make an application on the bank's prescribed form showing the necessary particulars such as the name of the payee, name of the place on which draft is required, amount in words and figure, signature and full name of the applicant with address. The issuing bank charges a commission for rendering this service and the amount of commission depends upon the amount to be remitted. The purchaser then sends the draft to the payee by whom the draft is presented to the drawee branch for payment.

You must have noticed that there are three parties to a bank draft: (a) the issuing branch or drawer, (b) paying branch or drawee, and (c) the payee. It means that the purchaser of the draft is not a party to the instrument. It is to be noted that this service is extended by banks to public in general and the purchaser of the draft need not necessarily be a "customer" i.e., an account holder of the bank.

Stopping payment of Bank Draft

A bank draft is the issuing bank's commitment in favour of the payee to pay a certain sum of money. Though the bank gives the undertaking at the instance of the purchaser of the draft, who gives due consideration for the same, but a bank draft is equivalent to the bank's promissory note and is accepted because of the credit and faith in the bank which is issuing the draft. The bank should not, therefore, comply with 'stop payment' instructions of the purchaser of the draft as readily as that of the drawer of a cheque.

If the bank draft is passed on to the payee, he acquires a right in the instrument which cannot be set aside by 'stop payment' instructions of the purchaser. Thus, it is clear that the purchaser of the draft can ask the bank from which he has purchased it to cancel the draft and pay back the money to him at any time before the draft has been delivered to the payee.

13.7.3 Standing Instructions

Sometimes a customer gives instructions to his bank to make some payments on his behalf regularly and such instructions are to be carried out till a notice to the contrary is given by the customer. Such instructions are called standing Instructions. Some of the standing instructions are - payment of insurance premium to LIC, membership subscription to clubs, transfer of funds from one account to another, collection of pension on behalf of account holder, collection of interest on Government Securities held in safe custody, collection of dividends on behalf of the customer, etc.

Such instructions which are obtained from the customer in writing, must be clearly and unambiguously worded. The bank is free not to accept standing instructions which are difficult to comply with, but once they are accepted, it is the duty of the bank to carry out the instructions carefully and promptly. Once the standing order mandate has been accepted, no further action is required by the customer except that he must keep sufficient funds in his account. It is the bank's duty to pay only on the due date. If funds were insufficient to make a payment on the due date, there is no obligation to the customer in respect of that month's payment.

Check Your Progress B

1. Define a cheque.

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2. What is a Bank Draft ?

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3. What is the purpose of crossing ?

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4. Name the parties to a Bank Draft.

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5. State whether the following statements are True or False:
   i) A cheque is always payable on demand.
   ii) An order cheque can be transferred by mere delivery.
   iii) A cheque becomes stale after eight months.
   iv) A cheque bearing Account Payee crossing can be negotiated.
   v) A bank draft is drawn by one bank upon another bank.
   vi) The purchaser of the draft is not a party to the instrument
   vii) The bank shall not be liable for not following standing instructions.
   viii) A bank draft cannot be drawn payable to the bearer.

13.8 ADVANCES

You learnt that one of the basic functions of a bank is to lend money. The major portion of the funds mobilised by banks through deposits is employed by way of loans and advances. Advances form the main source of income for a bank. As you know, bank advances enable' trade, commerce, industry and agriculture to meet their financial requirements. The banks follow a cautious policy in advancing loans. Primary concern of a bank as a lender should be 'safety' and 'liquidity' of advances. Besides, banks also need a good return from the employment of their funds to meet their expenses. This is known as 'profitability'. Banks have to maintain a balance between liquidity and profitability in such a way that they should be able to meet the demand of depositors for cash and at the same time earn sufficient profit from the advances.

Naturally the banks should not lock up the funds in few investments for a long period of time This is risky from the point of view of safety of investments. There is common saying that one should not put all eggs in one basket. Banks provide various types of advances to its customers according to their needs and repaying capacity. The advances may be in any of the following four forms: (1) loans, (2) overdrafts, (3) cash credits, and (4) discounting of bills. Let us briefly discuss about them one by one.

13.8.1 Loans

A loan is a financial arrangement under which an advance is granted by the bank to the borrower on a separate account called the loan account. When a loan is granted against security or otherwise, the entire amount of loan is paid to the borrower in lump sum either in cash or by transferring the amount to his account in the bank. Whenever borrower repays some money, the loan account is credited by that amount and the loan account is debited with the amount of interest and incidental charges. Interest is charged on the whole amount of loan sanctioned, irrespective of the amount actually withdrawn by the borrower. However, the rate of interest on loan is slightly lower than that charged on an overdraft and a cash credit.

Loans are sanctioned for short, medium and long periods. Loans repayable within a period of one year are called **short term loans.** They are suitable to meet the working capital needs of the business firms. Loans repayable within a period ranging from one to five years are termed as **medium term loans and** such loans are granted to finance expansion and development plans. Commercial banks normally grant short term and medium term loans only. When a loan is given for more than five years, it is called a **long term loan.**

The loans to individuals are granted on the basis of personal security and guarantee by another person. Loans to trade, industry or agriculture are granted against tangible and intangible securities. **A secured loan or an advances** means a loan or an advance made on the security of assets, the market value of which is not at any time less than the amount of such loan or advance.

The banks prefer to grant loans because of the following three reasons: (1) the bank can collect interest on the entire amount of loan sanctioned, (2) it involves very little accounting work, (3) the bank can review the loan account periodically. The main drawback of the loan system is that every time a loan is needed, it is to be negotiated afresh. Further, the banks have no control over the use of funds borrowed by the customer.

From the point of view of the borrower, the big advantage of taking a loan is that money will always be available over the agreed period and cannot be recalled as a result of restrictions imposed on bank lending. However, the main disadvantage to the borrower is that he is required to pay interest on the entire amount of loan, whether he has actually withdrawn the amount or not.

13.8.2 Overdraft

An overdraft is a financial arrangement under which a current account holder is permitted by the bank to withdraw more than the credit balance in his account, upto an agreed limit. Thus, by nature, it is a temporary financial accommodation to be made use the customer occasionally. The overdraft facility is given to those who have a current account with the bank and whose business relations with the bank continue to be good. Besides that, bank also considers the business of the customer, his reputation, how far'the arrangement will help the customer to improve his business, and ability to repay the money to the bank.

An overdraft is granted either against collateral securities or against the personal security of the borrower. An overdraft arrangement is very advantageous to the borrower as interest is charged on the amount actually overdrawn by him. But it is not advantageous to the bank because, while he can charge interest on the amount actually overdrawn, he is required to keep at the disposal of the customer the full amount of overdraft sanctioned. In order to protect the interest of the banker agreement a minimum interest clause is included in the agreement, which requires the customer to pay a minimum rate of interest on the sanctioned amount of overdraft, if the overdraft is not utilised fully.

Bank should be very careful while granting overdraft facility to a customer, because in case of default by the customer to repay the overdraft, the bank has to go through long legal formalities. In order to be safe, the banks generally obtain a promissory note from the customer.

13.8.3 Cash Credit

Cash credit is the main method of lending by banks in India. Cash Credit is a financial arrangement between the bank and the customer under which a bank allows his customer to borrow money upto a certain limit against the security of tangible assets or guarantees. The amount is credited to a separate account and the customer is allowed to operate the account.

In the case of cash credit, the borrower need not withdraw the whole amount at once. He can withdraw the amount in instalments as and when needed. Further, he can deposit into the account any surplus amount which he has in his hands. Thus, you note that it is an active running account to which deposits and withdrawals may be effected frequently. However, the debit balance in a cash credit account on any day should not exceed the cash credit limit. A cash credit is usually a more permanent financial arrangement than an overdraft.

In the case of cash credit, interest is charged not on the amount of cash credit sanctioned to him, but on the amount actually utilised by him for the actual period of utilisation.

Though the cash credit arrangement is very popular with borrowers, it is disadvantageous to the bank. While bank can charge interest only on the actual amount utilised by the borrower, but he has to keep at the disposal of the borrower the entire amount of cash credit sanctioned. For this reason, there is a provision of charging commitment charge on the unutilised portion of the cash credit limit. Normally, the minimum interest clause is included in the cash credit arrangement. However, it is very difficult for the bank to verify the end-use of the loan.

13.8.4 Discounting of Bills

Discounting of bills of exchange is another important form of lending. Under this system the bank takes a bill of exchange maturing within a short time, say *60* days or **90** days and credits the customer's account with **the amount** of the bill after some discount. The bank waits upto the date of maturity of the bill and presents it on the date of maturity to the drawee for payment. Since the bank has to wait till the date of maturity, the banks charge interest for the remaining duration of the bill and this amount is known as 'discount'. For example, a bill of Rs.5,000 payable after 3 months is discounted @6 per cent, the bank will credit the customers account with Rs.4,925 only.

Banks normally accept only such bills which are considered eligible for discount under the directions of Reserve Bank of India. The bills mostly discounted are documentary bills i.e., a bill of exchange accompanied by documents of title to goods. In case the bill is dishonoured on the due date, the bank recovers the amount of the bill together with interest and other charges from the customer. The bank has to take care that the dishonoured bills are immediately sent to the customer to enable him to take the necessary legal action.

The main advantage of discounting of bills is that, though the bank has no tangible assets with it as security, the bank can recover the full amount of the bill from the customer by debiting his account. It is a method of short-term financing. The bank is certain that after the stated period, the amount will be realised, so the bank can utilise its funds more profitably.

You notice from the above that discounting of bills is a method of financial accommodation by the bank to the customer. It helps the customer to carry on his business smoothly without bothering about the problem of money.

13.9 MODES OF CREATING CHARGE

While lending money, the bank has to keep three principles in mind viz., liquidity, safety and profitability. In order to minimise risks in advancing money, banks usually insist on good security and would like to create a charge on the tangible assets of the borrower in favour of the bank. When a charge is created, the bank gets certain rights on the tangible assets. In case the borrower fails to repay the advance, the bank can recover its money by disposing of those assets in the market. The important methods of creating a charge are: (1) pledge, (2) hypothecation, and (3) mortgage. Let us now study them briefly.

13.9.1 Pledge

Section 172 of the Indian Contract Act defines pledge as "a bailment of goods as security for payment of a debt or performance of a promise". So, a pledge is a contract whereby a borrower delivers his movable property to the lender as a security for the loan on the understanding that the property pledged will be returned to the borrower on repayment of the debt. The borrower who pledges the property is called the 'pledged' or 'pawner' and the person with whom the property is pledged is known as 'pledgee' or 'pawnee'.

From the above, you must have understood that delivery of goods and return of goods are the two essential features of pledge. Delivery of goods may be either physical delivery or constructive (symbolic) deliveiy. When the pledgee puts his own lock on the godown or when the keys of the lock are handed over to the bank, it amounts to delivery of goods. Similarly, handing over the duly endorsed documents of title to goods like railway receipt, bill of lading, etc., amount to delivery of goods.

While accepting a pledge as a charge, the bank should ensure that the contract is in writing to minimise the misunderstanding of the terms. The contract should be complete in all respects and should incorporate all the usual clauses of pledge. It is advisable for the bank to get a declaration from the borrower to the effect the goods deposited with the bank are left as a security for the advance. The bank should see that the borrower has a valid title to the property pledged. The bank should ensure that the goods are kept safely in the godown. It is desirable that the bank should ensure goods against theft, fire, riot, etc.

You must remember that when goods are pledged, only the possession over the goods is given and not the ownership. The pledger or the borrower continues to be the owner of the property.

If the borrower failed to repay the loan in time, the bank has a right to file a suit against the borrower for the recovery of the amount, and retain the goods as collateral security. But since this is a lengthy process, the banks are given the right to sell the pledged goods and recover their money. But before selling the goods, the bank must give a reasonable notice to the borrower about his intention to sell the goods.

If the proceeds of sale are less than the amount due, the borrower is still liable to pay the balance. But if the proceeds of sale is in excess of the amount due, the bank has to pay the surplus amount to the borrower. In case the goods are sold without giving a reasonable notice to the borrower, the sale cannot be set aside, but the bank will become liable to the borrower for damages.

From the above, it must be clear to you that for securing a charge on the property, the method of pledging is very simple and therefore, it is very popular. It should also be noted that the right to retain the goods pledged is applicable only in case of a particular debt for which the goods are pledged. The bank has no right to retain the security, as security for other debts owned by the borrower.

13.9.2 Hypothecation

Hypothecation is a mode of creating charge on goods or related documents without the surrender of possession of goods. According to Prof. Herbert Hart, "Hypothecation is a legal transaction whereby goods may be made available as security for a debt without transferring either the property or the possession to the lender".

Hypothecation is resorted to such cases where transfer of possession of the property from the borrower to the creditor is either impracticable or inconvenient. For example, if the borrower wants to borrow on the security of motor vehicle, which is being used as a taxi, it shall not be advisable to pledge the vehicle with the bank, as it will deprive him of his livelihood. In the case of hypothecation, an equitable charge is created on the goods for the amount of debt but the hypothecated goods actually remain in the physical possession of the borrower. The borrower who hypothecates the goods is known as 'hypothecator' and the lender is termed as 'hypoihecatee'.

Generally, hypothecation is done by the borrower by executing a document called a 'letter of hypothecation' in favour of the lender. In this letter it is stated that the said goods or property are at the order and disposition of the lender until the debt is cleared. It also empowers the lender to sell the hypothecated property in the event of default or repayment by the borrower.

As the hypothecated goods remain in the possession of the borrower, there is considerable scope for fraud. The same goods may be hypothecated with another person. It is a risky method no doubt. That is why this facility is granted to parties of unquestionable integrity and honesty. Even then the banker should obtain a declaration from the borrower to the effect that the goods are not hypothecated earlier with some other lender and that the borrower has a clear title to the property hypothecated. The bank should carry out regular inspection and physical verification of the hypothecated goods.

13.9.3 Mortgage

When immovable property like land and building is offered as security for debt, a charge is created thereon by means of a mortgage. A mortgage is the transfer of the interest in a specific immovable property by one person to another for the purpose of securing an advance of money. The transferor is called 'mortgagor' and the transferee is known as 'mortgagee'. The advance of money in respect of which the mortgage is effected is called the 'mortgage money' and the instrument by which the mortgage is effected is called the 'mortgage deed'.

In a mortgage, the possession of the property need not always be transferred to the mortgagee. Usually, it remains with the mortgagor. Since the mortgagee gets the interest in the property, he has a right to sell of the property and recover his loan. When the borrower repays the amount of loan together with interest, the interest in the property is re-conveyed to the mortgagor.

While accepting a mortgage as a charge, the bank should ensure that the borrower has a valid title to the property and this can be done by examining the original title deeds. The bank must not part with the title deeds to the borrower when the mortgage is pending. If the advance against mortgage is given to a joint stock company, then the charge should be registered with the Registrar of Companies within 30 days of the creation of the charge. The mortgaged property should be inspected periodically to ensure that it is in good condition. If the property mortgaged is building, the bank should ensure that it is insured against fire, riot etc.

There are several forms of mortgage. They are (i) simple mortgage; (ii) Usufructuary mortgage; (iii) English mortgage; (iv) Mortgage by conditional sale; (v) Equitable mortgage or mortgage by deposit of title deeds and (vi) anomalous mortgage.

13.10 OTHER BANK SERVICES

Apart from performing the main functions of accepting deposits and granting advances, the banks have started performing various other services to the customers. Such other services are as follows:

1. Collection of money on behalf of customers: A bank undertakes the responsibility to collect money on behalf of his customers, Banks collect cheques and bank drafts, and credit the proceeds to the customers' accounts. Banks also collectbills of exchange, promissory notes, postal orders, interest and dividend warrants on behalf of the customers. Banks even collect the salaries of his customers from their employers, when

they are away from their place of employment or are on leave. They often collect pension of the customers from their fonner employers and credit it in their account. At times, the banks collect even the rent due to the customer from his tenants and credit the amount to their accounts.

2. Leasing: A lease is the use of an asset which belongs to some other person. In a lease contract, the possession and use of asset vests with the user called the 'lessee', whereas the ownership remains with the provider called the 'lessor'. In simple words, leasing is a system by which a person gets the right to use an asset by paying a predetermined amount of money called 'rental' periodically over a period of time.

   The banks have undertaken this business in a big way. The main advantage of leasing to a business is that, although the legal title of the asset remains with the leasing company, once the first rental has been paid, the business firm gets the physical possession of the asset to put it on operation. has complete use of the asset without having to finance its acquisition out of its own valuable resources or to seek a loan to cover the cost. In this arrangement business firm need not spare the financial resources at a time to acquire the asset or seek a loan to cover the cost.

3. Tax Consultancy: This service is of a recent origin and provides advice on income tax and other personal taxes such as capital gains tax, wealth tax, etc. The bank's tax department offers advice on tax matters which consist of preparing the customer's annual statement of income and expenditure, claiming allowances as permitted, claiming the rebates, etc. The tax department also advises tlie customers as to how to arrange their affairs to the best advantage to themselves. The bank advises the customer regarding life insurance and other investments so as to reduce the tax burden.

4. Merchant Banking Services: Until a few years back this service was confirmed to few larger banks. But now it has become part and parcel of business of almost every bank. This service comes under rendering non-banking services to industrial and business houses. For this purpose banks have set up merchant banking divisions.

   Merchant banking division of a bank offers to industrial and business houses, under one roof, a wide range of non-banking services such as conducting of economic, technical and financial feasibility studies. It helps in undertaking market surveys. It helps its clients to obtain from the Government and other departments letters of intent, licences and permission required for setting up the industrial projects. This service also includes advising the clients as to the methods and terms of raising capital, organising the public issue arranging for the underwriting, etc.

5. Issuing of Credit Cards: Credit cards are issued by banks as a method of making payment without using a cheque. Credit cards provides instantaneous credit facilities to the card holder, The card holder can buy goods and services immediately but paying for them later. A specially designed plastic card is issued to the card holder on which the name of the holder, name of the issuing bank, card number and his or her signatures are inscribed.

   Each card holder is given a credit limit on his credit card account. Payment for goods and services through credit cards be made at establishments which are members. Such shops, hotels, travel agencies, railways airlines, etc., usually display the signs of tlie credit cards accepted by them.

When a card holder makes purchases against tlie credit card, he is required to sign the sales vouchei. The shop-keeper prepares the sales voucher which contains all details such as name of the credit card holder, credit card number, date of transaction, value of sales made or services rendered. Then the shop keeper compares the signature of the credit card holder in the sales voucher with specimen signature on the card. On being satisfied with its authenticity of the signature, he gives a copy of the voucher to the card holder and hands back the card. The retailer sends his copy of the sales voucher to the issuing bank for payment and receives the payment. After the payment is made the bank debits the account of the credit card holder. Each month a statement is sent to the card holder giving details about the transactions made by him. The card holder can make the full payment or he can pay a certain minimum amount and can carry forward the remaining balance to the next month, for which bank charges a certain amount of interest. Thus, tlie card holder gets the facility of credit.

The credit card system is advantageous to the business establishments in terms of increased sales turnover, assured payment, less bad debts, etc. Credit card business is also profitable for the issuing bank, as it gets commission upto 4% on each transaction.

The credit card holder is insured by the bank upto certain limits. Banks also permit the card holder to withdraw money from any of it branches all over the country. In the case of the banks which have automatic money withdrawal counters called 'Any Time Money (ATM)' card holders can withdraw money, round the day. Whenever the card holder wants to withdraw cash through ATM, he has to feed in his personal identity number alongwith the card, and can get cash. However, at present the facility of ATM is available only in major cities like Delhi, Calcutta, Bombay, Madras, Bangalore, etc.

Now most of the banks have introduced computers to facilitate the customers. For speedy cheque clearing, Magnetic Ink Character Recognition (MICR) cheques are used. Under this system cheques are processed at high speed on machines. So 'with computerisation the work is done quickly. The energies of the bank staff can be utilised towards more productive, innovative and developmental areas. All this put together will contribute towards greater business development, higher productivity and much greater customer efficiency.

Check **Your Progress C**

1 What is the difference between Overdraft and Cash Credit ?

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2. . What is discounting of bills ?

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3. List the forms of banker's advances.

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4. Enumerate three important methods of creating a charge.

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5. What is hypothecation ?

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....

6. State whether the following statements are True or False.

i) Loans are sanctioned for short term only.
ii) The borrower has to pay interest on the entire amount of loan.
iii) The rate of interest on loan is slightly lower than that charged on an overdraft.
iv) Cash credit is an active running account.
v) Discounting of bills is a method of long-ferm financing.
vi) In case of pledge only possession is given not the ownership.
vii) In case of Hypothecation the goods are handed over to the bank.
viii) Movable goods can be mortgaged to the banks.
ix) Credit cards are issued by retailers.

13.11 LET US SUM UP

Bank is an institution which accepts deposits from public which are repayable, and lends the money to those who need it. Banks may be commercial banks, co-operative banks, Land Development Banks, Rural Banks, Industrial Banks and Central Bank.

Banks play a very important role in the economic development of the country. They encourage habit of savings among people. We can make payments easily and safely through banks. Banks provide different types of credit facilities to its customers. Money can be remitted to at far of places with the help of banks.

A customer is one who has an account with a bank. The relationship between the banker and the customer is of a contractual nature whereby the banker is the debtor and the customer is the creditor. When bank accepts goods for safe custody, then the relationship is that of the bailor and bailee. Banks perform many agency functions on behalf of its customers such as collection of cheques and drafts, payment of insurance premiums, etc.

The bank has some obligations towards its customers. The most important obligation is to honour the cheques of its customers. The bank is under an obligation to maintain utmost secrecy about the position of the customer's account. But under certain circumstances the bank can disclose the position. The bank must follow the instructions of its customer. It is the duty of the bank to maintain accurate records of all transactions of the customer with the bank.

The Indian contract Act has given the right of general lien to the banks. The banks can retain any property of its customer till its claims are satisfied. The bank has the right to combine the two accounts of a customer to determine the net amount outstanding. Though banks allow interest on the credit balance, it has the right to charge interest on loans, overdrafts, etc.

Broadly, three types of accounts can be opened in a bank viz., fixed deposit account, current account and savings bank account. Fixed deposit account is meant for those who have spare money and who wants to earn without taking any risk. The amount of deposit is repaid by the bank with interest on the expiry of pre-deteimined period. A current account is suitable for businessmen who can deposit and withdraw money from their account as many times as they like, provided they have credit balance in their account. A savings bank account is meant to encourage the habit of savings.

The banks advance money in the form of loans, overdrafts, cash credits and discounting of bills. The banks lend money for short term, medium term and long-term. While advancing a, loan, the banks have to ensure that it will be paid back. the banks keep in mind the three points while lending money - liquidity, safety and profitability. The banks generally create some charge on the tangible assets of the borrower. It ensures that in case the borrower makes a default it can recover money by selling the property. The different methods of creating a charge are - pledge, hypothecatfon and mortgage.

In case of pledge of goods, the goods remain in the possession of the bank. The bank gets the right to recover the money by selling the pledged goods in the market. But before selling the goods, a reasonable notice has to be given to the borrower. In case of hypothecation of goods, the goods are allowed to remain in the possession of the borrower, only an equitable charge is created on them. The practice of mortgage is adopted when immovable property is offered as a security. In case of mortgage, the possession is not transferred but the bank gets the general interest in the property and so the bank can sell the property to recover the money.

Besides providing loans and advances, banks also render some other useful services. They collect money on behalf of customers and make payments according to their instructions. Banks have entered into the leasing business also. The banks provide merchant banking services to its big customers. The banks have introduced the credit card facility for its customers whereby the customer can make purchases without paying cash immediately.

13.12 KEY WORDS

Bank: An institution which accepts deposits from public repayable on demand and invests or lends the money. It also provides various other services to its customers.

Customer: A person who has an account with the bank.

General Lien: Right to retain any property belonging to the other till all dues are cleared.

Cheque: An instrument used for withdrawing money from bank. It is an unconditional order in writing on the specified bank by its customer, instructing the bank to pay the amount specified therein to the person named therein or to his order.

Pass Book: A book supplied by the bank to its customers showing his transactions with the bank.

Standing Instructions: Instructions to the bank for making certain payments and collections regularly on behalf of the customer.

Bank Draft: An instrument drawn by one branch of a bank upon another branch of the same bank, directing the other branch to pay the amount mentioned therein to the person named or to his order.

Overdraft: An arrangement between the bank and its customer where the customer can withdraw from the bank more money than is available in his account.

13.13 ANSWERS TO CHECK YOUR PROGRESS

A. 4) (a) bailee (b) an agent (c) debtor
8) i) True ii) False iii) True iv) True v) True vi) True vii) False viii) False

B. 5) i) True ii) False iii) False iv) False v) False vi) True vii) False viii) True

C. 6) i) False ii) True iii) True iv) True v) False vi) True vii) False viii) False ix) False

13.14 TERMINAL QUESTIONS

1. Define the term "Banker". Explain briefly the functions of a modem commercial bank.
2. Who is a customer ? When does a person become the customer of a bank ?
3. Explain briefly the various types of banks.
4. What is the relationship between a banker and his customer ?
5. "The relation between a banker and customer is primarily that of a debtor and creditor". Discuss.
6. Explain the nature of banker's right of lien.
7. Explain the rights and obligations of a bank.
8. Discuss various ways in which a commercial bank renders financial assistance to business.
9. Discuss the various modes of creating charges.
10. Distinguish between:
    i) Pledge and Hypothecation
    ii) Hypothecation and Mortgage.
    iii) Loan and Overdraft
    iv) Cash Credit and Overdraft

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

UNIT 14 BUSINESS RISK AND INSURANCE

Structure

14.0 Objectives
14.1 Introduction
14.2 What is a Business Risk
14.3 Pervasiveness of Risks in Business
14.4 Types of Business Risks
14.5 Risk Management
14.6 What is Insurance
14.7 Insurable Risks and Non-insurable Risks
14.8 Contract of Insurance
- 14.8.1 Components of an Insurance Contract
- 14.8.2 Legal Aspects of Insurance

14.9 Kinds of Insurance
- 14.9.1 Life Insurance
- 14.9.2 Marine Insurance
- 14.9.3 Fire Insurance
- 14.9.4 Motor Insurance
- 14.9.5 Miscellaneous Insurance
- 14.9.6 Difference between Life Insurance and Other Insurance

14.10 Let Us Sum Up
14.11 Key Words
14.12 Answers to Check Your Progress
14.13 Terminal Questions

14.0 OBJECTIVES

After studying this unit, you should be able to:

- define business risk and explain the pervasiveness of risks in business
- identify various types of business risks and state the process of risk management
- define insurance and identify insurable and non-insurable business risks
- state the components of an insurance contract and the legal aspects of insurance
- explain various kinds of insurance and identify their suitability for different purposes in business.

14.1 INTRODUCTION

As you know that all human activities which eliminate the hindrances and facilitate the flow of goods from producers to consumers come under **'aids-to-trade'** or **'auxiliaries** to **trade'.** The whole range of activities coming under aids-to-trade are classified under five categories viz., transportation, warehousing, insurance, advertising and banking. You have already studied about advertising in Block 3 and about transportation and warehousing in the previous units in this block. In this unit you will study about insurance. This unit discusses in detail the meaning and types of business risks, and various aspects of insurance such as meaning, contract, legal aspects, and types.

14.2 WHAT IS A BUSINESS RISK

The term 'risk' has been defined by different people in different ways. For this reason there is no single standard definition of this term which is universally used. The term is used to refer to (a) an insured object such as a home or a car, (b) a peril such as fire or earthquake, (c) the probability of an event which may cause loss, (d) the loss itself, (e) the hazardous condition, (f) the variation in the outcome that could

Cheque: An instrument used for withdrawing money from bank. It is an unconditional order in writing on the specified bank by its customer, instructing the bank to pay the amount specified therein to the person named therein or to his order.

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Standing **Instructions:** Instructions to the bank for making certain payments and collections regularly on behalf of the customer.

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- state the components of an insurance contract and the legal aspects of insurance
- explain various kinds of insurance and identify their suitability for different purposes in business.

14.1 INTRODUCTION

As you know that all human activities which eliminate the hindrances and facilitate the flow of goods from producers to consumers come under 'aids-to-trade' or 'auxiliaries to trade'. The whole range of activities coming under aids-to-trade are classified under five categories viz., transportation, warehousing, insurance, advertising and banking. You have already studied about advertising in Block 3 and about transpoitation and warehousing in the previous units in this block. In this unit you will study about insurance. This unit discusses in detail the meaning and types of business risks, and various aspects of insurance such as meaning, contract, legal aspects, and types.

14.2 WHAT IS A BUSINESS RISK

The term 'risk' has been defined by different people in different ways. For this reason there is no single standard definition of this term which is universally used. The term is used to refer to (a) an insured object such as a home or a car, (b) a peril such as fire or earthquake, (c) the probability of an event which may cause loss, (d) the loss itself, (e) the hazardous condition, (f) the variation in the outcome that could such as fire or earthquake, (c) the probability of an event which may cause loss, (d) the loss itself, (e) the hazardous condition, (f) the variation in the outcome that could occur over a specified period in a given situation, etc. Although the underlying meaning of most of these definitions may be the same, these definitions are suitable in different contexts. In the present context, we may use the term 'risk' mainly to mean the uncertainty of occurrence of economic loss. Based on this, the term 'business risk' may be defined as the uncertainty of occurrence of economic loss in the event of any business activity.

As you know business enterprises face a variety of perils. They run the risks of injury to their employees in job related accidents. They face the risk of loss or damage of property due to fire, floods, theft, natural calamity, etc. Due to changing consumer tastes, a company may loose its market share, and transform into a loss making company from a profit making one. For instance, as you know in 1984 a leak of deadly methanyl isocyanate gas manufactured in the Union Carbide factory in Bhopal killed more than 2000 people and many more became permanently disabled. This had resulted in a few hundred crore rupees law suits, which are yet to be settled. Thus, all business enterprises face a wide range of risks which can cause the losses.

14.3 PERVASIVENESS OF RISKS IN BUSINESS

Different risks pervade all kinds of business activities. Many failures of management can be traced to failure to recognise and deal with risks. It is the normal tendency for the managers to over emphasize the profit aspect of ente prise and under mind the risk factors. Let us understand how risk pervades all aspects of business. Let us examine how risk prevails in all the following main aspects of business: (1) property and personnel, (2) marketing, (3) finance, (4) production, and (5) environment.

Property and Personnel Risks: Every business firm is confronted by potential loss to its property and personnel through common perils such as fire, explosion, wind storm, flood, theft, business liability damage suits, earth quake and death or disability of its personnel. These perils may cause direct loss by damaging property or killing personnel. Losses may occur to business from the occurrence of some of these perils.

Marketing Risks: Marketing activity includes all those business activities necessary to move goods fromproducers to consumers. The major functions include buying, selling, transportation and storage. Activities like standarization, market information and research are also other important functions of marketing activities. There is an element of risk in all these activities. For instance, you may not be able to sell your products at the prices you want. Due to market conditions, you may be forced to sell at lower prices and incur losses. Similarly, due to sudden spurt in the raw material prices, your cost of production may go up and you may incur losses. Goods may be stolen, damaged or destroyed in transit from perils for which the transporter is not liable. Similarly, improper facilities for storage may cause unexpected losses. Normal perils such as fire, floods, storm, explosion, theft, etc., can cause extensive damage to goods in the storage. For instance, the fire due to electric short circuit may cause extensive damage to the goods in the storage.

Financial Risks: All business firms borrow money and also extend credit to customers. There is always scope for loss from both credit received as well as credit extended. Bad debts due to insolvency of customers is a continuous problem in business. Similarly, creditors like banks and financial institutions may fail or cancel the loans due to bad business conditions. This can cause financial loss to the firm due to curtailed operations. Similarly, unexpected rise in interest rates on bank loans may reduce profits. Business firms' investments in stocks and bonds always face risk.

Production Risks: Manufacturing enterprises face the problems such as production losses due to breakdown of machinery, defective products due to faulty machinery or poor quality of raw material, under utilisation of installed capacity, inventory build up to levels much higher than current demand, improper plant layout, uneconomical plant capacity, etc. Such production risks may be minimized by careful planning.

Environmental Risks: Business environment is a crucial factor for every enterprise. Environmental factors such as competition, changing tastes and preferences of consumers, technological developments, governmental policies, ecological issues, political developments, etc., have lot of impact on each and every business firm. All these environmental problems pose risks to business firms.

14.4 TYPES OF BUSINESS RISKS

We have already discussed the meaning.of risk in the context of business and how risk is pervasive in all aspects of business. Let us now study various types of business risks.

Pure vs. Speculative Risks

The occurance of perils like fire, windstorm, explosion, flood, earthquake, riot, etc., generally cause losses only. Their occurance never result into gains. The uncertainty concerning their occurance may be termed as pure risks. Thus, Pure risks are those risks in which tlie occurance of events causes losses only. For instance, car drivers always face the risk of accidents. If an accidence occurs, the driver may suffer physical and financial losses. If the accident did not occur, there would not be any gain. Thus, in the case of a pure risk, there is loss when it occurs, otherwise there is no loss or gain. On the other hand speculative risks involve events which may produce either gains or losses. For instance, expansion of operations in a new market (area) may lead to higher profits or loss of invested funds. Most business decisions relating marketing, production, finance, etc., are taken with the idea of making gains, but there are possibilities of incurring losses also. Thus, all business enterprises face both pure risks as well as speculative risks. Many pure risks can be handled through insurance, while most of the speculative risks are not generally handled through insurance. So business enterprises must find their own ways of handling specualtive risks.

Dynamic vs. Static Risks

Risks can also be classified as dynamic risks and static risks. Dynamic risks are related to uncerlainities caused by an ever-changing business environmental factors such as consumer wants, technology, competition, governmental policies, firms internal organisation, etc. On the other hand static risks are those which occur even if there are no changes in the business environment. Normally static risks are closely related to pure risks such as fire, flood, windstorm, etc., where as dynamic risks are more closely associated with speculative risks. Therefore, as discussed in the case of pure and speculative risks, most of the static risks can be handled through insurance while most of the dynamic risks may not be handled by insurance. However, it is increasingly becoming difficult to separate or distinguish clearly between the losses caused by dynamic risks and static risks. For instance, fie which is a static risk may be caused by an irrate crowd during a demonstration which is a dynamic risk.

Risk Classified by Loss Severity

Risks may also be classified as follows into three groups on the basis of tlie extent of loss and its importance on the financial position of the business firm:

Class 1: Those losses which do not disturb a firms basic finances.
Class 2: Those losses which would require borrowing or selling firms property.
Class 3: Those losses which might bankrupt the firm.

Here Class 1 risks cause small losses, Class 2 risks cause much bigger losses, and the firm may not survive with the occurance of Class 3 risks. Therefore, Class 1 and 2 risks can be handled by various internal methods but Class 3 risks are beyond internal capabilities of the business firms.

Objective vs. Subjective Risks

Objective risk is the measure of the degree of variation in the proportion of actual from the expected events. This proportion declines as the number of observed events increase. Hence we can say that the objective risk as a proportion declines **when** larger and larger number of events are involved. Subjective risk may be defined as the uncertainty of an event as seen or perceived by an individual. This perception depends on the attitudes of the concern individuals towards risk. Among people, there are 'risk lovers' who prefer a situation with a great deal of uncertainty, and also 'risk haters' or 'risk averters' who do not like to face risks.

14.5 RISK MANAGEMENT

We have already discussed various types of risks faced by business enterprises. Now the question is, how to handle these risk ? Now let us briefly discuss various steps involved in the risk management process. Risk management involves five basic steps:

1. Risk identification is the first step and also the most difficult function. Failure to identify all the loss exposers of the firm means you will not be in a-position to deal with those risks. Therefore, as a first step you should identify all types of loss exposers of your business.

2. After identifying the risks, you should assess the intensity of financial loss associated with each of those risks. At this stage you have to determine two aspects : (a) probability of the occurance of each of the perils or risk identified in the first stage, and (b) extent of financial loss to the firm, if that peril occur. With this assessment, you can identify the relatively more serious risks and can pay more attention to them.

3. After risk identification and proper measurement, at the third stage you should consider various tools of risk management and decide upon the best combination of the tools to be used for attacking the problem. There are basically six tools of risk management **viz.,** (a) assumption (or retention) (b) loss prevention, (c) avoidance, (d) transfer (insurance), (e) separation, and (f) combination. Business fims may adopt any one of these six methods or a combination of them. Let us discuss these methods briefly.

   a) Risk Assumption or Retention: This is a common way of handling risks. Business enterprises assume or retain risks consciously (intentionally) or unconsciously (unintentionally). Under conscious assumption, one is aware of the risk to which his/her business is exposed, but essentially does nothing to avoid it. A manager of a business who consciously assumes risk is doing something about it by the very act of being aware of those perils and hazards which may cause loss. Being aware of risk, he may knowingly or unknowingly make adjustments in operations which will help to alleviate the impact of that risk. Awareness of risk itself is a significant achievement in better management. In the case of **uiiconscious** risk assumption, risk is **not** recognised. As you are not even aware of the existence of some risk, losses stemming from it can cause disastrous surprises to-your business.

b) Loss Prevention: Another method of handling risk is to take appropriate measures to prevent the occurance of a peril, or minimise its financial impact on business. This approach is known as loss prevention. For instance, by using fire resistant building material, you can prevent the occurance of fire in the building. However, in most cases loss prevention measures may not totally eliminate the risk, but can reduce its probability in terms of frequency as well as severity.

c) Avoidance: Avoiding situations which have the potential to cause loss, is another approach. For instance, a firm can avoid the risk of loss due to bad debts by simply stopping credit sales. Similarly, a firm may avoid operations in certain areas which are known for some perils like terrorism.

d) Transfer: Transferring the risk to another party is a very widely followed approach to handle risks. Insurance is the most common method of transferring pure risks such as fire, windstorm, flood, riot, theft, etc. Business enterprises normally transfer the pure risks to the insurance company and devote their full efforts to their normal business.

e) Separation: Fifth method of risk control is separation of the firm's exposers to loss instead of concentrating them at one location where all of them might be involved in the same loss. For example, when a firm keeps its entire raw material in one warehouse, the entire raw material may be damaged if fire occur in that warehouse. Therefore, the firm may decide to store the raw material in ten separate warehouses. If fire occur in one warehouse, inaterials stored in that warehouse are damaged and the remaining nine warehouses are safe. Here through separation the firm increases the number of independent exposere units under its control. This methods is also a kind of loss prevention.

f) Combination: Strategies like diversification of products, law of large numbers, formation of more companies with unrelated lines of business, etc., come under this method. For example, if a firm is engaged in more products, the losses incurred in one product may be upset by the gains in another product. Similarly, if there are more companies, the losses incurred by one company may be upset by the gains by the other companies. Insurance companies work on this combination principle where a sufficiently large number of similar objects are combined to make the loss predictable within narrow limits.

Subjective risks can be reduced by having more knowledge about such perils. A person with better knowledge of the perils can handle them more easily than a person who do not have the knowledge. Therefore, subjective risks may be reduced through knowledge and research. An important aspect you should remember here is that while managing risks you should not just rely on any one method, instead you should usually employ some combination of various methods.

4. After taking a decision regarding the combination of risk management tools, the next step is the implementation of the decision made. For instance, if you have decided in the previous stage to transfer the risk, you have to get the insurance policy at this stage.

5. Finally, you have to evaluate the effectiveness of the risk management tools you have implemented.

The result of the decisions made in the four stages must be evaluated to determine their effectiveness and change the strategy, if required.

Check Your **Progress** A

1. What is business risk ?
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2. Differentiate between risk avoidance and risk transfer.
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3. Differentiate between pure and speculative risks.
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4. List the five steps of the risk management.
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5. State which of the following statements are True or False.

a) Business enterprises face risks only in some specific aspects.

b) Occurance of pure risks may result into gains to the business **firms.** .

c) Speculative risks sometimes can result into profits.

d) Objective risks as a proportion declines with the increase in the number of events.

14.6 WHAT IS INSURANCE

As discussed earlier, risk is born out of uncertainty and it is inseparable from business. You have also learnt that the business risks can not be eliminated, but they can be controlled to some extent by adopting appropriate measures. One of such risk control measure is risk transfer by means of insurance. Let us now understand what is insurance ?

Insurance is a device by which a loss likely to be caused by uncertain event is spread over a large number of persons who are exposed to it and who voluntarily join to insure themselves against such an event, Let us take the example of the peril of fire. It is a common knowledge that every year a certain number of houses are destroyed by fire, but no body can predict which particular house will be destroyed. Thus, all house owners run the risk of loss through'fire. If all of them pay a small sum into a **fund** every year, anyone who does lose his house can claim money from such fund to build a new house. In the absence of such a fund, the owner of the house has to bear the whole loss by himself. In the case of insurance, in the similar way, loss is being shared by a large number of persons instead of being borne by one. People are willing to lose a small sum in order to be certain that they will not lose a much bigger sum. In the above illustration the persons who got their houses insured are known as 'Insured'. The agency which helped them in entering into'this arrangement is known as 'Insurer' or the Insurance Company. The agreement or contract between the insurer and insured is known as 'Policy'. The amount paid by the insured in return of which the insurer undertakes to make good the loss is known as 'Premium'.

To conclude, we may define insurance as a form of contract between two parties (insurer and insured) whereby one party (insurer) undertakes in exchange for a fixed amount of money (premium) to pay the other party (insured), a fixed amount of money on the happening of a certain event (death or attaining a certain age in case of life) or to pay the amount of actual loss when it takes place through the risk insured (in case of property).

Insurance vs Assurance

Sometimes these two terms are used synonymously. But it is necessary for you to know the difference between these two terms. In fact insurance is now commonly used in a general sense to include assurance, though it is customary to speak of assurance in connection with life policies. The term 'assurance' is used in those contracts which guarantee the payment of a certain sum on the happening of a specified event which is bound to happen sooner or later. For example, human beings certainly attain a certain age or death. Thus, all life policies come under assurance. On the other hand 'insurance' contemplates the granting of agreed compensation on the happening of certain events stipulated in the contract which are not expected, but which may happen. Thus, insurance refers to risks such as fire, accident, theft, etc., which are contingent in nature.

14.7 INSURABLE RISKS AND NON-INSURABLE RISKS

You should know that all risks can not be transferred to the insurer. Mostly, pure risks can be transferred to the insurer. Now let us discuss the characteristics of risks which can be transferred to the insurer. The characteristics of the insurable risks are as follows:

1. The risk should be accidental or random in nature. The loss causing factor should not be within the control of the insured. Thus, the loss which has occurred already or which is veiy likely to occur can not be insured. For instance, a building which is on fire or which is already destroyed by fire can not be insured against fire. Similarly, a person who is infected with AIDS disease can not be insured because he is sure to die as there is no treatment to AIDS so far.

2. The amount of loss should be measurable and possible to estimate. This condition is necessary to set the premium at appropriate levels.

3. There should be a sufficiently large number of units exposed to the same risk. In other words, there must be a large number of people interested to insure against the same risk. This requirement follows from the law of large numbers, since an insurance operation is safe only when the insurer is able to predict fairly accurately its expected losses.

4. The units facing the same risk must be spread over large geographical area. In other words, the risk must be spread over a wide geographical area so that the happening of a single event in a small region may not cause heavy burden to the insurer. For instance, if an insurance company had accepted against fire for the buildings located in one area only, an incidence of fire in that area can destroy all those builds. The insurance company may become bankrupt with that single incidence as it has to pay to all the insured. Therefore, it is necessary that the values exposed to loss should not be concentrated in one area.

Normally, pure risks fulfill all the above four features and they are insurable. There are certain risks which do not fulfill these four requirements explained above, and cannot be insured against. They are called non-insurable risks. These non-insurable risks include:

1. Risks due to war (except cargo at sea) and certain risks such as radio activity arising from nuclear fusion.
2. Risks incapable of measurement such as unforeseen changes in fashion, marketing of new products, etc.
3. Risks too small and recurring too frequently, or risks so large and recurring so infrequently. For instance, a hotel can not insure the crockery against breakages.

14.8 INSURANCE CONTRACT

When a person buys insurance from an insurance company (insurer), it is essentially a contract between the insured and insurer. An insurance contract is a vehicle used for transferring risk from an individual or business firm to the insurer. ***Insurance contract, constitutes the agreement between the insured and insurer, and details the conditions under which the risk transfer takes place.*** Before we discuss the components of an insurance contract, you should understand the meaning and importance of the following three aspects.

The Proposal: A person wishing to effect an insurance contract is required to submit a proposal to the insurer. This proposal may be made either orally or in writing. Proposal form consists of a number of questions to which the person must give truthful answers. The insurer can reject the proposal if the proposal is incomplete or incorrect.

The Cover Notes: Insurance contract comes into existance only when the proposal is accepted by the insurer. While the proposal is under consideration by the insurer, sometimes the person making the proposal may wish to have immediate cover. In such case, on request, the insurer may issue a cover note whioh grants temporary protection. Thus, the main purpose of cover note is to confirm the risk cover prior to the issue of policy by the insurer,

The Policy: Insurance policy contains all the terms of the contract. Having accepted a proposal, insurer must issue the policy within one month of receiving the first premium. Most policies are for fixed periods, usually a year. Under a life policy the assured has an indisputable right of renewal while other policies are renewable by mutual agreement. Although not obliged to do so, the insurer usually issues a renewal notice reminding the insured of the date for payment of the next premium. It is, moreover, the voluntary practice of insurers to allow extra days, called days of grace, within which the renewal premium may be paid. Usually, grace period is 15 days for fire and accident insurance and 30 days for life assurance. With types of policy other than those mentioned, cover will usually cease with the day on which the policy expires. It is, therefore, not proper to delay payment of renewal premiums beyond the date on which they fall due.

14.8.1 Components of an Insurance Contract

Basically all insurance contracts consist of the following five parts (1) declaration, (2) insuring agreement, (3) exclusions and limitations, (4) conditions, and (5) binder. Let us discuss these five parts briefly.

1. Declaration: This is the first part of any insurance contract. It contains the information relating to identity of the insured, the property, the type(s) of coverage, term of the contract, insurance amount and the premium. Other

information may also be added to declaration depending on the type of contract and the specific circumstances surrounding the risk transfer. The declaration covers most of the basic information needed by the insurer in deciding whether to issue the contact and at what price.

2. **Insuring** Agreement: The insuring agreement is a formal statement detailing what the insurer promises to do in return for the premium paid. The perils insured against and services promised are stated and defined in the agreement. If there are limitations on the amount of recovery, these may be stated in the agreement. In the insurance contract, this agreement ordinarily follows the declarations. The insuring agreement is the most important section of the contract, since it contains the basic information about the nature of the risk transferred and what may be recovered in the event of loss.

3. Exclusions **and** Limitations: Insurance contacts may be written on an all risk basis, where the contract insures against all risks except those specifically excluded in the contract. The contract may be also on the named perils basis, where only losses resulting from the perils named in the contract are covered. Though the insured may prefer an all-risk contract since it offers the broader coverage, insurers normally do not undertake to insure against all risks. Perils which are covered in the contract are normally subject to limitations and/or exclusions. In general, such exclusions are of two types (1) certain kinds of property are excluded or certain perils are excluded or both things may occur, and (2) excluded property may be added by endorsement and the same is true of perils. It is important that the insured must understand the exceptions surrounding the transfer.

4. **Conditions:** The clauses are the conditions to be fulfilled by the insured to enforce his rights under the contract. Most of these conditions refer to the type of information that must be supplied by the insured in the event of loss or refer to the right of the insured if dispute arises in regard to the loss. It is essential for the insured to know his duties. Unless he fulfils all the terms of the contract, he may not be able to recover the loss from the insurer.

5. Binders: Sometimes a memorandum called a binder is issued by the insurer. The binder is a temporary insurance contract. The binder contains the essential facts about the transaction such as date, amount, name of insured, and risk to be covered. In the event of loss, the binder serves in lieu of the policy and has the same force as if the policy had been issued.

14.8.2 Legal Aspects of Insurance

The validity of every insurance contract rests upon certain principles. The basic principles which are applicable to various kinds of insurance contracts are: (1) utmost good faith, (2) proximate cause, (3) insurable interest, (4) indemnity, (5) subrogation, and *(6)*principle of mitigation of loss. Let us discuss these principles briefly.

1, Utmost Good Faith; **A** basic condition of every contract of insurance is that the insurer and insured should display utmost good faith towards each other. Each party must reveal to the other party, whether asked or not, all material facts which would influence the other party's decision to enter into the contract. It is not enough that the insured gives truthful answers to all the questions in the proposal form, but it is legal obligation to disclose all other information known to him that is likely to affect the insurer's estimation of the risk. If the material fact is not disclosed or if there is misrepresentation or fraud, the insurer is entitled to avoid the contract or refuse payment under it. This requirement of good faith is essential for the

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4. Conditions: The clauses are the conditions to be fulfilled by the insured to enforce his rights under the contract. Most of these conditions refer to the type of information that must be supplied by the insured in the event of loss or refer to the right of the insured if dispute arises in regard to the loss. It is essential for the insured to know his duties. Unless he fulfils all the terms of the contract, he may not be able to recover the loss from the insurer.

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1. Utmost Good Faith: **A** basic condition of every contract of insurance is that the insurer and insured should display utmost good faith towards each other, Each party must reveal to the other party, whether asked or not, all material facts which would influence the other party's decision to enter into the contract. It is not enough that the insured gives truthful answers to all the questions in the proposal form, but it is legal obligation to disclose all other information known to him that is likely to affect the insurer's estimation of the risk. If the material fact is not disclosed or if there is misrepresentation or fraud, the insurer is entitled to avoid the contract or refuse payment under it. This requirement of good faith is essential for the

protection of the insurer, since he can evaluate the risk only on the basis of what he is told by the insured.

2. Proximate Cause: To recover compensation under a policy, it must be proved that the loss sustained was proximately caused by the event insured against. In other words, the loss must be the result of the occurance of the peril stated in the policy or a peril very closed related to it. For instance, a fire insurance policy will cover not only loss caused directly by fire but also the loss caused due to the efforts made to put out the fire (such as the loss due to demolition of part of the building to prevent the fire from spreading). Similarly, theft also can be a cause proximate to a fire, if goods removed from the burning building are pilfered before the arrangements were made for their safe custody.

3. **Insurable** Interest: A person can not legally insure a risk in which he has no legal interest. For instance, a person can insure his own property but not that of his neighbour's property. In the same way, a creditor may insure the life of a person who owes him money. But you should note that sometimes interest may arise without ownership also. For instance, if a person had taken loan from a housing finance company to build his house, the housing finance company had an interest in the house, and is entitled to insure it. In the case of life insurance, it is well established that a man had unlimited interest in his own life and in that of his wife, and similarly the wife had unlimited interest in the life of her husband. In life insurance, the insurable interest must be present at the time when insurance is effected. In marine insurance the interest need exist only at the time of loss, but in fire and burglary, it must exist throughout the period of the contract.

4. **Indemnity:** Here the term indemnity is synonymous with compensation. Under the contract of indemnity, the policy holder is entitled to get the compensation from the insurer so that the policy holder neither gains nor losses from the mishap. For example, a building is insured against fire for Rs.1,00,000 and it is partly damaged by fire. It is estimated that it requires Rs.50,000 towards repairs. In this case the insured can recover only Rs.50,000 from the insured although the total sum insured is Rs.1,00,000. This clause is applicable in fire and marine insurances only, and not applicable in other insurances (life, personal accident and sickness insurances). The main purpose of indemnity is to compensate the loss incurred and not make profits out of mishaps. However, if the same interest (property) is insured with several insurers, the total sum recovered from all the insurers should not be more than the actual loss. As a rule, in case of multiple insurances the insured should claim the loss propoitionately from each insurer. In case of life assurance, the insurer must pay the agreed amount irrespective of the true value of the loss suffered. For instance, a person insured life for a very huge sum of one crore and died in an accident. The insurer must pay the total amount of one crore stipulated in the policy. Thus the principle of indemnity is not applicable in life, personal accident and sickness insurances. .

5 **Subrogation:** The doctrine of subrogation applies only to contracts of indemnity. According to the doctrine of subrogation, after the insured is compensated for the loss, the right of ownership of such damaged part of the property passes on to the insurer. If the damaged property has any value left or the lost property is recovered, such property can not be allowed to remain with the insured because in that case the insured will realise more than the actual loss, which is against the principle of indemnity. For example, if a car belonging to Mr. Satish is damaged due to negligence of Mr. Raju, and Mr. Satish is fully compensated by the insurer. In that case Mr. Satish can not sue Mr. Raju to recover any compensation. In fact the insurer can sue Mr. Raju for negligence. Here if insurer recovers from Mr.

Raju more than the compensation already paid to Mr. Satish, insurer must pass on the surplus to Mr. Satish. Similarly; an insurer who has paid on a burglary claim is entitled to the stolen goods when they are recovered. You should note that, as stated earlier, this doctrine of subrogation applies only to the contracts of indemnity.

6. Principle of Mitigation of Loss: An insured must take all reasonable care to prevent and reduce he loss. For instance, if a house is insured against fire and there is accidental fire, the owner must take all reasonable steps to extinguish fire and keep the loss to the minimum. Similarly, if a person had insured house hold goods against theft and burglary, he must take all normal prècautions (such as locking the house) to prevent theft.

Check Your Progress B

1. Differentiate between insurer and insured.

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What is an insurable risk ?

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List the legal aspects of an insurance.

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4. Match the items in Group A with Group B

Group A	Group B
i. Binder	a) Insurer's right of ownership of damaged property.
ii. Indemnity	b) Life Policies
iii. Subrogation	c) Risk due to war
iv. Assurance	d) A temporary insurance contract
v. Non-insurable risk	e) To make good the loss

5. State whether the following statements are True or False ?

a) Insurance is nothing but risk transfer.
b) Insurer pays premium to the insured.
c) A house already on fire can be insured.
d) Risks too small and recurring too frequently can not be insured.
e) Man had insurable interest in wife and vice versa.

14.9 KINDS OF INSURANCE

You have already studied the meaning of insurance, risks which can be insured, legal aspects and components of insurance contracts. Now let us discuss how different kinds of insurances cover various types of risks under the following five categories:

1. Life Insurance
2. Marine Insurance
3, Fire Insurance

4. Motor Insurance
5. Miscellaneous Insurance

14.9.1 Life Insurance

Life insurance is a contract under which one person, in consideration o f a premium paid (either in lump sum or by monthly, quarterly, half-yearly or yearly payment), undertakes to pay to the person for whose benefit the insurance is made, a certain sum of money either on the death of the person whose life is insured or on the expiry of a specified period of time. As you know, insurance policy may be taken by a person who had insurable interest. In section 14.8.2 of this unit we have already discussed the principle of 'insurable interest'. In case of life insurance, under this principle, any person who had a pecuniary claim against another or a right to support and maintenance from him can insure the life of that another person. The following persons, thus, have the insurable interest.

- A person has an unlimited insurable interest in own life
- A husband has an insurable interest in his wife while the wife had insurable interest in her husband
- A child had insurable interest in the life of the father while father do not have the insurable interest in the life of his son, unless father is dependent on son.
- An elder brother do not have insurable interest in the life of the younger brother.
- A creditor has an insurable interest in the life of debtor, to the extent of the amount of debt.
- A servant has an insurable interest in the life of his employer.
- A surety has an insurable interest in the life of his co-surety and the principal debtor.
- A company has an insurable interest in the life of its officers, whose death may seriously affect its business (Profits)

As discussed earlier, life policies are considered as life ***assurance*** policies. You have already learnt the difference between assurance and insurance in section 14.6. Life assurance contracts are not the contracts of indemnity. Therefore, in the case of life policies the insurer must pay the agreed amount (policy amount) on the occurance of the agreed event (death or expiry of the specified time). As you know, marine and fire policies are the contracts of indemnity, where the insurer is compensated to the extent of loss only if the actual loss is less than the amount specified in the policy

Types of Life Policies: There are eight broad types of life policies as discussed below:

1. Whole Life Policies: Under this policy, the sum assured is payable after the death of the assured. The premiums on whole life policies may be payable regularly through out the life of the assured, or alternatively they may be payable for a fixed period only (say 20 or 30 years). If the premiums are paid throughout the life, it is called 'ordinary life policy'. In the other case when premiums are paid for a limited period, it is called 'limited payment life policy'. Even in the case of the limited payment life policy also, insurer will pay the sum assured only after the death of the insured. Whole life assurance policy is ideal for a person who wishes to provide support for his/her dependents after the death.

2. Endowment Life Assurance: Under this policy the insurer undertakes to pay the sum assured either at the end of a specified period or on the death of the assured, whichever is the earlier. In case the assured dies before the expiry of specified period (or before attaining the specified age), the sum assured is payable to the legal heirs or nominees. On the other hand, if the

insured survives till the policy matures (i.e. expiry of the specified period), the sum assured is paid to the insured himself. The premium for endowment policy is a bit higher than the whole life policy.

3. Term Assurance: This is also called temporary assurance. Under this policy, the sum assured is paid when the assured dies before the stipulated date. No payment is made if the assured survives to that date. For example, policies of this kind are taken out by persons who travel abroad, to cover short-period bank loans so that the sum assured will be available to repay the loan if the borrower die before the policy lapses, etc.

4. Joint Life Policy: This type of assurance involves the insurance of two lives simultaneously in the same policy. The sum assured (policy money) is payable by the insurer upon the death of any one of the assured to the surviving person. If both the policy holders die at the same time, their legal heirs or nominees will be paid the assured sum. A good example of a joint life policy is that of a policy on the lives of a husband and wife, payable to the survivor on the death of either of the two.

5. Group Insurance: Under group insurance, a group of persons under the same employer are covered under a single policy. Premium is paid by the employer alone or by the employer and employee jointly. A group insurance policy may cover all the employees or a particular category/section of the employee of the same organisation. However, the employees are covered under this policy as long as they serve with that employer. In group insurance, the insurance contract is between the employer and the insurance company (insurer). A master policy is issued to the employer, wliile the each employee receives a certificate. The certificate issued to the employee stipulates the amount of coverage that person had, his beneficiary (nominee) and any other rights and privileges he may have under the plan.

   The policy is taken for a fixed period, usually 20 years. If the employee (assured) dies before the expiry of the term, the nominee (beneficiary) gets a fixed annual income for the remaining part of the period and the full assured sum at the end of the term. On the other hand, if the assured survives the term, the full assured sum is paid at the end of the term.

6. Childrens' Endowment Policies: These policies are taken for the purpose of education of children and marriage expenses of daughters. These policies are just like the endowment life policies discussed earlier. Premium (annual or lump sum) is payable by tlie person (father or guardian or other person) entering into the contract. Policy matures when the child attains certain age. Then the sum assured is paid either in lump sum (when intended for the marriage of the female child) or paid by installments over a specified period (when policy is meant for education).

7. Annuity Policies: This policy is suitable when people desire to have certain income after the attainment of certain age. Annuity policies are, for example, taken by employees who want some income after their retirement from service. Premium may be paid in instalments or in lump sum at the beginning. After the assured attains certain age, insurer pays the amount in instalments (monthly/Quarterly/half yearlylannual)

8. With Profit or Without Profit Policies: Most of the above discussed types of policies may be with profit or without profit. In the case of with profit policy, the assured is paid, in addition to the sum assured, a share in the profits earned by the insurer. The profits are declared by the insurer after certain intervals and credited to the policy-holder as bonus. Without profit policy is one under which the policy holder does not get any share in the

profits earned by the insurer. The premia on without profit policies are lower than those on with profit policies. With profit and without profit policies are also known as participating and non-participating policies respectively.

14.9.2 Marine Insurance

Marine insurance is an arrangement by which the insurer undertakes to compensates the owner of a ship or cargo for complete or partial loss at sea. Marine insurance covers ship, cargo and freight. Perils of the sea also includes any land risk incidental to sea voyage. The marine policy must specify the following aspects:

- The names of the insured and the insurer
- The subject matter insured and the risks insured against
- The voyage or time period or both
- The sum assured
- The amount of premium

Under marine insurance, *insurable interest must exist only at the time of loss. It is not necessary for the insured to have the insurable interest at the time of taking the marine insurance policy.. Marine insurance is a contract of indemnity.* The insured is entitled to recover only the actual amount of loss from the insurer. Similarly, *the principle of contribution and subrogation is applicable to all marine policies.* In case of several policies relating the same subject matter, each insurer is liable to contribute to the amount of compensation proportionately. Once the insured receives the compensation, all rights on the remains of damaged property passes on to the insurer.

Types of Marine Policies: The main kinds of marine policies are as follows:

Voyage Policies: This type of policy covers a ship or cargo during a specified voyage only. Thus the limits of the risk are from the port of departure to the port of destination. The risk which is covered starts from the departure of ship from the port and it ends when that ship reaches the port of destination. For example, you are shipping the export cargo from Bombay to Amsterdam in Netherlands and you have taken a voyage policy. This policy covers the risk of damage to cargo from Bombay port till it reaches the Amsterdam port. In the case of a voyage policy, issurer is not liable if the destination of the ship is changed or the ship deviates from the agreed route. However, deviation from the agreed route is allowed when it is necessary for the safety of ship/cargo or saving the human life or any other circumstance stated in the contract.

2. Time Policy: This type of policy covers the risk during a stated period of time irrespective of number of voyages made. This policy would cover all the risks from the perils of sea for a stated period of time, say 1'' April 1998 to 30th March 1999. Normally a time policy covers a period not more than 12 months. However, most time policies include a *contintiation clause* providing against expiration of the policy if the ship is still on the voyage. A monthly prorata premium is payable for the continuation.

3. Mixed Policy: This combines the elements of a time policy and voyage policy. Mixed policy covers the risk during a particular voyage for a specified period. For example, a mixed policy may be taken to cover the ship or cargo during voyage from Bombay to Amsterdam from 1st November 1998 to 31st January 1999.

4. Valued and Unvalued Policies: Under valued policy, the value of the subject matter insured (ship/cargo) is specified on the face of the policy. In the event of full loss the insurer compensates the amount specified in the

policy. If the loss is partial a proportionate amount is paid by the insurer. On the other hand, in the case of an unvalued policy, the value of the subject matter is not stated in the policy. In case of loss or damage, the compensation is ascertained by assessment of loss, subject to the limit of the sum insured.

5. Floating Policies: This policy is suitable to a merchants who makes regular shipments. To avoid the botheration of taking a separate policy for every shipment, of exporter can take a floating Policy. A floating policy is taken for a round amount, and leaves the details to be declared at a later time, Whenever some cargo is shipped, the shiper (insured) makes a declaration stating the sum for which it is to be insured. Then the total value of the floating policy is reduced by that amount. With each shipment, the value of the policy goes on decreasing. Thus the amount outstanding on the policy reduces progressively as shipments are made and premiums calculated. When the policy is fully covered, it is said to be fully declared and a new policy is taken.

14.9.3 Fire Insurance

Fire policies cover the losses directly caused through fire. However, it is necessary that fire must happen by ignition. If the fire is caused through the malicious act of the insured himself, he would not be able to recover the loss from the insurer. The fire insurance contract is an indemnity contract. Each contract specifies the maximum amount that can be claimed by the insured in case of loss. The insurer is liable to make good the actual amount of loss caused by fire, not exceeding the maximum amount fixed in the policy. In order to cover a particular loss or damage under a fire policy, the following three conditions should be fulfilled:

- The loss or damage should relate to the subject matter of policy.
- The loss or damage must be caused by ignition or fire.
- The ignition must be either of goods insured or the premises where it is placed.

In addition to fire, the standard fire policy covers such perils as lightning, explosion of domestic boilers, gas used for lighting and heating, and damage by water used to extinguish a fire on neighbonring property. For a small additional premium the policy may be extended to cover such other items as storm and flood, earthquakes and impact from road vehicles or aircraft, but not glass and china, jewellery, manuscripts and other items of value, except where specially mentioned. However, all these items may be covered in an 'all other contents' clause. As per the cause proxima condition, as discussed earlier, loss/damage by fire also includes the loss/damage caused by efforts to extinguish fire with a view to mitigate the loss.

Therefore, the following causes are covered by fire insurance:

- Damages due to usage of water to extinguish the fire.
- Wages paid to persons employed to extinguish the fire.
- Losses arising from efforts to avert damage by fire. For instance, property destroyed (e.g. adjacent building) by the fire brigade to prevent the spread of fire.

Usually a fire policy is for a fixed period. During that period if there are successive fire accidents, the insurer is liable to make good of all those successive losses.

Types of Fire Policies: Broadly, there are six types of fire insurance policies, as explained below;

- Specific Policy where the liability of the insurer is limited to a specified amount, which is normally less than the actual value of the property insured.
- Valued Policy where the insurer agrees to pay a fixed amount in the event of loss, irrespective of the actual loss suffered. Under this policy, the insured recovers a fixed amount, irrespective of the amount of actual damage
- Floating Policy where the amount of the policy may vary from time to time. This type of policy is useful in the case of goods in store where quantity and value change from time to time.
- Replacement Policy where the insurer has the option to replace the property/goods damaged by fire, instead of paying the loss by cash.
- Loss of Profit Policy where insured is protected against the loss of profit due to dislocation of business due to fire. Under this policy, insurer compensates to the extent of the loss in profits.
- Comprehensive Policy which provides cover against not only fire but also several other risks such as lightning, riot, earthquake, flood, storm, burglary, war, etc.

14.9.4 Motor Insurance

Owners of motor vehicles (two or four wheelers) can take insurance policies to cover different types of risks viz., (a) loss or damage to the vehicle, (b) injuries to or death of any passenger, and (c) damages payable to the third parties for accidents. Every motor-vehicle driver must be insured for against liability for death of or injury to third parties and for the cost of their medical/surgical treatment. Though there is no statutory duty to insure against damage to property as well as personal injury, most of the third party policies cover both of these risks. A comprehensive motor insurance policy covers not only full third party risks (property as well as persons including passengers), but also damage to the insured vehicle, loss of rugs and other articles, and may also cover the cost of hiring a substitute vehicle, if necessary. If no claims are made during the year, a discount or 'no-claim bonus' is allowed at the time of renewal. The discount is cumulative and after 4 or 5 years may reduce the premium rate by as much as 60 per cent

14.9.5 Miscellaneous Insurance

You have studied four major kinds of insurance viz., life insurance, marine insurance, fire insurance and motor insurance. Besides these, there are several other types covering various other aspects of risks. Some of them are discussed below.

Engineering Insurance

This is a highly technical branch of insurance. It is a branch of insurance that has expanded rapidly under recent legislation and especially under the Factories Acts, which prescribe compulsory inspection at regular intervals of certain types of industrial equipment, such as boilers, electrical plant, cranes and other lifting gear. Policies cover the inspection service, the cost of repairing or replacing plant, and also injury to persons and damage to property. Cover is also available for machinery in transit or in course of erection.

Aviation Insurance

Under aviation insurance, cover is available for loss of or damage to aircraft, personal accidents to passengers, third party risks in respect of both person and property and for cargo sent by air. However, accidents to staff who fly regularly are covered by group insurance schemes.

Householder's Policies

Most fire companies now offer an extensive range of cover on the buildings and contents of private dwellings under householders' or all-in policies. Normally, these policies are designed to provide protection in one document against a variety of risks (additional to those already covered by a standard fire policy) including burglary, housebreaking, theft, accidents to domestic servants, liability to third parties, glass breakages and other hazards. Under these policies it is normally insisted to insure buildings and contents for their full value to enable the insurer to earn an adequate premium.

Fidelity Guarantee Insurance

As you know, cashiers and others who handle money are frequently required by their employers to provide security as protection against their personal dishonesty. In such cases, fidelity guarantee insurance policy may be taken by the employer. The policy indemnifies the employer against losses from the dishonesty of his employees. The employer himself often takes out the policy. He may insure a number of employees either individually or on a group basis under a variety of policies.

Burglary, Theft and Robbery

Burglary is the act of unauthorised entry with criminal intentions, into any building or residence*Theft is the act of dishonestly taking property belonging to another with the intention of depriving him of it. Robbery is theft with violence or the threat of violence. Burglary insurance covers the loss caused on account of burglary, house breaking or theft.

14.9.6 Difference Between Life Insurance and Other Forms of Insurance

You have studied various kinds of insurance policies and how they cover various types of business risks. Now let us study the basic difference between life policies and other policies. Study the following table carefully to understand this difference.

	Life Insurance	Other Forms
1.	Relate to human lives.	Mostly relate to property.
2.	The event (i.e., attainment of certain age or death of insured) is certain to happen.	The peril insured may or may not occur.
3.	There must be insurable interest interest must at the time of. taking the policy	In fire and marine insurance, insurable exist only at the time loss occurs,
4.	It is a contingent contract. The Insurer is liable to total sum assured is payable on assured, whichever is less. of the event (death or attainment of certain age).	These are contracts of indemnity, make good only the actual loss suffered or the sum the happening
5.	These are long term contracts. subject to renewal at the end of the year.	Mostly one year contracts,

Check Your Progress C

1. Differentiate between joint life policy and group insurance.
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....
....

2. Differentiate between voyage policy and time policy.
....
....
....

3. State whether the following statements are True or False ?
   a) Life assurance contracts are indemnity contracts.
   b) Some of the marine insurance policies are not indemnity contracts.
   c) A surety has an insurable interest in the life of the borrower.
   d) In the case of life insurance, only actual loss is compensated by the insurer.
   e) Losses arising from efforts to avert damage by fire are covered under a fire policy.
   f) Motor insurance covers the damages payable to third parties for accidents.
   g) Marine insurance do not cover the recovery of freight.

4.10 LET US SUM UP

Risk means the uncertainty of occurance of economic loss. Based on this the term business risk may be defined as the uncertainty of occurance of economic loss in the event of any business activity. Business enterprises face a variety of risks, and thus risks prevail in all activities of business enterprises. Depending on the hature, business risks may be classified as pure risks and speculative risks, dynamic risks and static risks, risks classified by loss severity, objective risks and subjective risks, etc.

Business enterprises have to manage the risks systematically. Risk management process involves five steps: (1) identification of the risks, (2) assessment of the intensity of financial loss associated with each risk, (3) identifications of various tools of risk management and selecting the best combination of tools to be used, (4) implementation of the decision, and (5) evaluation of the effectiveness of the risk management tools.

Insurance is a device by which a loss likely to be caused by an uncertain event is spread over a large number of persons who are exposed to it and who voluntarily join together to insure themselves against such an event. Thus, insurance is a form of contract between two parties where by one party (insurer) undertakes in exchange for a fixed amount of money (premium) to pay the other party (insured) a fixed amount of money or compensate the loss on the happening of a certain event.

All risks are not transferable to the insurer. Only pure risks can be transferred. Characteristics of insurable risks are: **(1)** risk should be accidental or random in nature, **(2)** loss should be measurable, (3) there should be sufficiently large number of units exposed to the same risk, and (4) those units should be spread over a large geographical area. Risks which do not **fulfill** these conditions are non-insurable.

An insurance contract consists of five main parts: (1) declaration, **(2)** insuring agreement, (3) exclusions and limitations, (4) conditions, and (5) binders. Insurance contracts must fulfill six conditions viz., utmost good faith, proximate cause, insurable interest, indemnity, subrogation and principle of mitigation of loss.

Business enterprises can transfer several types of risks to insurance companies. There are different kinds of insurance such as fire insurance, marine insurance, life insurance, motor insurance, fidelity guarantee insurance, burglary and theft insurance, etc. Within each of these kinds there are again different types to suit various requirements. Life insurance relate to human lives while other types of insurances cover properly.

4.11 KEY WORDS

Risk: Uncertainty of occurance of economic loss.

Business **Risk:** Uncertainty of occurance of economic loss to a business firm in the event of any business activity.

Pure Risk: **A** type of risk whose occurance causes loss only.

Speculative Risk: **A** risk whose occurance may cause either gain or loss.

Static Risk: **A** risk which may occur without any change in the business environment.

Dynamic Risk: A business risk which arises due to changes in the business environment.

Insurance: A farm of contract between two parties where one party undertakes in exchange for a fixed amount of money to pay the other party a fixed amount of money or pay **the** amount of actual loss on the happening of a certain event.

Insurable Risks: Pure risks which can be transferable to the insurer.

Non-insurable Risks: Risks which cannot be transferred and therefore not insurable.

Insurance **Policy: A** document containing all terms of contract between the insurer and insured.

kinder: **A document** in lieu of the insurance policy issued by the insurer.

Marine Insurance: An agreement whereby the insurer undertakes, in return for a consideration, to compensate the owner of a ship or cargo for complete or partial loss due to perils of the sea.

fire Insurance: An agreement whereby one party in return for a consideration undertakes to indemnify the other party against financial loss which the later may sustain by reason of certain defined subject matter being damaged or destroyed by fire or other defined perils upto an agreed amount.

Life Insurance: An agreement whereby the insurer, in consideration of a premium paid either in lumpsum or by regular instalments, undertakes to pay a certain sum of money either on the death of the insured or on the expiry of a specified period of time.

14.12 ANSWERS TO CHECK YOUR PROGRESS

A. 5 (a) False (b) False (c) True (d) True
B. 4 (i) d (ii) e (iii) a (iv) b (v) c
5 (a) True (b) False (c) False (d) True (e) True
C. 3 (a) False (b) False (c) True (d) False (e) True (f) True (g) False

14.13 TERMINAL QUESTIONS

1. What is risk ? Explain how risks are pervasive in business.
2. What is a business risk ? Explain the process of risk management.
3. What is a business risk ?Describe various types of business risks.
4. 'All business risks are not insurable'. In the light of this statement, explain insurable risks and non-insurable risks.
5. What is insurance ? Discuss the general principles of insurance.
6. What is an insurance contract ? Describe the parts of insurance contracts.
7. Comment on the following statements:
   a) 'A contract of insurance is a contract of indemnity and indemnity only'.
   b) 'All risks are not insurable'.
   c) 'Insurance is sometimes spoken of as pooling of risks'.
8. Explain the principle of insurable interest. State the significance of this principle in the case af life, fire and marine policies.
9. Briefly explain salient features of various types of life insurance policies.
10. Write short notes on the following:
    a) Cause proxima
    b) Doctrine of subrogation
    c) Insurable interest
11. Distinguish between the following:
    a) Risk transfer and risk separation
    b) Risk avoidance and loss prevention
    c) Life insurance and other insurances
    d) Whole life policy and endowment life policy
    e) Voyage policy and time policy
12. What is marine insurance ? Explain various types of marine policies.
13. Explain the features of a fire policy and State various types of fire policies available.

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

UNIT 15 TRANSPORT AND WAREHOUSING

Structure

15.0 Objectives
15.1 Introduction
15.2 Trade and Barriers to Trade
15.3 Transport– Its Importance
15.4 Essentials of a Good Transport System
15.5 Modes of Transport
15.5.1 **Road Transport**
15.5.2 **Rail Transport**
15.5.3 **Sea Transport**
15.5.4 **Air Transport**
15.5.5 **Miscellaneous Modes**
15.6 Choice of Mode of Transport
15.7 Containerisation
15.8 Clearing and Forwarding Agents
15.9 Warehousing
15.10 Types of Warehouses
15.11 Let Us Sum Up
15.12 Key Words
15.13 Answers to Check Your Progress
15.14 Terminal Questions

15.0 OBJECTIVES

After studying this unit you should be able to:

- explain the role and importance of transport as an adjunct of trade
- state the essentials of a good transport system
- enumerate the various modes of transport
- describe the procedures involved in different modes of transport
- explain the suitability of the various modes of transport
- discuss the basis on which choice of a mode of transport can be made
- describe the meaning and importance of containerisation in transport
- enumerate the functions of forwarding and clearing agents
- describe the purposes served by different types of warehouses.

1.1 INTRODUCTION

Modern business involves manufactures of goods on a large and making them available to consumers in distant places. Thus goods must be moved from the place of production to the place of consumption to create place utility to them. Similarly, trading involves distribution ensuring the availability of goods to consumers as and when needed. This involves holding of stocks by traders as near as possible to the markets and supplied to buyers. Thus transportation and warehousing functions ensure consumers to get a ready supply of goods as the right place and right time. In this unit you will study these functions in detail. You will study the nature and importance of transport service modes of transport, procedure involved and the suitability of various modes. You will also learn the meaning and usefulness of warehousing and the purpose served by different types of warehouses.

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15.1 INTRODUCTION

Modem business involves manufactures of goods on a large and making them available to consumers in distant places. Thus goods must be moved from the place of production to the place of consumption to create place utility to them. Similarly, trading involves distribution ensuring the availability of goods to consumers as and when needed. This involves holding of stocks by traders as near as possible to the markets and supplied to buyers. Thus transportation and warehousing functions ensure consumers to get a ready supply of goods as the right place and right time. In this unit you will study these functions in detail. You will study the nature and importance of transport service modes of transport, procedure involved and the suitability of various modes. You will also learn the meaning and usefulness of warehousing and the purpose served by different types of warehouses.

15.2 TRADE AND BARRIERS TO TRADE

Trade, as a business activity involves buying goods from producers and selling the same to consumers. In other words, those who are engaged in trade need to procure goods produced or manufactured at particular places and supply them to customers in different places. Goods which may have little use at the place of production thus become useful when these are made available to customers by traders. In the modem world, there are goods produced in a country may be exported and sold abroad. However, production and manufacture as well as buying and selling include operations which need certain facilitating services to be provided. Markets of goods produced on a large scale are spread over the length and breadth of the country and even extent to countries across the borders to help traders bridge the distance between the places of production and the markets i.e. to enable traders to create place utility for goods and earn their income, facilities must exist for carrying the goods i.e. transportation of goods (to over come the distance barrier) for warehousing (to overcome the barrier of time lag between procurement and sale) banking facilities (to meet the credit and financial requirements), and insurance service (to cover the risks of loss or damage due to theft, burglary, fire, accident etc.)

15.3 TRANSPORT – ITS IMPORTANCE

Transport, simply stated, means carrying of goods and passengers from one place to another. In the context of trade, transport involves carriage of goods from places of production to centres of distribution and sale, which may be within the country or abroad. Thus, transport facilitates trading activities to create place utility to goods by removing the barrier of distance between production and consumption.

In modern societies the scope of trade has increased not only due to the range of goods produced, but also on account of large scale production and widening of the market geographically. Transport plays an important role in the continuous supply of raw material to the industry and distribution of goods to ultimate consumers. It also contributed to the growth of large-scale industries by facilitating the inflow of raw materials and outflow of finished goods. Transport enables traders to adjust the supply of goods at different places according to changing demand from time to time. Thereby price fluctuations are reduced to the minimum.

Consumers derive benefits from transportation in three ways. ***Firstly,*** a large variety of products manufactured at different places are available to consumers all over the country as well as abroad. This is known as the benefit of diversified consumption. *Secondly,* as economics of scale achieved due to large-scale production and extension of markets with the help of transportation, goods are available at lower prices to the consumers. *Thirdly,* goods are available at stable prices as transport enables supplies to be moved quickly from surplus to deficit areas.

Economic benefits which are derived from transport facilities may be outlined as follows:
(i) Development of industry and trade depends a great deal on the availability of transport. Easy transportability of raw materials, finished products and also movement of labour, have contributed immensely to the growth of trade and industrial activities. (ii) Extension of markets through transport development enables buyers to have a wider choice of goods at competitive prices. Extended markets also provide opportunities to the sellers to sell at the most profitable markets. Thus, buyers as well as sellers are benefited due to proper transport facilities.
(iii) International competition is encouraged with the improvements in transport system. It makes markets accessible to sellers and buyers of different countries, and leads to wider choice of quality products. (iv) Well-developed sea and ocean transport have led to increased imports and exports. This has made it possible for each country to specialize in the production of goods for which it has competitive advantage. (v) Transport has facilitated economic interdependence of countries, which has, in turn, enabled people to interact, and promote material welfare of the human kind.

15.4 ESSENTIALS OF A GOOD TRANSPORT SYSTEM

A good transport system is one which should serve the purpose of transportation and satisfy the following requirements.

1. It should be ***economical.*** The cost of transport service should be low enough to enable the users to carry their goods at the lowest possible charge so that the ultimate consumer get the products at a reasonable price.
2. It should be capable of ***carrying goods as speedily as possible.*** There should not be any delay in reaching the destination except for natural calamities or unavoidable causes.
3. The transport service should be ***available regularly*** as and when required. It must ensure the safety of the goods.
4. It should be ***operated*** by ***the properly skilled and efficient*** persons capable of handling problems in emergency.
5. It should provide ***for insuring the risks of loss*** or damage to goods in transit, and assure payment of due compensation in case of delay causing loss to the owner of goods.
6. There should be ***proper arrangements for loading and unloading*** of goods promptly and at minimum cost.
7. As far as possible, ***delivery*** of ***goods should be made at locations*** convenient to the receiver of the goods.

Check Your Progress A

1. Which of the following statements are true and which are false ?

   a) Transport removes the barrier of distance in trade.
   b) Transport facility is needed only by traders, not by manufactures.
   c) Trade can take place even without transport facility.
   d) Efficient Transport system leads to adequate supply of goods in the market.

2. Fill in the blanks with the appropriate words given within brackets:

   a) Transport helps traders to create..………………utility (time/place/form).
   b) Traders having transport facility can …………………… goods in the most profitable market (buy/sell/hold).
   c) Large manufacturers need transport facility for ………………raw materials (holding/procuring/using).
   d) Movement of goods from one country to another improves ……………….. goods (supply/quality standard/variety).

15.5 MODES OF TRANSPORT

Modes of transport or means of transport, can be divided into the following four broad categories:

1, Road transport
2, Rail transport
3. Sea transport
4. Miscellaneous modes

Transport by road may be possible by means of: (a) pack animals like horses, camels, bullocks, mules, donkeys, etc., (b) vehicles drawn by animals e.g. bullock-carts, horse-drawn carts, camel-drawn carts, etc., (c) motor vehicles e.g. trucks, vans, tempos, etc. However, use of pack animals and carts drawn by animals have limited use only in rural areas and short distance local transport in urban areas. These are slow-moving means and wherever motor vehicles can be brought to use, these means of road transport are not preferred.

Rail transport by land consists of carriage of goods by trains which move on railway tracks laid for the purpose. Loading and unloading of goods for rail transport may be possible at rail stations or sidings.
Sea or ocean transport by vessels provide transportation facilities in coastal areas or across the sea and ocean. It is also possible by rivers and canals by boats and steamers.

Transport by air requires specially constructed airports for take off and landing of aircraft. Transportationby aircraft is possible within a country as well as between different countries.

Miscellaneous modes of transport include pipelines; postal mail and courier services. Let us examine the procedures involved in transportation by different modes and the suitability of the respective modes.

15.5.1 Road Transport

Large producers and dealers of goods often use their own motor trucks, delivery vans and other vehicles for inward and outward transport of goods. There are also public transport agencies which operate trucks and vans on hire. Vehicles owned by producers and dealers are put to use whenever required. A separate department is generally entrusted with the task of proper maintenance of the vehicles and regulating their movement.

Hired vehicles are generally used on a contract basis for regular purposes. Alternatively vehicles are hired from agencies as and when required. A truck service can also be arranged for less then full truck load. Before they are loaded into the vehicle, goods are required to be packed in crates or wooden cases or in bales or any other form depending on the nature of the product. However, packing may not be needed in the case of goods like iron rods, beams, bricks, sand, stone chips, minerals, coal, etc., which are carried in bulk. Motor vehicles are also specially made known as tankers, for carrying liquids in bulk.

Advantages

There are several advantages of motor transport by road.

1. The user gets complete service by way of loading of goods at the desired location and unloading at the exact place where required. The time of loading and unloading can also be adjusted according to convenience. The truck service can be arranged for varying quantities of goods. Besides, the transport operator can serve a number of places on the way for loading and unloading. Overall, the road transport service offers a lot of flexibility in operation.
2. For short distances, motor transport is speedier as well as cheaper. It is cheaper than rail transport because the truck operators are not required to construct or maintain the roads.
3.. Goods do not have to be loaded and unloaded more than once. There is no necessity of transhipment on the way. Thus, handling operations are minimum. Loading and unloading can be done in shorter time and at lesser expense. Fragile goods and goods susceptible to damage can be taken care of at the loading and unloading stages as the sender and receiver have the opportunity to supervise the handling operations.
4. The regularity of service (schedules of operation) is maintained by most established transport agencies. The reliability i.e. safety of goods and timely service, is also assured with little or no difference in cost.
5. The pressure on railway transport has been taken over by road transport, which also serve as feeder to railways.
6. Inaccessible terrains like hilly and mountainous areas can be reached by road transport, which is the only means of transport available in such terrains.

Limitations

There are some limitations of road transport as outline below:

1. Services may be delayed on account of break down of vehicle or road congestion.

2. There is no uniformity of rates charged by different agencies. The rates are neither competitive nor stable over time.
3. In the case of small operators, there is no fixed time schedule and thus the service is not dependable.
4. Adequate protection against loss or damage is often lacking and risks cannot be insured easily.
5. For heavy and bulky loads to be carried over long distances as also for goods of small value, road transport is relatively costlier than railway transport due to the limited carrying capacity of motor trucks and high cost of fuel.

Suitability of Road Transport

Considering the advantages of road transport, it may be found more suitable in the following cases:

1. For small consignments over short distances.
2. Where speedy movement is required and the distance is short.
3. When loading and unloading of goods are required at locations and at hours convenient to the sender and receiver of goods.
4. For handling goods to and from railway stations and sidings i.e. as a feeder service.
5. In hilly and mountainous terrains which are not accessible by rail transport.
6. Fast movement of perisliable goods like vegetables, milks, fruits, etc., for limited distances.

15.5.2 Rail Transport

In terms of carrying capacity over long distances, rail transport is unequaled by any other mode of land transport. In India railways are controlled by the Government of India. To avail of the rail transport facility for sending the goods, you have to follow the following procedure:

1. You have to fill in a prescribed form known as *Forwarding* ***Note*** or Consequent ***Note*** giving particulars of the goods to be sent. Printed forms of this note are available from the railway goods offices. The terms and conditions on which goods are carried by the railways are printed at the back of this note. In this note you have to mention the description of goods, number of packages, weight, identifying marks, and the names and addresses of the sender (consignor) as well as the receiver (Consignee). The note is marked either 'Freight Paid' or 'Freight to Pay' depending on whether the sender or the receiver is to pay the freight.

   The form of forwarding note is to be marked either 'Railways Risk' or 'Owner's Risk'. Higher freight rate is charged if goods are sent at 'Railway's Risk' because in such case the railway authorities can be held liable for any delay, loss or damage of goods except which is due to natural causes beyond the control of the railways. Freight rates are lower for goods sent at 'Owner's Risk', in which case the railway authorities can be held liable for delay, loss or damage only if it is due to will full negligence or dcfault.

   When the forwarding note is submitted to the 'parcel' office, the sender is given a receipt known as ***Railway Receipt (R/R)***. The R/R is an acknowledgement of the goods received with an undertaking from the railways to carry the goods as per instructions and subject to the terms and conditions specified in the forwarding note. This R/R serves as a document of title to the goods. Goods are delivered to the receiver after the submission of R/R at the inward parcel office at the destination, The Railway Receipt is, therefore, forwarded by the sender to the receiver (consignee) to enable him to take the delivery of goods.

   On arrival of goods at the destination, the consignee (receiver) is expected to take delivery immediately within a specified period. Otherwise he has to pay an additional charge per day of delay, which is known as 'Demurrage'. If delivery is not taken within a reasonable period of time, the railways can dispose of the goods by public auction.

Advantages

Transportation of goods by rail has certain distinct advantages:

1. For sending goods over a long distance by land, the railways happen to be the speediest means as trains can run at high speed over along distance.
2. Compared with road transport, it is relatively economical to carry heavy and bulky goods to distant places due to lower cost of traction by power on smooth rails.
3. The number of wagons and rakes can be adjusted for handling larger volume of traffic and thus the carrying capacity is quite flexible.
4. It provides a dependable service as railway movement is not much obstructed by weather conditions like rain and storm.
5. Goods can be carried safely without risk of total loss or severe damage, except when goods are transported on open wagons at the request of the sender.
6. As trains run very smoothly, damage of goods during transit is very limited.
7. A variety of services are provided by railways besides transportation of goods, e.g. warehousing of goods, express freight and delivery service, private sidings for factories, dock-sidings for immediate delivery and dispatch, depots at railway terminals, facility for transport of special categories of goods like animals, explosives, valuables, perishable, etc.

Limitations

Transportation by rail has the following limitations:

1. It proves to be a more expensive means of transport for small consignments over short distances. Expenditure on packing and handling are higher than in road transport. The speed of rail transport for short hauls is much slower than that of motor trucks.
2. Goods are transported by railways only between certain fixed places (i.e. railway stations). Hence it is necessary to carry goods to the railway station by the senders and the receiver has to obtain the goods at railway stations and arrange other modes of transport to carry it from station to his premises. Only in the case of large and regular users, sidings are provided at the factory site.
3. Railway transport facility is very limited in hilly and mountainous areas.

Suitability

Taking into account the advantages and limitations of rail transport, you may infer that it is most suitable as a means of transportation in the following cases:

1. Where heavy and bulky goods are to be carried over a long distance.
2. When regularity and reliability of transport are important factors to be kept in view.
3. Where goods are bulky but have low unit value like minerals, coal, etc.
4. Where the goods need to be sent speedily over a long distance.
5. When weather conditions on the way are uncertain and goods are likely to be damaged in course of transit.

15.5.3 Sea Transport

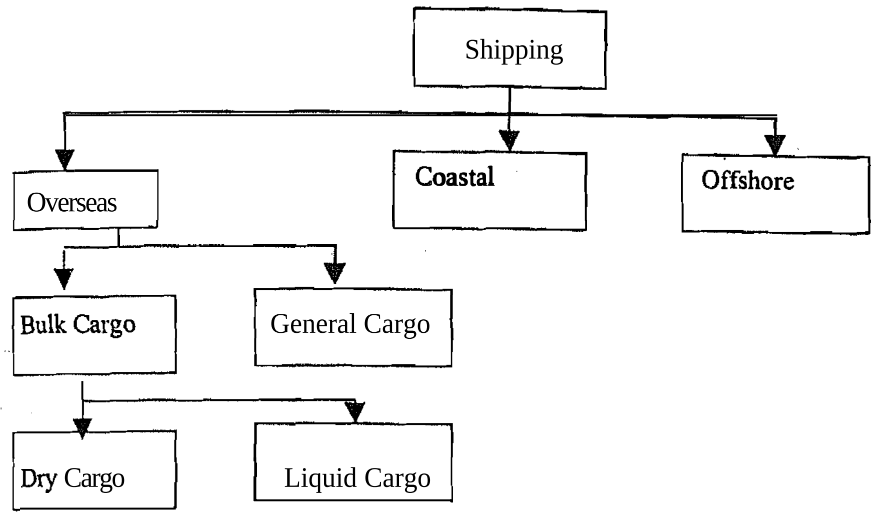
Water transport in general may be classified as : (1) river and canal transport by boats and steamers i.e. inland waterways, and (2) sea or ocean transport by ships.

In the case of inland water transport, loading and unloading of goods can be arranged by setting up private jetties on the route. For instance, transport of jute takes place along the Hooghly river for jute mills in the Calcutta industrial area. The cost of transport is relatively lower than road or rail transport. However, it is a slow moving means of transport. Natural calamities like rains, floods and droughts make inland water transport unreliable. Its limited use is due to the limited areas served by waterways.

Transportation by sea and ocean is most useful in coastal areas and for international trade. Rail and road connections do not exist between many countries and sea transport is the only means for imports and exports.

For overseas transport, two types of vessels are avail able: (1) Liners which undertake regular voyages between ports according to a fixed schedule and itinerary, and (2) Tramps which do not have any fixed schedule or itinerary of voyages, but move from port to port and undertake transportation of goods as per agreement with the shippers.

Figure 15.1 : Classification of shipping based on area of operation



Look at Figure 15.1 carefully and examine the classification of shipping. Shipping can be broadly divided into three segments viz., coastal, offshore and overseas. The coastal shipping segment encompasses the movement of cargo between different ports belonging to the same country. The **offshore shipping** segment is limited to the supply of manpower, spares and necessities to offshore installations. The overseas shipping encompasses import and export of merchandise between different countries. This overseas segment can be further divided into two categories as bulk cargo which is concerned with the movement of commodities in bulk and general cargo which involves in the movement of various items in various quantities. Bulk Cargo is further divided into: (1) dry bulk cargo which includes dry commodities like grain, coal, iron ore, etc. and (2) liquid cargo which includes liquids like crude oil, diesel, furnace oil, etc.

Procedure

1) Whenever goods are desired to be transported by sea, it is essential for the consignor to enter into a contract with shipping company. This is known as a contract of **affreightment** whereby the shipping company agrees to carry goods, and there is hiring of space in a ship for transportation of cargo of the consignor as per terms and conditions laid down in the contract. When the contract of affreightment involves hiring of a ship or a part of it for a particular voyage or for a specified period, it is known as Charter Party. If it is for a particular voyage, the contract is known as *voyage* Charter, whereas if it relates to a specified time period, it is known as Time Charter.

2) Having booked the cargo to be carried, the shipper obtains a 'Shipping Order' from the shipping company or its agent. This is an order hereby the captain of the ship is asked to receive on board the ship specified goods from the shipper.

3) At this stage, to comply with customs formalities, you have to fill up Shipping Bill in triplicate and submit to the customs office, which scruitinizes the Bill and passes an

order for export of the goods. Then you have to pay warfare at the office of the port trus upon which a ***Customs Export Pass*** is issued to the, shipper.

4) You have to deliver the goods at the dock and receive ***Dock's Receipt.*** When the goods are loaded, the Shipping Order and the Shipping Bill are to be handed over to the Mate, the captain's assistant. After checking the number of packages and packing, the Mate issues a receipt to the shipper, known as the ***Mate's Receipt*** which is ***an*** acknowledgement of receipt of the goods specified in it on board the ship.

5) The Mate's Receipt is a provisional receipt which has to be produced at the office of th shipping company for obtaining the ***Bill*** of *Lading.* This is a document which is issue by the master of the ship or the ship owner or an agent, stating that the goods mentione in it have been taken on board the ship for transportation as per terms an conditions specified in it. The Bill of Lading, besides being an acknowledgement o receipt of the goods, also serves as a contract of affreightment and as a document o title to the goods. It is freely transferable by delivery, with or without endorsement, an the transferee, as a holder in due course, obtains a valid title to the goods.

6) A freight note is then sent to the shipper giving details of the freight payable on th consignment plus a charge for supervision of the loading, known as *primage.* Paymen of the amount may be arranged by the shipper. However, if the freight is to be paid b the consignee, the Bill of Lading is marked 'Freight Forward'.

7) When the consignor (exporter) has shipped the goods, he sends an advice note to th consignee (importer) intimating the date of shipment and the probable date by which th ship is likely to reach the port of destination. The exporter also draws a bill of exchang on the importer for the full amount as per the invoice of the goods sent. Alongwith th bill of exchange, exporter also sends the invoice, bill of lading, insurance policy, etc These are forwarded to a branch or agent of the exporter's bank, with the instruction tha the documents may be handed over to the importer either on acceptance or payment o the bill of exchange.

8) When the ship has reached the port of destination, the importer has to arrange paymen of the freight, if it has not been already paid by the shipper. The shipping company the makes an endorsement on the back of the Bill of Lading which is known a 'Endorsement for Delivery'.

9) At the same time, a Bill of Entry giving details of the goods is prepared by the importe in the form supplied by the customs authorities for payment of customs duties, if th goods are dutiable. He is also supposed to pay Port Trust dues and obtain a receipt.

10) Delivery of goods is finally obtained when the above formalities have been complete and the documents of title to the goods are surrendered.

Advantages

Transportation of goods by sea or ocean is relatively more economical for bulky goods to b carried over a long distance. This is because there is no necessity of constructing or maintainin tracks on sea routes. Countries with a long coast line as India, can also make use of sea transpor for movement of goods by coastal shipping.

Disadvantages

Although sea transport is the only means of transporting goods economically where land connections do not exist between countries, it is a relatively slow-moving means of transportation as compared with air transport or land transport. Moreover, seas and oceans in some parts of the world e.g., in Northern Europe (Scandinavia), North America, etc., are not navigable round the year, Although modem devices have made such waterways navigable, but it is more expensive.

Suitability

Sea transport is obviously the cheapest mode of transport particularly for heavy and bulky goods. However it is not so suitable, even though cheap, for the fast movement of goods. None the less, it is indispensable for trade between countries which are separated by seas.

15.5.4 Air Transport

Though air transport is largely used for passenger traffic, its importance as a mode of transport for goods is no less. Its use has considerably increased as a result of the large cargo planes. Besides, certain categories of goods like perishable items, costly goods of light weight as well as products like sensitive electronic goods and ready made garments are now transported by air.

Procedure

For sending goods by airways, the consignor has to prepare an air *Consignment Note* which is a document containing particulars such as the number of packages, method of packing, marks on the packages, weight, quantity, volume, freight to be paid, party to pay, value of the goods, make and address of the consignor and the consignee, the place of departure and destination, etc. The Air Consignment Note has to be prepared in three parts. One part is signed by the consignor and marked 'For the Carrier'. The second part is signed by the airways and the consignor and marked 'For the Consignor'. The third part is signed by the airways as an acknowledgement of the goods received for carriage. This is forwarded to the consignee who is to receive delivery of the goods at the destinatioll.

Advantages

Transport by air has certain distinct advantages to the user. The airways follow the shortest and the most direct route for carrying goods. It is the speediest means of transport. Where time is valuable, airways constitute the only choice. The transport cost which is relatively higher is compensated by quick delivery of goods, increased turnover, reduced inventory holding and storing cost.

Disadvantages

There are two serious limitations of air transport. One is that transport of bulky goods of small value involves prohibitive costs. Secondly, unfavourable weather conditions may delay flights,

Suitability

Air transport is the most expensive means of transport. But it is the speediest means and provides the quickest means of transportation. Hence it is most suitable for the transport of perishable goods, articles of high value and low volume as well as items urgently needed, such as life saving drugs, spare parts of machinery or electronic components.

15.5.5 Miscellaneous Modes

Besides roadways, railways and airways, liquids are transported through pipelines also. Moreover, postal services and courier services also provide facilities for transport of goods. However, these courier service agencies make use of rail, road and air transport for carrying goods. Let us discuss about courier each of these modes in detail.

Pipelines

One of the most economical means of transporting crude petroleum and oil products, natural gas, and coal gas is through pipelines. Though heavy capital expenditure is involved for constructing the pipeline, the recurring expenditure to maintain it is very low. The volume and the duration of supply (long duration) of oil/gas justify the capital expenditure on construction of pipeline. Although waterways may cost less than pipelines, navigable canals and rives are not there between many places. Thus, use of water transport for oil is restricted. There are several examples in India where pipelines are used to transport petroleum. Imported crude petroleum is transported by 1,222 Km long pipeline from Salaya in the Gulf of Kutch to Koyali and Mathura refineries via Viramgam in Gujarat. Oil wells in Naharkatiya are connected by pipelines with refineries at Nunmati in Assam and Barauni in Bihar. Coal gas is transported from Durgapur to Calcutta by pipelines.

Postal **Office**

Postal service undertakes transport of parcels of goods within India and abroad by surface mail or air mail. Parcels may be registered or unregistered. However for a parcel weighing 4 kg. or more, registration is compulsory. For registered parcels, acknowledgement of the consignee is also available to the sender by post. For this purpose the parcel has to be sent within 'Acknowledgement Due' and an additional amount is charged to the postage payable.

Another facility provided by the postal department is the ***speed post service*** whereby parcels can be sent to selected destinations within and outside the country very quickly. Large post offices in the major cities of India offer this service. Postage is to be paid by the sender. Charges are very high and vary according to the weight of the parcel and destination.

High volume users are given special privileges, such as delivery under contract to any place in India, even a remote village or a far flung town. Besides, regular users can avail of the facility of scheduled pick ups from their own premises at no extra charge. Credit facility is also given to high volume users who can pay only once a month.

Advantages: Postal service, as a means of transport, has the following advantages : (1) It is a convenient means of transport where the quantity is small and the volume is low. (2) Post Offices are located mostly near market places. Hence despatch of parcels can be arranged easily. **(3)** Parcels are delivered at the doorstep of the addressee's. (4) The parcel may also be sent under VPP (Value Payable Post) and the amount due from the consignee can be realised by the sender through the post office. (5) Main advantage of the speed post service is the assured and speedy delivery of goods.

Disadvantages: The disadvantages of postal services are: (1) Sending large quantities of goods by parcel post is more expensive than rail or sea transportation. (2) The maximum weight of a parcel peimitted is 20 kg. The packages should not to be more than one metre long. Thus, heavy and bulky goods cannot be sent by parcel post. **(3)** The main disadvantages of speed post service are that it is very expensive and is available at selected places only.

Suitability:-On the whole, postal service is useful for sending small quantities urgently, where such quantities are uneconomical to carry by other modes such as trucks, trains or ships. For bulky and heavy goods, parcel post or speed post are expensive and not ordinarily found suitable means of transport.

Courier Service

Many private agencies known as couriers operate from different cities and towns and undertake to carry goods to places within the country and abroad. The courier service actually involves transportation of goods by road/rail or airways. For short distances, mostly within town/city, they use messengers. Quick and assured delivery is the main advantage of courier service. It also provides the pick up service at no extra charge. The limitations of courier service are it is quite expensive, and available only in cities and towns between which traffic is regular and substantial.

15.6 CHOICE OF MODE OF TRANSPORT

We have already discussed the advantages and disadvantages of various modes of transport and their suitability. Naturally, which mode of transport should be chosen by a business firm will depend upon the nature, weight, bulkiness and volume of goods to be transported. Generally four major factors viz., cost, speed, flexibility and regularity of the service influence the choice of a particular mode. Let us discuss these factors briefly.

Cost

The most important factor is the cost of transport. Sea transport is by far the cheapest mans of transporting bulky and heavy goods, provided the speed of carriage is not an essential requirement. Rail transport is also a relatively cheaper mode of transport for heavy and bulky goods to be carried over long distances: It is also speedier than sea transport. But transport by rail is possible only when places are connected by railways. Transport by motor trucks is cheaper and speedier than rail transport for small consignments over short distances. But the cost of road transport by trucks is higher than that of rail transport for bulky goods of small value to be carried over long distances. This is due to the limited carrying capacity of trucks. Air transport is the fastest mode of transport but it is also the costliest mode. Its use is thus restricted to the carriage of perishable goods, valuable goods or spare parts of machinery urgently needed.

Speed

As regards speed of transport, motor transport by road is speedier than rail transport over short distances. But railways are potentially a speedier means than road transport for long distances. The quickest mode of transport is of course, air transport, and the slowest is water transport.

Flexibility

While choosing a particular mode of transport, you have to consider the flexibility of service also. In this respect, road transport is the most flexible mode. Carriage of goods by motor trucks is possible between all places. Goods can be picked up and delivered at any point and loading as well as unloading can be arranged at any convenient time. Rail transport is relatively less flexible, as it is generally available for carriage of goods only between certain definite places. Sea transport provides services only between sea ports and to that extent is inflexible, but it is indispensable for trade between countries without common land frontiers. Air transport is also inflexible as a mode of transport. Carriage of goods is possible only between airports which are fewer and far between.

Regularity

In the case of rail transport, regularity of service is most assured. The scheduled movement of railways is relatively less affected by weather conditions. Motor trucks may or may not have scheduled services but transport by trucks is somewhat affected by bad weather conditions. Sea transport is also available according to some schedule. Only in certain parts of the world, storms and freezing of sea water may affect this mode of transport. Air transport is also available according to a fixed schedule but the services are very much affected by weather conditions.

Check **Your** Progress B

1. Which of the following statements are true and which are false ?

a) Both road transport and rail transport can be arranged for varying quantities of goods.
b) I-Iigher freight is charged for goods sent by railways at owner's risk.
c) For lieavy and bulky goods, rail transport is cheaper than road transport irrespective of the distance.
d) Male's Receipt is issued when goods are loaded and the Shipping Order and the Shipping Bill are handed over to the mate of the ship.
e) The Bill of Lading serves as a document of title to the goods carried by a ship and hence it is not transferable.
f) High cost of air transport is compensated by reduced inventory holding and storing cost.
g) Sea transport is ruled out for transportation of petroleum due to the low cot of transport by pipelines.
h) Speed post service is available only at selected cities.

i) Choice of the mode of transport is mainly determined by the cost and speed of carriage, and less by flexibility and regularity of sei-vice.

2. Prepare a chart showing the relative merits and short comings of road and rail transport.

Road Transport	Rail Transport

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....

3. Define the following terms:

j) Air Consignment Note
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ii) Railway Receipt
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iii) Bill of Lading
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iv) Charter Party
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v) Demurrage
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vi) Primage
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vii) Bill of Entry
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viii) Shipping Bill
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15.7 CONTAINERISATION

Containerisation refers to the technique of using specially made containers for transportation of goods. It involves carriage of goods in large box like containers that can be loaded and unloaded to and from trains, trucks, ships and air crafts by mechanical devices instead of manual labour being engaged in transferring packaged lots. Actually, containerisation is intended to eliminate manual handling of cargo, mechanising the operation and ensuring automatic control over transfer of goods in containers from storage to carriers and from one type of carrier to another. Containers can be hauled by trucks to railway yards, docks or airports and can be transferred readily to rakes, flatcars, ships or airplanes, thus, the main advantage of containerisation is its adaptability to efficient transfer between different modes of transportation. The transfer can be made by mechanical devices with minimum use of manual labour. For sea transport, operation of larger and faster general cargo vessels has become possible due to containerisation. Specialised container ships are required for the purpose, and it involves heavy capital expenditure. Even then it is found economical since loading big containers is easier, less time consuming and less costly compared with loading of small boxes or pieces.

Movement of cargo by air may also be possible more conveniently with the prospect of containerisation enabling goods to be loaded and unloaded using highly automatic mechanical devices. However, it remains to be seen whether it is economically feasible to operate huge air freighters which are required to cany containerised cargo.

In the West European countries and the United States, containerisation has become an integral part of the transport system. It is gradually gaining ground in India. At present Inland Container Depots (ICDs) serve as dry ports to promote exports and imports from and to inland locations. In India, presently ICDs function at seven places : Bangalore, Guntur, Anaparti, Coimbatore, New Delhi, Aimngaon (Guwhati) and Ludhiana. Besides, there is a Container Freight Station (CFS) at Patparganj in Delhi, for consolidation and dispersal of less than container load cargo. The highly computerised and automated Jawaharlal Nehru Port at Nhava Sheva is linked with the ICD at Delhi. A public sector enterprise namely Container Corporation of India was set up in 1988 under the administrative control of the Ministry of Railways. The main objective of this Corporation is to bring containerisation to hinterland, and to set up a network of ICDs and CFSs all over the country to serve as dry ports in order to promote multi-modal transport of containers between gate-way ports and inland locations.

15.8 CLEARING AND FORWARDING AGENTS

Clearing and forwarding agents are generally engaged by importers and exporters to comply with various formalities prescribed by the customs and port authorities for goods to be imported or exported. Clearing agents not only undertake to complete all the formalities for receiving delivery of the imported goods, but also to deliver the goods at the importer's warehouse. They charge a commission for all their services. Importers find it worthwhile to entrust the work to clearing agents instead of employing separate staff for the purpose.

Forwarding agents are similarly engaged by exporters to comply with the customs formalities and other requirements of the port and dock authorities in connection with shipping goods for export. Forwarding agents are also engaged to look after the arrangements for transportation of goods from the exporter's premises to the dock or ship. Consignment and despatch of goods within the country are often arranged by merchants with the help of forwarding agents. Their services are rendered for a commission on fixed charge which vary with the volume and nature of goods.

15.9 WAREHOUSING

Warehousing refers to the storage of goods on a large scale and as a specialised function. It involves providing facilities for preservation of goods in proper condition so as to prevent Ioss or damage, and making the goods available to traders or dealers for sale. Warehouses are places where storage facility exists. Thus, warehousing is an essential aid to trade or ancillary of trading activity. It creates both time and place utilities, as goods stored in warehouses can be available whenever and wherever needed by buyers. Manufacturers, wholesalers as well as dealers can make use of warehousing facilities to bridge the gap between the time when goods are procured or manufactured and the time they are demanded by customers. The warehousing also arised from the modem systems of production and distribution of goods. Large scale production generally takes place in anticipation of demand for goods, but not necessarily in response to specific orders of customers. Such goods cannot be sold immediately after production. The manufacturers thus need adequate facilities for storage of their products to meet the demand schedule of customers.

Again, there are certain products which have seasonal demand, but produced throughout the year. For example, woolen mills have to keep wool or woolen textiles in storage until the winter season. Many agricultural crops like wheat, cotton, tobacco, rice, etc., are harvested during specific seasons while they have continuous demand throughout the year. Thus, storage is necessary in all such cases. Warehousing enables wholesalers to buy goods in bulk from manufacturers and sell the same in small lots to retailers. Warehousing also performs the function of price stabilisation. Prices normally go down due to excess supply and increase due to shortage. Fall in price can be controlled by storing the excess supply and also price rise can be minimised by supplying the product from storage. Storage may enable better prices to be secured by the producer or wholesaler as supply can be adjusted to demand.

15.9.1 Types of Warehouses

There are three types of warehouses which provide facilities for proper storage of goods:

1) Bonded Warehouses
2) Public Warehouses
3) Private Warehouses

Let us examine the nature and characteristics of each of three categories.

Bonded Warehouses are those which are located in or near ports where imported goods are stored till importers fulfill all formalities and take delivery of them. Actually when an importer is unable to take delivery of the goods by paying the required customs duty, the customs authorities permit the goods to be kept in a bonded warehouse, and allow delivery as and when the duty is paid.

The bonded warehouses are licensed specially for storing imported cargo on which customs duty is yet to be paid. Goods stored are said to be 'in a bond'. These warehouses are generally owned by government, but can also be privately owned in which case they are subject to government supervision and control.

Bonded warehouses enable importers to pay customs duty on the goods as and when it is convenient. The import duty is not required to be paid on the entire lot at the same time. Delivery of a part of the goods be taken on payment of the proportionate amount of duty. Besides, these warehouses also can provide services of branding, blending and packaging, thereby facilitate re-export of the same. Moreover, buyers are allowed to inspect the goods there. Thus, importers can recover the amount of duty included in the price when the goods are delivered directly to the buyers.

Public Warehouses are those which provide warehousing facilities to manufacturers, producers, as well as traders on payment of specified charges. These warehouses are located at favourable sites on railway routes and highways and near ports. Railway sidings are also provided with many of these warehouses.

Public warehouses are privately owned by organisations, as well as by the central and state governments. The Central Warehousing Corporation of India, established in 1957 by the Government of India, operates public warehouses at centres of all India importance. There are State Warehousing Corporation which run public warehouses at the state and district level. Besides, co-operative warehouses are also existing. Privately owned public warehouses are allowed subject to certain government regulations. Public warehouses run by dock authorities facilitate storing of goods which cannot be immediately shipped on reaching the port, or imported goods where importer is not able to take immediate possession. Mechanical handling of heavy goods is also possible at warehouses on railway routes and at ports.

Small scale manufacturers and traders cannot afford to build warehouses of their own and can make use of public warehouses located in different regions. The receipts issued by public warehouses are accepted by banks as collateral security for loans granted. The warehouses also provide the facilities of grading, blending and packaging. These warehouses also undertake loading and unloading of goods, and arrange delivery according to the owner's direction.

Private Warehouses are owned by large manufacturers and wholesalers for storing goods of their own. The maintenance of these warehouses is the responsibility of the owners. These warehouses are not available to the traders and producers in general and hence have limited usefulness.

Check Your Progress C

1. Which of the following statements are true and which are false ?
   a) Containerisation is possible only in sea transport.
   b) Forwarding agents may act on behalf of exporters as well as merchants for domestic consignments.
   c) Warehousing is essentially concerned with storage of goods.
   d) All private warehouses are owned by large scale manufacturers.
   e) Buyers can inspect goods in bonded warehouses.

2. What is 'Containerisation' ?
   ....
   ....
   ....

3. What is a bonded warehouse?
   ....
   ....
   ....

4. Why is a public warehouse so called ?
   ....
   ....
   ....

15.10 LET US SUM UP

Transportation involves carriage of goods from places of production to places of consumption. Thus, transport services remove the barrier of distance that separates producers from consumers and creates 'place utility'. Transport helps raw materials and goods to be carried to places within a country as well as places abroad.

A good transport system should be economical, that is, involve minimum cost, fast moving, flexible enough for goods to be loaded and unloaded conveniently, and regular in operation. Besides it should provide for insurance of the risks of loss or damage in transit.

Road transport, Rail transport, sea transport and air transport are the principal modes of transport. Road transport by motor trucks is most suitable for carriage of small consignments of goods over short distances. For transporting heavy and bulky goods over long distances, railways are better suited. Sea transport is the cheapest mode for carrying **bulky** and henvy goods. **It** is the only mode of transport available where there is no road or rail connection between countries. Air transport is most suitable for carriage of perishable goods, high value and low volume goods, and emergency supply of goods. It is the speediest mode of transport but is also the most expensive. Pipelines constitute another mode of transport. It is most economical and useful for transporting liquids and gases such as petroleum products, natural gas, coal gas, etc. Parcels and packaged goods can be senr through post offices for destinations within the country and abroad, provided the weight and size of the parcels are within permissible limits. Post offices offer 'speed post' service from selected centres to ensure quick delivery. Private agencies known as couriers provide similar services for sending parcels. However, the appropriate mode should be chosen on the basis of the cost involved, the speed of transport, flexibility and regularity of services.

Containerisation is the technique of transporting goods in large box like containers which can be moved by mechanical devices to and from ships, railways, trucks and aircrafts.

Clearing and forwarding agents are generally engaged by importers' and exporters to comply with the various formalities prescribed by the customs and port authorities for obtaining delivery of imported goods or shipping goods for export.

Storage of goods on a large scale undertaken as a specialised function is known as warehousing. It consists of all arrangements for storing goods in proper condition and protecting the goods from loss or damage till required by the owners. Warehousing results in the creation of both time and place utilities. There are three types of warehouses viz., bonded warehouses, public warehouses and private warehouses. Bonded warehouses, located at or nearer to parts, are used by importers for storage of imported goods before payment of customs duty. Delivery of the goods can be obtained as and when customs duty paid. Public warehouses provide storage facilities to manufacturers, wholesaler and traders on payment of prescribed rent or charges. These warehouses are generally located at favourable sites on railway routes and high ways, and are operated by private parties or the government. Private warehouses are owned and run by large manufacturers or wholesalers for storage of their own goods.

15.11 KEY WORDS

Air Consignment Note: A document to be submitted by the consignor of goods by airways containing all particulars relating to the goods, one part of which is signed by the airways in acknowledgement of the goods received for carriage and has to be forwarded to the consignee to receive delivery of the goods.

Bill of Entry: A document continuing details of goods imported which is prepared by the importer for payment of customs duty.

Bill of Lading: Document issued by the ship owner or captain of the ship in acknowledgement of the goods taken on board the ship under the terms specified in it.

Bonded Warehouse: Warehouse for storage of imported goods on which customs duty is yet to be paid.

Clearing Agent: One who is engaged by importers for getting delivery of imported goods after complying with the necessary formalities prescribed by the customs and port authorities.

Charter Party : A contract for hiring a ship or a part of it for a particular voyage or specified period.

Demurrage: Extra charge payable to the railways when the consignee delays taking delivery of the goods at the destination.

Forwarding Agent : One engaged, on behalf of the exporter, to comply with the customs and other formalities in connection with export of goods.

Linear Ship which undertakes regular voyages between ports according to a fixed schedule.

Mate's Receipt : Receipt issued by the Mate of a ship in acknowledgement of the goods having been received on board the ship.

Primage : charge payable for supervision of the loading of goods on board the ship.

Railway Receipt: Acknowledgement receipt issued by the railways for goods received for carriage, which has to be presented by the consignee for taking delivery at the destination.

Shipping Bill: A document which contains the order passed by the Customs office for export of goods.

Shipping Order: Written order issued by the shipping company to the captain of a ship to receive the goods specified in the order on board the ship.

Time Charter: A contract for hiring a ship for a specified period.

Tramp: A ship which does not have any fixed schedule or itinerary of voyage.

Voyage Charter: **A** contract for hiring a ship or part thereof for a particular voyage.

Warehouse: A place providing facilities for proper storage of goods on a large scale and as a specialised function.

15.12 ANSWERS TO CHECK YOUR PROGRESS

A. 1. (a) True (b) False (c) False (d) True
2 (a) Place (b) Buy/Sell (c) Procuring (d) Quality standard

B. 1 (a) False (b) False (c) False (d) True (e) False (f) True **(g)** False (h) True (i) False

C. 1 (a) False (b) True (c) True (d) False (e) True

15.13 TERMINAL QUESTIONS

1. Explain briefly the advantages and disadvantages of road transport. What are the circumstances in which roadways are more suitable for transport of goods than other modes ?
In what respects i's rail transport superior to road transport? What are the limitations of rail transport ?
3. What are the essential features of a good transport system ? briefly explain.
4. What are the factors to be taken into account while selecting the mode of transport for goods ?
5. 'Sea Transport is the cheapest means of transport'. Why ? Outline the procedure to be followed for transport of goods to a foreign country by sea.
6. Discuss the role of clearing and forwarding agents in connection with import and export of goods.
7. Briefly explain the usefulness of warehousing as an adjunct of trading operations.
8. What is a bonded warehouse ? What purpose does it serve ?
9. Write notes on:-
a) Railway Receipt,
b) Mate's Receipt,
c) Bill of Lading,
d) Air Consignment Note
e) Shipping Bill,
f) Public Warehouse
10. What are the advantages of air transport? What are its disadvantages ?

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

SOME USEFUL BOOKS

Gartside, *L. Commerce – A Guide to the Business World,* Pitman Publishing, London.

Ghosh, P. K *and Y. K. Bhushan, Business Organisation and Office Management,* Sultanchan *Co.,* Delhi.

Singh B. *P* and Chhabra, *T.* N. *Business Organisation and Management,* Dhanpat Rai & Sons Delhi.

NOTES

UNIT 16 GOVERNMENT IN BUSINESS

Structure

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16.0 OBJECTIVES

After studying this unit, you should be able to:

- state the reasons why government controls the business activities of private enterprises
- explain various forms of government control
- define a public enterprises
- explain rationale for government participation in business through public enterprises
- state the objectives and features of public enterprises
- describe the performance, problems and limitations of public enterprises in India.

16.1 INTRODUCTION

Traditionally, business activities were left to individuals and private organisations. It was assumed that in a competitive market, the profit motive of businessmen and the forces of demand and supply should ensure efficient production and distribution of goods and services in the general interest of all. But it led to unchecked growth of monopolies and concentration of wealth in the hands of a few business houses. Private entrepreneurs, as they work mainly with profit motive, do not show interest in such industries where the profit margin is less, gestation period is long, investment is huge, etc. Industries are also concentrated in a few places where there are certain natural advantages such as availability of raw-materials, technical skills, infrastructural facilities, nearness to market, etc. Lack of such natural advantages in some regions has led to regional imbalances. This necessitated the government to take some measure to check the growth of monopolies and concentration of wealth, and to ensure balanced regional development, Hence, government started regulating the business activities of the private enterprises alongwith direct participation in business.

In this unit we shall discuss the reasons underlying government control over private business, the various forms of such control, rationale behind the government participation in business, the objectives and features of public enterprises as well as the contributions and limitations of these enterprises.

16.2 REASONS UNDERLYING GOVERNMENT CONTROL OVER PRIVATE BUSINESS

Let us discuss in detail about the causes which have led to the government regulation and control of private business activities. The main reasons are as follows:

1) Evils of free enterprise and private ownership: The following evils are associated with free enterprise and private ownership:

   i) Freedom of enterprise often gave rise to monopoly of large business firms. Monopoly power was generally used to restrict production and increase prices so as to earn higher profits.

   ii) Private ownership of business has led to concentration of wealth in the hands of a few business houses. This caused wide disparities of income and wealth among the people.

   iii) The growth of large companies prevented the entry of new firms in the market.

   iv) For the sake of profits, private enterprises started indulging in wasteful advertisement and unfair competition.

   v) Business conditions were subject to booms and depressions at periodical intervals. Depression brought about widespread unemployment and human misery. On the other hand, speculalive activities during booms led to business failures and economic crisis.

2) Establishment of welfare state: There was increasing public pressure on Government to ensure social welfare and protect the interest of the general public by controlling monopolies, establishing fair trade practices and ensuring equitable distribution of income and wealth.

3) Planned economic development: Government intervention is necessary for rapid development of certain key industries which require large investments or which yield low returns. Besides, to take the economy in planned direction, it is also necessary to give priorities to the growth of certain industries. But, for a private entrepreneur profitability is the main consideration rather than priorities of development. Moreover, private enterprises are likely to be concentrated in certain areas where facilities are easily available. Thus backward regions in the country would be deprived of the benefit of industrial development. Therefore, for rapid economic development of the nation, government is required to regulate private business and channelise private investment in the planned direction. It is also necessary for government to directly participate in industrial and commercial activities to hasten the process of development.

4) Other reasons: There are several other reasons which necessitate the government to regulate the private business as follows:

   i) To prevent the misuse of scarce natural resources like minerals, forests, etc., by private business firms for profit.

   ii) Ensuring the proper use of scarce resources keeping in view the future needs.

   iii) Encouraging and protecting small-scale industries.

   iv) Protection of the economy from the dominance of foreign investors.

16.3 INSTRUMENTS OF GOVERNMENT CONTROL

You have studied the reasons underlying govemment regulation of private business. Now we will discuss about the actual measures adopted by the govemment to regulate private enterprises.

Government regulation of private business does not necessarily mean only restriction of private activities. As a matter of fact government measures of control may have inducive as well as restraining effects on business. Measures may have inducive effects if the objective is to stimulate, encourage, facilitate or induce a particular type of trade or industrial activity through technical and financial assistance, tax concessions, subsidy, bank credit, supply of foreign exchange for imports of raw materials or machinery, protection against foreign competition, etc. On the other hand, certain measures may have restraining effects if they are aimed at limiting or restricting private trade and industry by means of legal enactment and administrative orders. These may include licensing requirements for starting or expanding industries, control over capital issues, fixation of maximum price, etc. However, some of the measures may have both the effects. For example, industries which require imported raw materials may be adversely affected if imports of such raw materials are restricted or stopped. At the same time, due to such restriction on imports, the producers of competing goods may have a positive effect and earn more profit. There is another way of distinguishing between the instruments of control. Thus, controls may be classified into two categories depending on whether the measures are directly applicable or indirectly applicable. Accordingly, the two broad types of control measures may be: 1) direct controls and **2)** indirect controls. Let us now discuss briefly about these two categories.

Direct Controls: Direct controls are the measures which are applied at the discretion of government authorities. Such a control may be used to promote. restrict or limit the activities of private organisations or categories thereof. Examples of these controls are:

1) Licensing of new enterprises or expansion of existing large enterprises.
2) Control over issue of shares, debentures, etc., by companies for raising capital (control of capital issues).
3) Import and export control through direct prohibition or quota restriction.
4) Fixing maximum or minimum prices for particular commodities.
5) Control over distribution of commodities through rationing.
6) Grant of subsidies for industrial growth.
7) Incentives for export promotion like grant of subsidy, credit facilities, etc.

These controls are also knows as **discretionary controls** because they involve discretions to be made by concerned government officials.

Indirect Controls: These indirect controls affect private business firms in an indirect manner. The following are some common examples of indirect controls:

1) **Changes of tax rates:** Tax rates may be lowered to encourage the business or raised to discourage the business.

2) **Changes in import and export duties:** Import duties may be raised so as to increase the prices of certain goods. This may be aimed at discouraging imports of those goods or to protect domestic industries from foreign competition. Import duties may be lowered to allow large imports of certain products. Similarly, export duties may be raised or lowered so as to influence the domestic demand and supply. For instance, if the export duty is raised, exports may be discouraged and domestic supply may increase to meet higher domestic demand. If it is lowered, exports may rise.

3) **Changes in interest rates on bank loans:** Government can change its monetary policy to control the prices. For instance, interest rates on bank loans and credit may be raised so as to prevent excessive borrowing and expenditure by business enterprises and to reduce new investment by business firms. On the other hand, interest rates on bank loans, may be reduced to induce business firms to borrow and expand their business activities,

Indirect controls are also known as **non-discretionary controls.** Government authorities do not have any discretionary power to apply the measures to particular firms and not to others in the same category.

Economic Planning

Many developing countries today have recognised the importance of planning for economic development and adopted broad economic policies for industrial growth. In India this is done through Five Year Plans. The First Five Year Plan was launched in 1951. Since then, six successive plans have been completed and the Seventh Five Year Plan is running its last year. The main objectives laid down in the plans have been:

i) To achieve a target growth of national income so as to improve the standard of living of people.

ii) To bring about industrial growth according to certain priorities and with particular emphasis on basic and heavy industries like steel, fuel and power, chemicals, fertilisers, engineering goods, etc., and provision of transport and communicatio' facilities.

iii) To generate more employment opportunities to absorb the increasing labour force.

iv) To increase agricultural production and achieve self sufficiency in foodgrains.

v) To reduce regional inequalities and achieve balanced regional development.

vi) For the utilisation of limited resources to the best possible advantage.

Economic planning gives a general indication of the priorities of development of various industries and accordingly guides the development process. Besides, it indicates th'e extent to which private organisations will be allotted scarce resources like fuel, power, finance and other facilities for growth. The economic and social activities which the government will undertake on its own are also laid down in the five year plans.

Industrial Policy

The industrial development of our country is guided, regulated, controlled and promoted according to the industrial policy. After Independence, a number of policy statements have been issued by the Government of India which define the respective roles of government, private, cooperative and joint sector organisations in industrial development. Policies also indicate the relative importance of large, medium and small-scale industrial units. In April 1948, the government adopted the first Industrial Policy Resolution, which emphasised a. progressively active role of the state in industrial development. At the same time, the policy also laid down that private organisations should play a complementary role within the framework of the policy.

In 1956 the government adopted a new industrial policy resolution with the following objectives.

i) To increase the rate of economic growth.
ii) To speed up industrial development.
iii) To enhance the scope of government participation in industrial growth.
iv) To prevent private monopoly and concentration of economic power.
v) To define the role of small, village and cottage industries.
vi) To bring about a balanced regional development.

Under the resolution, industries were divided into three categories.

I) Industries listed in Schedule A of the Resolution which would be developed as state monopolies. The development of these industries would be the exclusive responsibility of the state. These include atomic energy, arms and ammunition, heavy machinery, railways, air transport, etc.

2) Industries listed in Schedule B which would be progressively state-owned and the state would generally take the initiative in establishing new units. At the same time, private enterprises would also have the opportunity to develop in the field either on its own or with state participation.The industries in this category include aluminium, drugs, machine tools, fertilisers, road and sea-traosport, etc.

3) Remaining industries are those in which private organisations would take the initiative in establishing new units and expanding the existing industries.

In course of time the government modified some aspects of the policy adopted in 1956. But the basic policies remained more or less the same.

Industrial Licensing

As an instrument of government control and regulation, the system of industrial licensing was introduced to implement the Industrial Policy Resolution. Provision was made for that purpose in the Industries (Development and Regulation) Act, 1951. The Act has provided that no new industrial unit could be established or substantial expansion of existing plants made without a licence from the Central Government, Further, while granting licence for any new undertaking, govemment may lay down conditions regarding location, minimum size, etc.

The industrial licensing system was expected to achieve the following objectives:

1) Regulation of industrial development and guiding investment in industries according to the planned priorities and targets of growth.

2) To control monopoly and concentration of wealth.

3) Protection of small-scale industries against undue competition from large units.
4) Prevention of concentration of industries in few locations and secure regional decentralisation of industries.
5) Best possible use of scarce foreign exchange resources.

Check Your **Progress A**

1) Which of the following statements are True and which are False?

   i) The main reason for government intervention in business operations was to bring all economic activities under government ownership and management.
   ii) Planning for economic development has been the only factor which required regulation and control of industries.
   iii) Raising or lowering the rates of import duty tariff is a measure of direct control.
   iv) Indirect control includes changing the interest rates for bank lending.
   v) Small-scale industries are protected through industrial licensing.

2) Fill in the blanks

   i) Direct controls may have .... or .... effect.
   ii) Restricting imports by quota system is a type of .... control.
   iii) Grant of cash subsidy for exports is a type of ...... control.
   iv) Economic planning .... the process of industrial development.
   v) The Industrial Policy Resolution of 1956 classified industries into .... categories.
   vi) The system of industrial licensing was introduced to implement ....

16.4 WHY DOES THE GOVERNMENT PARTICIPATE IN BUSINESS?

We have learnt that the government control the private enterprises on the one hand and directly participate in the business on the other. We have already discussed about the need and forms of government control of private business. Let us now study the rationale of government participation in business.

Government today is engaged in various types of business undertakings. There are several types of services which are provided by government organisations such as electricity, water, postal, telecommunications, transport services, etc. Besides these organisations, there are many manufacturing industries owned and managed by government. They produce steel, locomotives, machine tools, watches, railway coaches. telephone equipment, and so on. Government undertakings are also involved in the supply of consumer goods like milk (through government milk schemes), bread (Modem Bakeries), cloth (National Textile Corporation), etc. Now you may ask: why does the government participate directly in business? 'The reasons for the direct participation of government in business and industry may be divided into three categories: I) basic reasons, 2) ideological reasons, and 3) specific reasons. Let us discuss about these reasons in detail.

16.4.1 Basic Reasons

The government of India was rightly convinced that political independence without economic independence would not have much meaning. It was, therefore, decided to industrialise the country in a big way as early as possible. The government felt that if the private sector was to take the initiative. it would take an unduly long time to achieve this objective of rapid industrialisation. It was so because the private enterprises lacked adequate entrepreneurship and resources to start large scale ventures. l'he government, therefore, made a Lwo-pronged attack on the problem. The government encouraged private enterprises to set up new industries, but also, went into industry in a big way.

It was decided to establish steel plants. fertiliser factories and other units necessary for industrial and agricultural growth. The following is a list of some major enterprises and power projects set up by the government within a decade of Independence.

1) Steel Plants at Rourkela, Bhilai and Durgapur
2) Chittaranjan Locomotive Works
3) Hindustan Machine 'Tools
4) Sindri Fertiliser Factory

5) Hindustan Shipyard
6) Hindustan Antibiotics
7) Hindustan Cables
8) Integral Coach Factory
9) Indian Telephone Industries
10) Power and Irrigation Projects — Tungabhadra, Bhakra Nangal, Hirakud, Damodar Valley, Chambal, etc.
11) Industrial Finance Corporation of India for providing finance to private enterprises.
12) National Industrial Development Corporation to support industrialisation in the private sector.

The intention of the government was to have economic self-reliance in as many areas and as early as possible. We have achieved this objective in a good measure.

Most of the projects set up by the government involved heavy investment, i) long period of construction (for example, a steel plant may require five to six years), and ii) low returns on investment. In many cases, however, there was a heavy element of risk which private enterprises, by and large, were not willing to take. The government, therefore, has played an important entrepreneurial role in industrialising the country. A large number of industries set up by the government would never have been established if·we had waited for the private sector to come forward and make the necessary investment and take the risk.

16.4.2 Ideological Reasons

There is another side of the picture as usual. Apart from the economic and social consideration, the government had strong ideological commitment to the philosophy of public ownership of the means of production. This is the Congress Party's appŕoach which ruled this country so far except during the brief period of 1977-79 when there was the , Janata Party Government. It is important to note that even before Independence the Congress party committed itself to socialism through ownership of the means of production. It may be noted that the Industrial Policy Resolution of 1956 which is valid till now, has greatly and clearly emphasised the need for the government in business and this-- explains the importance of the govemment owned enterprises in Indian Economy.

16.4.3 Some Specific Reasons

There are many other reasons for the govemment to participate in business. These are specific to a particular decision. Some of these are listed below.

Air **Transport Business:** Till 1953, there were many private air companies in the country. Most of these were financially unsound and had no money to invest in modem and costly aeroplanes, The air transport is of strategic importance to the country. The government, therefore, nationalised nine air companies and created Indian Airlines Corporation and Air India International Corporation in 1953.

Insurance Business: Today, the whole of insurance business is with the government. The life insurance business is operated through the Life Insurance Corporation of India and other types of insurance business through the General Insurance Corporation of India and its four subsidiary companies.

The government went into the life insurance business in 1956 nationalising scores of private companies which were not fulfilling the main objective of the life insurance business, namely, i) effective mobilisation of the people's savings, ii) spreading the message of insurance as far and as wide as possible, and iii) using the insurance funds for economic development.

Before nationalisation of life insurance business in 1955, there were only 47.8 lakh policies with a total sum assured of Rs. 1,220 crores. By the end of March 1987 there were 298.8 lakh policies with a total sum assured of Rs. 60,795 crores. Moreover, funds with the Life Insurance Corporation (LIC) are invested for national development. For Example, out of the total investment of Rs. 14,000 crores by the end of March 1987, Rs. 1,300 crores was given as loan to the State Electricity Boards and Rs. 561 crores for water supply and sewage schemes in the country. Over 50% of the investments are in government securities. Thus, savings of the nation are now being channelised for nationally important objectives,. which was not so before nationalisation, The high figures of number of policies and the sum assured also show that the message of insurance is spreading far and wide.

Similarly, the general insurance business which is now wholly run by the government companies after its nationalisation in 1971, has been given the necessary social orientation. This would not have been possible had the over 100 private companies continued to run the general insurance business.

Commercial Banks: The government today is in the banking business in a big way. Over 90% of commercial banking is in the hands of the government. What was the objective of the government in going into banking business? The government rightly wanted the banking system to serve the developmental needs of the economy in conformity with national policy and objectives. It also wanted the banks to have new criteria for advancing loans in order to benefit the weaker sections of the society. The private sector banks were not prepared to help the government to achieve these objectives and hence 14 major banks were nationalised in 1969 and six more banks in 1980. Earlier in 1955 the government had nationalised the Imperial Bank of India and had converted it into State Bank of India. This was done because the government's desire to open adequate number of branches in rural areas was not fulfilled by the Imperial Bank of India.

By the end of September 1987, we have 30,463 rural branches (56%) out of 54,163 branches of commercial banks as compared to 22% rural branches in 1969. Further at the end of June 1986, we find that the total advances of the nationalised banks for various agricultural activities were Rs. 9,231 crores for as many as 166 lakh accounts opened for this purpose. Similarly, loans to small scale industries were Rs. 7, 836 crores in 18 lakh bank accounts.

Coal Industry: The coking coal mines were nationalised in 1971. It was done because coking coal which is essential for production of iron and steel has very limited reserves in the country. The private sector was mining this fast depleting and scarce natural resources in a very wasteful manner. Other coal mines were also nationalised in 1973. The reasons for this were: i) the private sector owners did not have the necessary funds required for increasing the coal production, ii) the coal which is a scarce natural resource was being mined in a very unscientific way, and iii) the private coal miners were greatly exploiting the labour employed in the mines.

Oil Industry: In the 1970's the foreign oil companies Burmah Shell, Caltex and Esso were nationalised. Here the objective was that the government should have control over a critical and strategically important resource like oil. Today, the govemment has full control over the production and distribution of oil. And this has paid us rich dividends in terms of self-reliance and generation of resources.

Various Other Types of Business: There is yet another important reason for the government going into business of various types. Over one hundred cotton textile mills and dozens of engineering and other enterprises have been taken over by the government since Independence. This is done because the govemment cannot afford to lose production capacity which exists in the units which become sick and which the private sector wants to close down. Further, if a sick unit is closed, hundreds and thousands of employees may be out of job, which is undesirable both socially and politically.

We have listed above various nationalisation measures which show the failure of private enterprises to meet the challenge of the situation. This forced the government to step into the picture. By and large, the conclusion so far is that the government in India went into business due to economic and social compulsions.

From the above discussion we can conclude the reasons for government participation in business as follows:

1) The government's role in business in India is greatly justified by economic and social reasons.
2) Had the govemment not initiated a large number of industrial activities, the Indian economy would never have got the sound base and self-reliance which it has today.
3) A large number of enterprises have been forced on the government when they became sick and they could not be allowed to be closed down due to social and economic reasons.
4) There is an element of ideology in the role which the government has in business today. Had the ideology not been there, the government would have disengaged itself from at least some of its business activities after completing its role as path finder or initiator.

5) The government continues .to be in business in a big way because of ideological as well as economic and social considerations.

16.5 WHAT IS A PUBLIC ENTERPRISE?

We have already mentioned that the govemment owned enterprises are also called Public Enterprises (PEs). Strictly speaking the term public enterprise, as a business entity, refers to any industrial or commercial undertaking which is owned and managed by the central, state or local govemrnent and of which the output is marketed i.e. not supplied free. Thus public enterprises include manufacturing, trading as well as service organisations which are essentially business undertakings.

Public enterprises consist of nationalised private organisations as well as new enterprises promoted under government ownership and control. Life Insurance Corporation, Indian Airlines Corporation, Coal India Ltd., etc., are examples of public enterprises established by nationalising private organisations. Hindustan Machine Tools, Hindustan Antibiotics Ltd., Chittaranjan Locomotive Works, etc., are examples of public enterprises promoted by govemment.

Difference Between a Public Enterprise and a Private Enterprise

Private enterprises, on the other hand, refer to industrial and commercial organisations which are set up under individual or group ownership within the general framework of regulatory laws and rules of the government. These include manufacturing and commercial companies, medium and small firms organised as proprietory and partnership concerns.

Private enterprises are primarily motivated by private profit. Public enterprises are governed by public policies framed by government and aimed at maximising social welfare and upholding public interest. The objectives of public enterprises in India are laid down in conformity with the objectives of the development plans. They are accountable to the government and the parliament or state legislatures regarding the fulfilment of their objectives. Private enterprises are free to set their objectives and to undertake any business activity except those which are illegal. However, private enterprises are also regulated by government controls of different kinds.

16.6 FEATURES AND OBJECTIVES OF PUBLIC ENTERPRISES'

Features

The main features of public enterprises as distinguished from private enterprises are as follows:

1) Public enterprises are owned and managed by the government or agencies set up by the government.
2) The whole or major part of the capital required for the public enterprises is provided by government.
3) A public enterprise can be organised as a departmental undertaking or as a statutory corporation or as a government company.
4) These are governed by public policies laid down by the government in the public interest and are not entirely guided by profit motive.
5) Their objectives are laid down in conformity with the development plans. They are accountable to the Parliament or state legislature for their performance and fulfilment of objectives.

Objectives

It should be clear from the reasons which prompted the growth of public enterprises, that the principal objectives of these undertakings are many. The objectives are outlined below:

I) To achieve rapid economic development through industrial growth in accordance with the development plans.
2) To channelise resources in the best possible manner for economic growth.
3) To secure public welfare and to reduce inequalities' in the distribution of income and wealth.

4) To ensure balanced regional development of industry and trade.
5) To prevent the growth of monopoly and concentration of economic power in a few private hands.
6) To control the prices of essential consumer goods in the market to prevent public hardship.
7) To mobilise public savings through financial institutions to meet the demands of public and private enterprises in accordance with planned priorities.
8) To provide satisfactory employment conditions to the personnel as model employers.

Check Your Progress B

1) What is a public enterprise?

....

....

....

....

2) State whether each of the following statements is True or False?

i) Public enterprises operate mainly with profit objective.
ii) Life Insurance business in India was nationalised in 1956.
iii) Indian Airlines Corporation is an example of government in business.
iv) All public enterprises must be wholly owned by the Central government.
v) One of the objectives of public enterprises is to achieve rapid economic development.

3) Fill in the blanks.

i) Public enterprises are essentially .... undertakings.
ii) Government role in business in India is justified by .... and .... reasons.
iii) Objectives of public enterprises are laid down in conformity with .... plans.
iv) The general insurance business is operated by government through ....

16.7 PERFORMANCE OF PUBLIC ENTERPRISES

You have studied the meaning, features and objectives of public enterprises. Now the question is, how is the performance of public enterprises?

It is not easy to answer this question because there is no unanimity about the fact as to what constitutes government's business activity. For instance, some consider port trusts, railways and post office as business activities. But others do not agree with this. Further, a number of important business activities of the government operate in 25 states and eight union territories, for which information is not easily available. Many commercial activities are also undertaken by municipal corporations for which data is almost impossible to get.

The most commonly quoted figures of the extent of the government's business activity (referred to as public enterprise) relate to autonomous units of the Central government. It is so because a report entitled 'Public Enterprise Survey' covering these enterprises is presented to Parliament every year just before the budget. Look at Table 16.1 carefully. It presents the number of public enterprises, their investment, and persons employed by them for the period 1980-1987.

Table 16.1
Total Number of Public Enterprises, their Investment and Employment

As on March 31	No. of Units	Total Investment (Rs. Crores)	Number of Persons Employed (in lakhs)
1983	209	30,038	20.2
1984	214	35,394	20.7
1985	221	42,791	21.1
1986	225	50,362	21.5
1987	226	61,603	22.1

Source: Public Enterprise Survey

Look at Table 16.2 for the contribution of public enterprises in the manufacturing sector (both of the Central and State governments).

Table 16.2
Share of Public Enterprises in the Registered Factories during 1982-83

Type of Ownership	All Registered Factories		Fixed Capital		Total Employees	
	Number	% to Total	Rs. in Crores	% to Total	No. in Lakhs	% to Total
Central. State and Local Governments	5.116	5.5	26,735	65.2	21.9	27.3
Joint Sector	1,821	2.0	2,996			6.1
Private Sector	86,229	92.5	11,275	27.5	53.3	66.6
Total	93,166	100.0	41,006	100.0	80.1	100.0

Note: Fixed capital is depreciated value of all assets which have a normal economic life of one year or more.
Source: Annual Survey of Industries

Table 16.2 indicates that though out of 93,116 factories in the country, 92.5%.(86,229) were in the private sector. Their fixed capital was only 27.5% of the total.capital employed in all factories in the country.'The total employees of the private sector factories constituted 66.6% of the total persons (80.1 lakh) employed in all the factories in the country by the end of March 1983. As against this, public enterprises were only 5.5% in number but had 65.2% of fixed capital with them and had 27.3% employees. This means that public enterprises, though much less in number, are large in size as they contribute a major share in the fixed capital. Further, public enterprises are capital intensive, i.e, they employ more capital as compared to manpower.

Yet another way of showing the importance of public enterprises is their share in paid-up capital. By the end of 1987 there were 1,066 government companies with a paid-up capital of Rs. 33,793 crores. The total number of joint stock companies were about 1,50,620 with an aggregate paid-up capital of Rs. 43,614 crores. This means that the paid-up capital of the public enterprises is over 77% of all the joint stock companies in the country, though their number is less than 10%.

Apart from the huge investments and a large number of persons employed in public enterprises the areas of their operations are very diverse. They are involved in the production of heavy, medium and light engineering 'goods, transport equipment, communication equipment, basic raw materials (minerals and metals, steel, coal, petroleum, fertilisers and chemicals), consumer goods (textiles, paper, salt, footwear, etc.), and services. As a matter of fact almost the entire production and distribution of energy (coal, oil, electricity and atomic energy) is through public enterprises. The whole of the air and rail transport, manufacture of aircraft, ships, railway engines and coaches are in the public sector, Public enterprises contribute 80% of production of steel, 100% of copper and primary lead, and 87% of zinc. All the life and general insurance companies and institutions which provide long-term finance are public enterprises. Government also owns 90% of commercial banking.

With a huge amount of capital invested in public enterprises, the question is often asked whether they have been successful from the financial point of view. This is a difficult question to answer because there is no single and clear measurement of success. Different persons measure success in different ways. The most common measurement of success for business enterprises is profit on a continuous basis. Here again, opinions can differ about the quantum of profit and how one arrives at the figure of profit.

Judged in terms of financial performance, the profitability of public enterprises is inadequate. The total net profit (before payment of tax) and the total capital employed for all the 214 Central government enterprises is presented in the Table 16.3

Table 16.3

Total Profit Earned and Capital Employed by the Central Government Public Enterprises during 1984-87

Particulars	Years		
	1984-85	1985-86	1986-87
Capital Employed	36,382	42,965	51,931
Profit Before Tax	2,099	2,173	3,095
Profit as a Percentage on Capital	5.8	5.1	6.0

Further, we have to note the fact that bulk of the profit is earned in the petroleum, power and telecommunication sectors which have large elements of monopoly. Look at the Table 16:4 carefully. It presents sector-wise details of after tax profit/loss made by 214 Central government public enterprises.

Table 16.4
Group-wise Performance of Public Enterprises during 1986-87

S.No.	Group	No. of Enterprises in the Group	Net Profit or Loss (Rs. in Crores)
1)	Steel	6	(-) 26.4
2)	Minerals & Metals	14	2.0
3)	Coal'	7	(-) 331.0
4)	Power	3	233.8
5)	Petroleum	12	2,142.1
6)	Chemicals & Fertilizers	28	(-) 146.3
7)	Heavy Engineering	16	8.9
8)	Medium & Light Engineering	20	54.8
9)	Transport Equipment	13	(-) 50.6
10)	Consumer Goods	16	(-) 141.1
11)	Agro-based Products	5	(-) 4.0
12)	Textile	14	(-) 189.6
13)	Trading & Marketing	19	40.4
14)	Transportation Services	9	(-) 55.6
15)	Contracts & Construction	7	(-) 27.5
16)	Industrial Development & Technical Consultancy	11	2.9
17)	Development of Small Industry	1	(-) 0.3
18)	Tourist Services	2	(-) 0.8
19)	Financial Services	5	38.3
20)	Telecom. Services	2	201.8
21)	Non-Commercial Public Enterprises Under Section 25 of the Companies Act	4	17.2
	Total	214	1,769.1

(-) indicates loss.

16.8 CONTRIBUTION OF PUBLIC ENTERPRISES

Many people argue that if we judge the contribution of public enterprises only in financial terms, we are less than fair to them. There are many other important aspects of their contribution which cannot be ignored. Non-financial gains of public enterprises are diverse and substantial. Some of these gains are as follows:

1) Public enterprises have a great deal for the country to emerge as an industrial nation. Today, India is considered to be among the industrialised nations of the world. We are also self-reliant in many major areas of industrial production and most items of consumer goods and services.

2) They have helped the industrialisation and development of backward areas.,

3) They have also assisted the development of backward communities, particularly scheduled castes and bcheduled tribes, by providing employment opportunities.

4) Expansion of public enterprises have led to the reduction of income disparities. As 'compared to private enterprises, the salary differential between the lowest and the . highest paid employees is much less in public enterprises.

5) The constitutional objective of avoidance of concentration of economic power in few hands, has been greatly achieved by the public enterprises. In the absence of these enterprises, economic power would have gone into the hands of a few large and established business houses. It may be noted that the large business houses, which are often in the news and weild political influence, do not at present possess even one tenth of the assets owned by the public enterprises. If the industry in the hands of the government today had been with the private sector, it would have dominated the government rather than the government directing it.

6) The dealings of public enterprises with their suppliers, dealers, customers, employees and public at large have a higher level of morality than in the counter part private enterprises.

Thus, we find that public enterprises are an important instrument in implementing the nation's social and economic policies, and their success cannot and should not be measured only in terms of profit.'

16.9 PROBLEMS OF PUBLIC ENTERPRISES

We have learnt that the government in India is in business in a big way covering varied fields of activity. We also studied about the performance and contributions of public enterprises. Now let us study the limitations of these enterprises.

1) Even though public enterprises are often registered as joint stock companies like any other private sector companies, their way of working is not fully commercial. It is so because these enterprises being close to the government system, often adopt the procedures, practices and attitudes prevalent in government departments.

2) The Board of Directors of public enterprises are not fully professional. Often there is no continuity in the job of the top men.

3) There is too much job security at all managerial levels below the board and this affects the level of performance in public enterprises.

4) The system of reward and punishment in public enterprises more often resembles that in the government than in similar private enterprises.

5) Many important and large public enterprises are in areas where technology is difficult and new. And also the location is not always decided from the economic point of view.

6) The workers unions are strong and well-organised. So, they are able to extract from these enterprises more than their rightful share.

7) Most public enterprises show poor performance due to surplus manpower and low productivity of the personnel, almost at all levels, particularly so at lower levels.

8) Public enterprises are very large in size as compared to private enterprises. Of the first 20 largest industrial enterprises in the country (in terms of assets), not less than 16 are public enterprises. The complexity of managerial probiems increase in geometric progression with increase in size. The public enterprises, by and large, have not been able to adequately cope with their complex managerial and administrative problems.

9) Many constraints are also caused due to the public enterprises being subject to the government type audit by the Comptroller and Auditor General of India, and Parliament's scrutiny of their affairs.

So far right answers to many of these problems have not been found. Many expedients and remedies have been tried from time to time, but without much success.

Check Your Progress C

1) Which of the following statements are True and which are False?

   i) Most public enterprises have appointed an excessive number of professional directors.

   ii) Only a few public enterprises earn profits.

   iii) Public enterprises have not made any contribution to the public welfare.

   iv) The security of managerial jobs is the same in the public and private enterprises.

   v) The system of reward and punishment to employees is quite effective in public enterprises.

vi) Public enterprises, though smaller in number, employ larger amounts of capital than private enterprises.

2) Fill in the blanks.

i) The public enterprises have government type audit by the ....

ii) The three more profitable industries under public enterprises in 1986-87 were ....

iii) Public enterprises have helped the development of .... by providing employment opportunities.

iv) As compared to private enterprises the salary differential is .... in public enterprises.

v) Most public enterprises are lacking in .... management.

vi) Over .... percentage of commercial banking is in the hands of government.

16.10 LET US SUM UP

The evils of free enterprises and private ownership, establishment of welfare state, planned economic development, optimum utilisation of scarce natural resources, encouraging and protecting small-scale industries, protecting the economy from the dominance of foreign investors, etc., have led to the regulation and control of private business activities by government. Governmental controls may be classified into: i) direct controls, and ii) indirect controls. Direct controls include such measures as licensing of new manufacturing enterprises or expansion of the same, subsidies for promoting exports, quota restrictions on imports and exports, price control and rationing of goods, etc. Indirect controls consist of measures like levy of customs duty on imports or exports, changing the rate of interest on bank loans, and so on.

The need for direct government participation in business may be explained by three types of reasons: i) basic reasons, ii) ideological reasons, and iii) specific reasons. The term 'public enterprise' as a business entity refers to any 'business undertaking which is owned and managed by the central or state or local government, and of which the output is marketed i.e., not supplied free of charge. These enterprises are governed by public policies framed by government and aimed at maximising social welfare and upholding public interest. They are accountable to the government and the Parliament or state legislatures regarding the fulfilment of their objectives. The justification of public enterprises may lie in the following:

1) The inability or unwillingness of private entrepreneurs to invest in industries which are crucial for rapid industrial growth.

2) Need for balanced regional development.

3) Bringing about greater equality of income and wealth.

4) Prevention of concentration of economic power and monopoly in the private sector.

5) Fulfilment of the priorities and targets laid down in development plans.

6) Larger resources at the disposal of government to promote basic and heavy industries.

The main features of public enterprises are : government ownership and control, contribution of capital by the government, governance by public policies, objectives in conformity with development plans, accountability to legislature, etc. The objective of public enterprises are: rapid industrialisation, channelising resources for development, reduction of inequalities in the distribution of income and wealth, balanced regional development, control of monopoly power and concentration of wealth, check of rise in prices, mobilisation of public savings, provision of satisfactory employment conditions, etc.

Judged in terms of financial performance, the profitability of public enterprises is quite inadequate. A large number of public enterprises are running in losses. Enterprises in the petroleum, power and telecommunication industries which have large elements of monopoly are earning profits. However, contribution of public enterprises in certain respects cannot be ignored, There are many problems and limitations associated with the working of public enterprises.

16.11 KEY WORDS

Capital Employed: Total fixed assets less accumulated depreciation plus working capital. The working capital means all current assets less current liabilities and provisions.

Industrial Policy Resolution: It is a formal decision of the government in the form of a resolution regarding its industrial policy, including the place which the public and private enterprises would have in the economy.

Public Enterprise: Is an industrial, commercial or business activity of the government, where a return on investment is expected.

Socialist Pattern of Society : Broadly it means a system in which the benefits of economic development accrue more and more to the relatively less privileged classes of the society and there is an effort to avoid concentration of wealth and to reduce disparities of income.

16.12 SOME USEFUL BOOKS

Bhushan Y.K., *Fundamentals of Business Organisation and Management*, Sultan Chand & Sons: New Delhi, (Part Nine, Chapters 4 & 5).

Ghosh, P.K., 1982, *Public Enterprise in India*, Book World: Calcutta, (Chapters I & 2).

Khera S.S., 1963, *Government in Business*, Asia Publishing House: New Delhi, (Chapter I).

Kolesov, V., 1980, *The Public Sector*, Sterling Publishers: New Delhi, (Chapter 2).

Laxmi Narain, 1988, *Principles and Practice of Public Enterprise Management*, S. Chand & Co.: New Delhi, (Chapters 1 & 2).

Rarnesh, M.S., 1985, *Principles and Practice of Modern Business Organisation, Administration & Management*, Kalyani Publishers: New Delhi, (Volume I, Chapter 8).

Singh, B.P., and Chhabra, T.N., 1988, *Business Organisation and Management*, Kitab Mahal: Allahabad, (Part One, Chapters 43 & 44).

16.13 ANSWERS TO CHECK YOUR PROGRESS

A 1) i) False ii) False iii) False iv) True v) False

2) i) Positive, negative ii) direct iii) indirect iv) guides v) three vi) the industrial policy resolution

B 2) i) False ii) True iii) True iv) False v) True

3) i) business ii) social, economic iii) developmental iv) General Insurance Corporation

C I) i) False ii) True iii) False iv) True v) False vi) True

2) i) Comptroller and Auditor General of India ii) petroleum, power, telecommunications iii) backward communities iv) much less v) efficient vi) 90

16.14 TERMINAL QUESTIONS

1 What is a public enterprise? What are its characteristics? How is it different from a private enterprise?

2 Explain fully the reasons underlying Government control over private business activities.

3 Distinguish between the following with examples:

i) Inducive and restraining controls.

ii) Direct and indirect controls.

4 Why is it necessary for government to directly participate in business and industry?

5 Write short notes on:

i) Extent of government participation in business.

ii) Rationale of public enterprises.

6 Outline the nature of problems and limitations associated with the operation of public enlerprises.

7 Comment on the financial performance of public enterprises in India. In what respects the public enterprises have made a positive contribution to the well being of the nation?

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

UNIT 17 FORMS OF ORGANISATION IN PUBLIC ENTERPRISES

Structure

17.0 Objectives
17.1 Introduction
17.2 Departmental Organisation
- 17.2.1 Features
- 17.2.2 Merits
- 17.2.3 Limitations

17.3 Public Corporation
- 17.3.1 Features
- 17.3.2 Merits
- 17.3.3 Limitations

17.4 Govemment Company
- 17.4.1 Features
- 17.4.2 Distinction Between Govemment and Non-government Companies
- 17.4.3 Merits
- 17.4.4 Limitations

17.5 Comparison of the Forms of Organisation
17.6 Let Us Sum Up
17.7 Key Words
17.8 Some Useful Books
17.9 Answers to Check Your Progress
17.10 Terminal Questions

17.0 OBJECTIVES

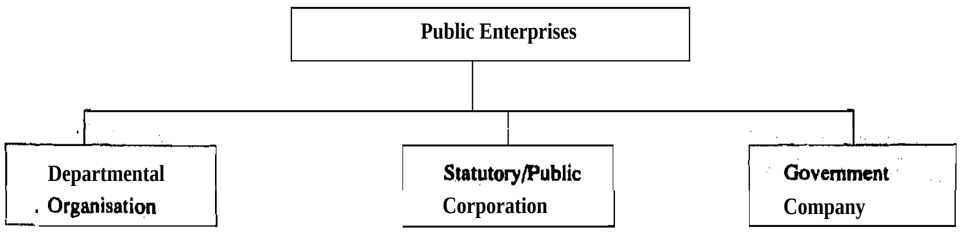
After studying this unit, you should be'able to:

- describe various forms of organisation in public enterprises
- describe the features of each form of organisation
- explain the merits of each form of organisation
- evaluate the suitability of each form of organisation.

17.1 INTRODUCTION

In Unit 16 you have studied the meaning, objectives, features, merits and limitations of. public enterprises. But, what are the forms of organisation in public enterprises? Are the forms of organisation in public enterprises same as private enterprises? As you know (Unit 2) the business enterprises promoted by private entrepreneurs are organised in any of the following three forms: 1) sole proprietorship, 2) partnership, and 3) joint stock company. But, the forms of organisation in public enterprises are different. In the case of public enterprises there are three forms of organisation: 1) departmental organisation, 2) public corporation, and 3) government company. Look at Figure 17.1 for the forms of organisation in public enterprises. In this unit we shall discuss about the features, merits and limitations of each of these three forms of organisation and evaluate which form is suitable under a given situation.

Figure 17.1
Forms of Organisation In Public Enterprises



17.2 DEPARTMENTAL ORGANISATION

Departmental form of organisation is the oldest form of organising public enterprises. Under this form of organisation, business activities of the undertakings are conducted under the overall control of one of the departments of the govemment. In other words, when a public enterprise is organised, financed and controlled in much the same way as any other government department. it is known as 'departmental form of organisation.' This form of organisation is generally, chosen for such undertakings which are important from the view point of public interest and national interest. This form is suitable for most of the undertakings which are not run on pure commercial principles. Departmental form of organisation, generally, is suitable under the following situations:

i) Where the basic purpose of an enterprise is to procure revenue for the government.

ii) Where the government desires to have firm control over service sectors keeping in view public interest (e.g., posts and telegraph, broadcasting, etc).

iii) Where maintenance of secrecy is regarded as a matter of strategic importance (e.g. atomic energy, defence industries, etc.).

iv) Where projects are in earlier stage of initial planning and require constant efforts and continuous funds that can be provided only by the government.

However, the latest trend seems to favour the participation of private enterprises even in defence industries. For instance, the Bharat Electronics Ltd., which is a stale owned undertaking, is given a company form of management. A part of the telecommunication services was converted into two joint stock companies in 1981. One of them is called the Videsh Sanchar Nigam Ltd., which is responsible for the overseas telecommunication service; the other is the Mahanagar Telephone Nigam Ltd., which is responsible for telephone systems in Bombay and Delhi.

17.2.1 Features

The main features of departmental form of organisation are as follows:

1) Overall control rests with the minister: Under this form of organisation, overall responsibility of management rests with the minister under whose ministry the undertaking functions. The minister, in turn, delegates authority downwards to the various levels of the organisation. Thus, the line type of authority relationship is represented between executives at different levels. In some cases, to manage the day-to-day operations, the government may appoint a Board. The examples of such Boards are the Railway Board, the Postal Services Board, the Telecommunications Board, etc. However, in this form of organisation, the overall responsibility rests with the minister and the minister is answerable to the legislature for the efficient operation of the undertaking.

2) Employees are the **civil servants:** The employees in the case of departmental organisation are civil servants. For example, Union Public Service Commission (UPSC) is responsible for the recruitment of gazetted personnel in railways and postal services (which are departmental organisations) as it is for administrative and police service. The terms and conditions of service of the employees are also the same as for the other government employees.

3) **Financed through** budget appropriations: The finances of a departmental form of organisation are not independent of the govemment. They are financed out of the government treasury through the annual budget appropriations and its revenues are paid into the treasury. For example, railways and postal (they are departmental organisations) budgets form part of the government budget.

4) Accounting and auditing systems: This form of organisation is subject to budget, accounting and audit controls. For this purpose, the undertaking is treated on par with other government organisations. .

5) Sovereign **immunity:** Being an integral part of the govemment, it enjoys the sovereign immunity of the state: Therefore, it cannot be sued without the consent of the government.

17.2.2 Merits

You have learnt about the meaning and features of departmental form of organisation. Now let us discuss about the merits of this form of organisation.

1) Maximum degree of government control : This form of organisation lends itself to the maximum degree of government control. Therefore, government can met its social obligations very effectively.

2) Limited scope to misuse public funds: As you know, departmental undertakings are managed by the concerned ministry. Hence, the accountability of the enterprise to Parliament is complete. You have also learnt that these undertakings are treated on par with other government departments for purposes of budgeting, accounting and auditing. Therefore, the danger of misuse of the public funds is reduced. In the words of Krishna Menon's Committee 'the accountability of departmental undertakings to Parliament is complete, their management being under the ministry concerned'.

3) Governmental control over economic activities: It provides an opportunity for the government to secure absolute control of economic activities. The government can freely use departmental undertakings as instruments of its social and economic policy.

4) Multiplies economic progress: The surplus coming from departmental undertakings increases the revenue of the government. Thus, this surplus can be utilised for the economic progress of the nation and the welfare of the masses.

5) Responsible to Parliament: A departmental enterprise is responsible to Parliament even for its day-to-day operations. It is not possible for a departmental enterprise to claim certain privileges from Parliamentary scrutiny. For example, if members of Parliament ask questions regarding the appointment or dismissal or promotion of a particular employee, or regarding a particular sale or purchase transaction, it is a matter of day-to-day operations. Such a question can be allowed to be asked of a departmental enterprise but not of a statutory corporation or a government company.

17.2.3 Limitations

Departmental form of organisation suffer from the following limitations:

1) Bureaucracy and red-tapism: You know that the staff of these departmental undertakings are the civil servants. So it is too close to the bureaucratic system of the government where much importance is attached to rules, regulations and precedents for every decision. Therefore, scope for initiative is limited. Normally a business enterprise needs much flexibility and quickness in decision making which you do not find in the departmental form.

2) Suffers from political instability: These undertakings are generally at the mercy of the political party which is in power. The fate of departmental undertakings also depends on the balance of power between the ruling party and the opposition. Hence there is even a possibility of victimising such undertakings because of political changes and political instability. Thus, these undertakings are subject to political changes and attacks motivated by political considerations.

3) Excessive parliamentary control: You have learnt that the departmental undertakings are completely answerable to Parliament even for their day-to-day operations. As a result there is less scope for any initiative and skill in the departmental organisation. Every detail relating to their working are scrutinised and question in Parliament and outside. This causes delay in making vital decisions relating to the organisation.

4) Lack of professional expertise: These undertakings, as you know, are managed by civil servants who often lack business acumen. They are selected and trained altogether for a different purpose. Regid adherence to formalities and procedures causes delays in decision making which is quite opposed to business principles. Besides, there is no bar on transfers of these officers. This hampers their understanding commitment and responsibility.

5) Absence of competition and profit motive: Departmental undertakings are run with the objective of service motive. So, the commercial principles which are necessary for their very success are neglected. Further, due to lack of competition there is little incentive to improve their operational efficiency.

6) Financial constraints: You know that these undertakings are financed through annual budget appropriations made by the legislature and its revenues are paid into the treasury. They are not allowed to raise finances on their own and depend completely on the government. As a result, sometimes, these undertakings suffer due to shortage of funds. Further, these enterprises do not have much flexibility in financial matters, as they are subject to budget, accounting and audit controls.

Check **Your** Progress A

1) What are the forms of organisation in public enterprises?

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2) What is a departmental form of organisation in public enterprises?

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3) State whether each of the following statements are True or False.

i) Under departmental form of organisation overall control rests with the managing director.

ii) **A** public enterprise organised under departmental form can raise the capital by public issue of shares.

iii) The staff working under departmental form of organisation are the civil servants.

iv) In departmental form of organisation, individuals are not allowed to subscribe to the capital.

v) Departmental form is suitable when the enterprise is working with profit motive.

vi) Departmental form of organisation is not suitable where maintenance of secrecy is regarded as a matter of strategic importance.

vii) Departmental form of organisation suffers from red-tapism and bureaucracy.

viii) Personnel working in departmental undertakings are not subject to transfer.

17.3 PUBLIC CORPORATION

Public corporation is a corporate body created by the Parliament or State Legislature as the case may be, by a special Act which defines its powers. duties, functions, immunities and the pattern of management. Public corporation is also known as statutory corporation. The capital is wholly subscribed by the government. It is managed by the management committee constituted according to the provisions of the Act. It is answerable to the Parliament or State Legislature as the case may be.

As stated by Roosevelt, public corporation is an organisation which is clothed with the power of the government but is possessed of the flexibility of private enterprise. Herbet Morrison views a public corporation as a combination of public ownership, public accountability and business management for public ends. Thus the public corporation device is an attempt to combine public interest with the flexibility of operation most prominently found in a company form of orgartisation working in the private sector.' Normally, the public corporations are constituted for any of the following purposes:

i) To transfer the business of a nationalised undertaking to the corporation.

ii) To facilitate the acquisition of undertakings belonging to an existing company.

iii) To promote, develop and operate certain schemes.

iv) To extend certain social services and utility-services.

v) To provide for regulation and control of the working and operations of an institution or for other matters connected therewith or incidental thereto.

The development of the public corporation is largely a post-independence phenomenon. The first public corporation was the Damodar Valley Corporation which was established under a Parliament Act in 1948. It is a multi-purpose river project. In the same year, the government set up the Industrial Finance Corporation of India to provide finance for industries in the private sector. In 1953 when the Indian Airlines and Air India were set up, the Air Corporations Act was passed. In 1955 the State Bank of India was established through the State Bank of India Act and the Life Insurance Corporation of India was set up through the Life Insurance Corporation Act of 1956. Thus, we find that whenever the government wants to undertake a commercial activity, it goes to Parliament and gets approval to set up a distinct entity.

It may be noted that it is not necessary that each corporation will have an Act of its own. More than one statutory corporation can also be established under the same act of the legislature. For example, the State Electricity Boards have been established in most of the states under the Electricity (Supply) Act of 1948. Similarly, most of the States have State Financial Corporations set up under the State Financial Corporations Act of 1951.

17.3.1 Features

You have studied what a public corporation is. Now let us discuss about the main features of the public corporations.

1) **Created by a special Act of legislature:** Public corporation is an autonomous corporate body created by a special Act of a legislature as the case may be. The Act defines the powers, duties, privileges, immunities, relationship to the government department, etc.

2) **It is a corporate body:** A corporation, like a joint stock company (Unit 2), is a legal entity. It means that a corporation is an 'artificial person' which exists in the eyes of law. Like a living being, it can enter into contracts and can transact any business under its own name. Since it does not have physical existence, it operates through its agents, which is its Board of Directors.

3) **Owned by the State:** It is Fully owned by the state and the capital is wholly subscribed by the state.

4) **Managed by a Board of Directors:** It is managed by a Board of Directors constituted according to the provisions of the Act. The members of the Board represent various interests and are appointed by the concerned public authority.

5) **Answerable to legislature:** Public corporation is answerable to legislature (Parliament/ State Assembly) which creates it. The way the corporation would be held accountable is mentioned in the Act. Parliament is not expected to interfere in its day-to-day working. But it can discuss matters of policy and the overall performance of the corporation. Sometimes, however, questions are asked and answered on the floor of the house even though they relate to the day-to-day functioning of a corporation. You may ask why this happens. Parliament in a democracy is supreme and it is not possible to curtail its freedom. Further, when public enterprises are mismanaged. Parliament cannot be stopped from enquiring into their performance even though it may involve infringement of a principle agreed to by Parliament itself.

6) **Relation with the government:** Even though a statutory corporation is owned by the government, it does not operate as a wing or part of' the government. The legal relationship and channels of communication between the government and the corporation are laid down in the Act of its incorporation. For example, the Life Insurance Corporation which is a statutory corporation, would be guided on matters of policy involving public interest as per the directions issued in writing by the Central Government. Thus, the relationship with the government is formal and clear.

In practice, however, there is a lot of informal dealing with the statutory corporations. An example would clarify as to how this happens. Suppose the government wants the Indian Airlines to operate a service between Delhi and Imphal which is not being run by the Indian Airlines because it is uneconomical. Now, under the Air Corporation Act, the government can ask the Indian Airlines to run a service by issuing a written directive. But the government will only suggest the Airlines to undertake such service. If there is a formal order by the government, it may have to meet the loss, if any, suffered by the Indian Airlines in carrying out its orders. In many matters, therefore, the government prefers to remain informal and get things done without owning the responsibility for its actions.

7) **Own staffing system:** Although a corporation is owned and managed by the government, its employees are not government servants. The employees are recruited, remunerated and governed by the rules and regulations laid down by the corporation. Their pay and benefits are also different from those of the government servants. Thus, the corporation can have the necessary freedom in regard to its employees in runnińg its business. However, the government closely regulates the terms and conditions of employment of corporations, but that is mainly to maintain uniformity in the pay and benefits received by the employees of the various corporations.

8) **Financial independence:** A major source of autonomy of a statutory corporation is its independence in respect of its finances. Unlike departmental form of organisation, a public corporation is not subject to the budget, accounting and audit controls. The corporation shall have its own funds and all receipts of the corporation'shall be credited thereto and payments shall be made therefrom. Once the funds are given to a corporation, it manages them on its own. It does not have to go to the Parliament to get its budget approved. A corporation can also borrow money within and outside the country after getting approval from the government.

17.3.2 Merits

Public corporation strikes a mid-way between departmentally run public undertakings and the privately owned and managed corporate bodies. It absorbs some of the salient desirable features of both of them to fetch the best of both forms. At the same time, it eliminates some of their major weaknesses also. Let us discuss about the merits of a public' corporation form of organisation.

1) **Initiative and flexibility:** As it is an autonomous corporate body set up under an Act of legislature, it manages its affairs independently with its own initiative and flexibility. It experiments in new lines, exercises initiative in business affairs and enjoys the operational flexibility as in private enterprises.

2) **Avoids red-tapism:** The evils of red-tapism and bureaucracy associated with departmental form of organisation are avoided. Business functions cannot be carried out efficiently in a government set-up, which is marked by rules, regulations and procedures. Compared with a departmental organisation a public corporation can take quick decisions and prompt actions on any matter affecting its business.

3) **Easy to raise capital:** Public corporations are government owned statutory bodies. They can easily raise required capital on their own whenever needed by floating bonds at relatively lower rates of interest. Public also comes forward to subscribe to such bonds since they are safe.

4) **Protects public interest:** As you know, compared to a departmental organisation, a public corporation is relatively free from political interference, parliamentary enquiry and departmental checks and controls. Although it has a considerable degree of administrative autonomy, its policies are subject to Parliamentary control. Thus, it ensures protection of public interests. Further, the Board of Directors of the public corporations consists of persons from various fields such as business experts and the representatives of special interests like labour, consumers, etc., who are nominated by the government. Thus, exploitation of any class at the cost of another is ŕuled out.

5) **Works with service motive:** Public corporation avoids the defects of profiteering, exploitation, illegitimate speculation, etc., which are often associated with private

enterprises. A public corporation works primarily with service motive and profit earning is only a secondary consideration. Though it works efficiently to show good results in the form of 'surplus,' such surplus must not be the result of exploitation. The surpluses generated by the public corporations are used for the good of the consumers and the community.

6) **Secures working efficiency:** It secures greater working efficiency by providing better amenities and more attractive terms of service to its employees which in turn; reduces the labour problems.

7) **Secures benefits of large scale economies:** Economies of large scale operations are realised by the virtue of increased size and scale of the business. Further, it is easy to reap considerable economies in management by affecting the integration of several companies under this form. For example, giant government undertakings organised as autonomous units such as, banking, insurance, transport, etc., can secure better management and staff with comparatively lesser costs.

17.3.3 Limitations

You have learnt about the merits of public corporation form of organisation. This form of organisation also suffers from certain limitations.

1) **Less autonomy:** Compared to departmental form, public corporations enjoy more autonomy. But, in practice, the autonomy of public corporation is closely and systematically controlled by the government even in matters where they are supposed to have freedom. For example, the Food Corporation of India and the Electricity Boards in various States (these are statutory corporations) are of important to the government and to the public at large. But, the Central and State Governments often find it difficult to allow them the freedom which they are entitled to as per their Acts.

2) **Inflexibility:** A public corporation is set up by a special Act of legislature. Any change in the objects and powers of the corporation requires an amendment in the Act by the legislature. This tends to make a corporation inflexible and insensitive to changing situations.

3) **Clash amongst divergent interests:** As you know, the corporations are owned by the government and are managed by a Board of Directors appointed by the govemment. When the Board of Directors represent different interests there may be clash of interests. This in turn, may hamper the smooth functioning of the corporation. Sometimes, the directors may abuse their autonomy and authority by indulging in undesirable practices. This would defeat the social objectives of public corporation.

4) **Ignores commercial principles:** Public corporations do not have to face any competition. They are neither guided by profit motive nor haunted by the fear of loss. Therefore, there is a possibility of ignoring commercial principles in their working. This may ultimately lead to inefficiency and losses to the corporation. The losses, thus arising are met by the govemment through subsidies.

5) **Excessive public accountability:** You know that the public corporations work with the service motive rather than profit motive. This public accountability of the corporation sometimes acts as a stumbling block in the operational efficiency of the enterprise.

Check Your Progress B

I) What is a public corporation?

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2) List the features of a public corporation.

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3) Fill in the blanks.

i) For public corporation capital is fully subscribed by ....

ii) Public corporation is created by a ....

iii) Public corporation is managed by ....

4) State whether each of the following statements are True or False.

i) Members of the Board of Directors of a public corporation are elected by the public.

ii) Capital of public corporation is partly subscribed by the private entrepreneurs.

iii) Public corporations can raise required capital on their own.

iv) The employees of a public corporation are government servants.

v) The budget of the public corporation is to be approved by Parliament every year.

vi) Members of the Board of Directors of a public corporation are nominated by the concerned public authority.

17.4 GOVERNMENT COMPANY

According to the Indian Companies Act. **a government company is a company in which 51 per cent or more of the total paid-up capital is held by the central government or any state government or by many state governments or partly central government and partly by one or more state governments. Any company which is subsidiary of such a company is also considered a government company.** Thus **a** government company is an enterprise wherein government is a predominant shareholder having the bulk of controlling interests, Government company is registered under Indian Companies Act. When the government applied to the Registrar of Joint Stock Companies for setting up a new company, it has to follow all the rules and procedures as are applicable to private persons. Just because the government is getting a company registered it does not get any concession in regard to the formal requirements. You have studied about the formalities and procedure of registration of a company in Unit 4.

Of late, we come across mixed-ownership companies wherein capital is jointly held by the state and private (Indian or foreign) interests. A government company in which both the government and private (enterprises/individuals) are shareholders, is known as a **mixed-ownership company.** The Government of' India has registered and organised a large number of its commercial and industrial undertakings mostly as private limited companies even though their control and regulation actually rests with the government by virtue of its owning majority of shares. But why does the government do like that'? Government, normally, establishes the company form of organisation for the following reasons.

1) **Public interest :** Government sometimes acquires shares of the existing private enterprises when they are unprofitable or have become insolvent or are in financial crisis. Government acquires such companies in the interests of the country. Eastern Shipping Corporation and Hindustan Shipyard Ltd., are examples of the companies taken over by the Government of India.

2) **Mixed-ownership :** Sometimes, in order to secure capital, technical knowhow, expert guidance, etc., the government may be desirous of starting an enterprise in association with private entrepreneurs. In such situations, the government may set up mixed-ownership companies. The examples of mixed-ownership companies are Hindustan Machine Tools, Hindustan Shipyard Ltd., Heavy Engineering Corporation, Hindustan Cables, etc.

3) **Industrial promotion :** In order to encourage industrial promotion, sometimes, government may establish some companies. Such companies are not directly connected with any manufacturing activity, but they are expected to bring out commercially

feasible projects to be eventually established in private or public sectors. National Industrial Development Corporation, and National Small Industries Corporation are some examples in this category.

4) **Promotion of trade·or commerce :** Government may also establish some companies to promote trade or commerce. State Trading Corporation, Export Credit & Guarantee Corporation (ECGC), etc., are some examples.

5) **Lack of incentive :** The private entrepreneur does not come forward to establish enterprises because of certain risks such as longer gestation period, heavy investment outlay, lack of profit in the initial years of its formation, etc. In such cases the government may establish government companies.

17.4.1 Features

The basic features of a government company are the same as those of a statutory corporation. However, there is one major difference i.e., an act of legislature (central/state) is necessary for establishing a statutory corporation while a government company does not require it. This difference has some constitutional implications. You would leam about the distinction between public corporation and government company in this unit later. The other features of the government company are about the same as those of the statutory corporation. Now we shall discuss the features of government company in detail.

1) **Created under Indian Companies Act :** Government company is a corporate body created under the Indian Companies Act, 1956, like any other joint stock company in the private sector. With regard to registration, memorandum, articles, meetings, capital structure, accounts, audit, etc., it is governed by the provisions of the Companies Act. But the government has the authority to exclude or modify certain provisions of the Companies Act by special notifications duly approved by the legislature.

2) **It is a corporate body :** A government company is a legal entity. It is an 'artificial person' which exists in the eyes of law. Like a living being it can file a suit in a court of law or be sued, can enter into contract and acquire property in its own name.

3) **Scope for private participation in the capital : A** government company may be wholly or partly owned by the government. In any case, the share of the government is not less than 51%. In case it is partly owned by the government, the private persons (individuals as well as corporate bodies) can also participate in the capital. Thus, there is scope for the private sector to participate in the capital.

4) **Managed by a Board of Directors :** It is managed by the Board of Directors. All the directors or the majority of them, depending on the extent of private participation, are appointed by the government. While constituting the Board the government may give representation to various interests like technocrats, labour, consumers, foreign . collaborators, etc.

5) **Enjoys financial independence :** Government company can use and reuse the revenue derived from the sale of its goods and services. If necessary, it can borrow money from the financial institutions and the general public.

6) **Independent staffing :** Its employees are not civil servants. They are appointed by the company on its own terms and conditions. It regulates its personnel policies according to its Articles of Association.

7) **Independent accounting and auditing system :** It is exempted from the accounting and audit laws and procedures applicable to government departments. Its accounting practices are more akin to those of commercial enterprises and its auditors are chartered accountants appointed by the government on the advice of the CAG.

8) **Annual reports :** Its annual reports and accounts alongwith the audit reports are to be presented to the legislature, as per the Companies Act.

17.4.2 Distinction Between Government and Non-government Companies

There are certain differences between a govemment companies and other joint stock companies called 'non-government companies'. They are as follows:

1) **Paid-up capital :** In the case of a government company not less than 51% of the paid-up share capital is held by the central govemment or by the state government or jointly by the central or one or more state governments. There can be any combination of the shares owned by the central and state governments. But the total paid-up capital owned by one or more governments should be 51% or more, to make it a government company. It may be noted that there are a few government companies which have private participation in the equity. In the case of non-government companies, major share of the paid-up capital is held by the private individual.

2) **Auditor appointment :** The auditor of a government company is appointed by the government on the advice of the Comptroller and Auditor General of India (CAG). He is also empowered to direct the auditor about the manner and method of auditing. Sometimes, the CAG himself carries out the audit of government companies under the Companies Act. The Auditor of a non-government company is appointed .by the General Body of the company.

3) **Annual reports :** The annual reports alongwith audit reports of government companies are laid before Parliament if it is a central government company, and before the state legislature in case of a state government company. In case of a non-government company, the audit reports are laid before its General Body.

4) **Provisions of the Companies Act :** Central government has the power to exempt any provision of the Companies Act from applying to a government company except the provisions regarding audit. But, central government has nothing to do with regard to the provisions of the Companies Act relating to a non-government company.

17.4.3 Merits

You have learnt about the meaning and features of government company form of organisation in public enterprises. Now let us discuss about the merits of this form of organisation.

1) **Easy to form :** Most of the public enterprises in India are in the form of joint stock companies. The main reason for this is the ease with which the government can form a company. Whenever the need arises to take up a new activity, the governrnent can float a new company. It can avoid all the problems of getting a bill passed by the legislature, as is required when a statutory corporation is to be set up.

2) **Easy to bring changes in the constitution :** Government favours this form because it is easy to bring changes in the constitution through amendments to Articles. Most of the government companies are fully-owned by the government. As the sole shareholder, the government has all the right to amend the Articles of Association of the company and pass resolution in the meeting, when the need arises.

3) **Facilitates taking over a running enterprise :** This fonn facilitates taking over a running enterprise by the government after securing a majority interest in the equity of the company. For example, after acquiring the equity of the Burmah-shell group of companies, the government changed their name to Bharat Petroleum Corporation Ltd., which now operates as a government company. In the same way, dozens of private sector companies which were taken over by the government are running as government companies, with or without a change in name.

4) **Facilitates private participation :** This form of organisation facilitates private participation in the equity of public enterprises. If the government wants. it can easily do so by selling a part of the equity of a government company to the public at large.

5) **Easy to transfer ownership :** This form is also helpful in disposing of a public enterprise easily. Once the price at which the shares are to be transferred is decided, the transfer of ownership becomes easy by selling the shares to the private party.

6) **More autonomy :** It has almost all the advantages available in the public corporation form of organisation. It has its own charter, autonomy of operations, self-sufficiency in finance, freedom in personnel matters, etc.

7) **Flexibility in operations :** As you know, the employees of the government company are not the civil servants. So, the evils of red-tapism and bureaucracy associated with departmental form of organisation are avoided. This enables a government company to take decisions and prompt actions on any matter affecting its business.

17.4.4 Limitations

The government company form of organisation suffers from the following limitations:

1) **Evades constitutional responsiblity :** The government company can be created without specific approval of Parliament. Parliament does not discuss the reasons for setting up a government company or its constitution. Thus it evades constitutional reponsibility.

2) **Government interference :** Being the sole shareholder in most cases, the government can revise the Memorandum and Articles of Association of a government company, whenever necessary. Thus, the constitution of a government company can be altered without any public discussion but public scrutiny is necessary in the case of a statutory corporation. This may affect the autonomy of the company.

3) **Fear of piiblic accountability :** The directors and chief executives of a government company always have the fear of public accountability. As a result, they may not take the initiative in breaking new ground and in entering into new areas of activities.

4) **Public criti'cism :** The performance of a government company is shown in the annual reports of the ministry concerned. These annual reports are placed before the Parliament or State Legislature as the case may be. As such, they become public documents exposing the enterprise to the glare of public criticism.

5) **Lack of professional management :** As you know, the directors of a government company are mostly appointed by the government. So, these enterprises fail to achieve business efficiency found in similar enterprises in the private sector.

Check Your Progress C

1) What is a government company?

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2) Fill in the blanks.

   i) The auditors of a government company are appointed by the .... on the advice of the ....

   ii) To become a government company, the minimum percentage of the paid-up capital to be held by the government is ....

   iii) Most of the public enterprises in India are organised in the form of ....

   iv) Government company is created under the .... Act.

   v) Government company is managed by a ....

3) State whether the following statements are True or False.

   i) The General Insurance Corporation of India is a government company.

   ii) The government company is a corporate body.

   iii) The government has the right to run a government company as it likes.

iv) All the funds of government companies are always provided by the government,

v) A government company is free to employ persons according to its requirements without any reference to government.

vi) A company with 51% or more shares owned by the government is a government company.

vii) The government can exempt government companies from the application of some of the provisions of the Companies Act.

17.5 COMPARISON OF THE FORMS OF ORGANISATION

We have already discussed the features and limitations of each of the three forms of organisations i.e., departmental organisation, statutory corporation, and government company. Now let us compare the features of these three forms and evaluate which form is suitable in a given situation. Look at Table 17.1 which summarises the features of all the three forms.

Table 17.1
Comparative Study of the Three Forms of Organisation in Public Enterprises

S.No.	Basis	Departmental Organisation	Public Corporation	Government Company
1)	Formation	Created by the government and attached to a particular ministry	Comes into existence by a special Act of legislature.	Formed by ministry under the Companies Act.
2)	Legal Status	No separate legal status.	It is a separate legal entity.	It is a separate legal entity.
3)	Management	Managed by the concerned ministry of the government.	Managed by the Board of Directors nominated by the government.	Managed by the Board of Directors consisting of members nominated by the government plus the elected shareholders.
4)	Capital	Provided wholly by the governnient out of budgetary appropriation.	Fully subscribed by the government.	Minimum of 51% by tlie government.
5)	Scope for Private Participation	No scope for private participation.	No scope for private participation.	Scope for private (national/ international) participation in its share capital and hence in its affairs too.
6)	Operational Autonomy	Least or no autonomy. Works as a part and parcel of the government.	Works as an autonomous body within the provisions of tlie Act. Enjoys considerable degree of autonorny as there is no government interference in day-to-day affairs.	Runs on commercial principles like a private enterprisr and enjoys higher degree of freedom from govemment interference.
7)	Flexibility	Subject to government control completely. Subject to budget, accounting and audit procedures of the government.	Subject to some restrictions by the government. Not subject to budget, audit and accounting procedures of the govt.	More freedom from government control. Not subject to audit budget and accounting procedures of the governnlent.
8)	Public Accountability	Concerned Minister is accountable to the legislature.	Accountable to the public through legislature.	Government and the concerned ministry is accountable to the public.
9)	Operating Finance and Borrowing Powers	Budgetary allocation only. No powers to borrow. Its revenues are paid into the treasury.	Makes own arrangements and enjoys borrowing powers. It has authority to use its revenues.	Makes own arrangements and enjoys borrowing powers. It has the authority to use tlie revenue.
10)	Staffing and Terms of . Service	Employees are the civil servants and governed by civil service code.	Employees are not civil servants. Employees governed by its own contract of service.	Employees are not civil servants. Employees governed by its own contract of service.

The comparison of the features of the three forms of organisation clearly shows that the accountability to legislature and the government control are maximum in departmental organisation and minimum in government company. In the matters of staffing, financing and day-to-day operations, the departmental organisation has the least autonomy while the company form enjoys the maximum autonomy. Similarly, departmental form of organisation is the least flexible while company form enjoys the maximum flexibility. The main features of the public corporation and government company are about the same. There is hardly any difference in the working of these two forms of organisation. For example, the Life Insurance Corporation of India is a statutory corporation, but the General Insurance Corporation of India is a govemment company. But both of them function alike in respect of their working and management.

The main difference, however, is that the public corporation is established by a special Act of legislature while the government company is incorporated under the Companies Act without referring to legislature. There is scope for private participation in capital and management in the case of government company whereas there is no such scope in a public corporation. Then the company form of organisation is able to evade parliamentary control.

From this relative assessment of the features of these three forms of organisation, it should be obvious that company form of organisation is best suited to industrial and commercial undertakings, while statutory corporations should be preferred in the case of public utility undertakings. To run efficiently the Industrial and commercial enterprises must have maximum autonomy of management and manned by professional managers so as to ensure their functioning on business lines. For such enterprises, it is essential that there is least interference from the Ministry or Parliament in their day-to-day affairs. Besides, there should be adequate flexibility with regard to formulation of policy and strategy. With the company form of organisation, these requirements are substantially fulfilled because of the juristic entity of companies and there being no need for getting parliamentary approval for changes in strategy or policies. On the other hand, public utilities are best organised as statutory corporation in view of their monopoly character and the necessity of strict regulation of their rates by government.

You will observe that various government organisations often include in their names the words like 'corporation' (State Trading Corporation of India Ltd.), 'company' (Hindustan Photofilms Manufacturing Company Ltd.), 'authority' (Steel Authority of India Ltd.), and Commission (Oil and Natural Gas Commission). But, there are no legal implications of this. They do not necessarily indicate the form in which they are organised. For example, the word 'corporation' is used as a part of the names of both the statutory corporations and the government companies. The Life Insurance Corporation of India is a statutory corporation but the General Insurance Corporation of India is a government company. It is, therefore, not possible to distinguish between a statutory corporation and a govemment company on the basis of the words used in their names.

To some extent, we can distinguish between a statutory corporation and a government company with the word 'limited'. Normally, the government company carries the word 'limited' as a part of its name. But there are some exceptions even in this case. If a government company is registered under Section 25 of the Companies Act it need not use the word 'limited' as port of its name because such companies are established for cultural social or non-commercial purposes only. They do not pay dividends to its members and should apply their income mainly to promote specific objectives. There are four central government companies in this category. They are: i) National Research Development Corporation. ii) Indian Dairy Corporation. iii) Trade Fair Authority of India, and iv) Artificial Limb Manufacturing Corporation of India. These companies do not use the word limited in their names. even though they have been incorporated under the Companies Act.

Check Your Progress D

1) Fill in the blanks.

   i) .... is created by a special Act of legislature and .... is incorporated under Companies Act.

   ii) .... form is closer to bureaucratic system compared to the other forms,

   iii) The scope for private participation in the capital is there in .... form.

   iv) .... form of organisation is subject to budget, accounting and audit procedures of the government.

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

   i) For all practical purposes there is no difference between a statutory corporation and a government company.

ii) Both the statutory corporation and the government company are corporate bodies.

iii) Compared to other forms of organisation, departmental organisation has more financial autonomy.

iv) The words 'corporation' and 'company' in the name of a public enterprise can indicate different forms of organisation.

v) Operational autonomy is more in the case of statutory corporation compared to departmental organisation.

17.6 LET US SUM UP

There are three forms of organisations in public enterprises: 1) departmental organisation, 2) statutory corporation, and 3) government company.

Under the departmental form of organisation, the enterprise is organised, financed and controlled in the same way as any other government department. The overall control rests with the concerned minister and the minister is answerable to the legislature for its efficient operations. It is financed through annual budget appropriations made by the legislature and its revenues are paid into the treasury. It is subject to budget accounting and audit controls as applicable to other government departments. Employees of this organisation are civil servants.

Departmental organisation has certain advantages. Since its accountability to legislature is complete, government gets maximum degree of control over the operations of these enterprises. Therefore, there is limited scope to misuse public funds, The government can use departmental undertakings as instruments of its social and economic policy. The surpluses coming from these undertakings can be utilised by the government for the economic progress of the nation. These undertakings suffer from bureaucracy and red-tapism, extensive legislative control, political instabilities, lack of professional expertise, lack of flexibility and autonomy in financial matters, and absence of competition and profit motive.

Public corporation is a corporate body created by the Parliament or a State Legislature by a special Act which defines its powers, duties, functions, immunities, and the pattern of management. It is also called 'statutory corporation'. Public corporation is fully owned by the state and the capital is wholly subscribed by the state. It enjoys financial autonomy. It is managed by a Board of Directors nominated by the government. Its employees are not the civil servants. Public corporation is answerable to the legislature which creates it. But the legislature is not expected to interfere in its day-to-day operations.

Public corporation form of organisation has certain merits. Being an autonomous corporate body, it can manage its affairs independently with initiative and flexibility, and can also avoid red-tapism. Since it has financial independence, it can easily raise capital whenever needed. As it works with service motive and answerable to legislature, it protects the public interest and avoids the defects of profiteering, exploitation, illegitimate speculation, etc. It can secure working efficiency and economies of scale. Public corporations suffer from excessive government interference,.inflexibility in policy matters, clash of interest among Board members, excessive public accountability and lack of commercialism.

Government company is a corporate body registered under Indian Companies Act in which not less than 51% of the paid-up share capital is held by the central government or any state government or by several state governments or partly by the central government and partly by one or more state governments. Any company which is a subsidiary of such a company is also considered a government company. For establishing a government company, the government need not go to the legislature. In this form of organisation there is scope for private participation in the capital as well as management. It is managed by the Board of Directors consisting of members nominated by the government and the elected members of the private shareholders, if any. It has financial autonomy and independent staffing system. It is free from auditing, accounting and budgetary controls applicable to departmental organisations.

The major advantage of the government company is that: while taking care of all the disadvantages of the departmental form, it provides all the benefits of the public corporation. It is easy to form and also easy to bring changes in its constitution whenever needed. There is scope for private participation in capita1 and management. It facilitates taking over a running enterprise by the government or transferring the ownership to private enterpreneurs. Being autonomous in financial, staffing and accounting aspects, government company has more operational flexibility. The major limitation of this form of organisation is that it evades parliamentary probe. It also suffers from lack of professional management, government interference, fear of public accountability among top executives, and so on.

The relative assessment of the features of all the three forms indicates that the departmental form of organisation is suitable for such undertakings which are very important from the view point of public interest and national interest. The company form of organisation is best suited for commercial and industrial undertakings, while public. corporations should be preferred for public utility, undertakings.

17.7 KEY WORDS

Autonomy : In the context of public enterprise, autonomy refers to the management's independence in policy-making and execution of policies without political interference.

Corporate Body : An organisation having a legal entity created by an Act of the legislature, or by registration under the Companies Act.

Departmental Organisation : A form of organisation where a public enterprise is organised, financed and controlled in the same way as the govemment department.

Government Company : A company registered under the Indian Companies Act in which not less than 51% of the paid-up share capital is held by the central govemment or any state government or partly by the central government and partly by the one or more state governments.

Mixed-Ownership Company : An enterprise where capital is jointly held by the government and private interests (Indian or foreign).

Public Accountability : Answerability of public enterprises to the public through Parliament or stare legislature as the case may be.

Public Corporation : An autonomous corporate body created by a special Act of Parliament or state legislature with defined functions and powers.

The Comptroller and **Auditor-general of India :** An authority under the Constitution of India to ensure thorough audit of accounts of government organisations.

17.8 SOME USEFUL BOOKS

Administrative Reforms Commission, 1967. ***Report of the Study Team on Public Sector Undertakings***, Government of India: New Delhi. (Chapter 2).

Bhushan, Y.K. 1987. ***Fundamentals of Business Organisation & Management,*** Sultan Chand: New Delhi (Part Nine, Chapter 5).

Ghosh, P.K., 1982. ***Public Enterprises in India,*** Book World: Calcutta (Chapter 3).

Ramesh M.S., 1985. ***Principles and Practice of Modern Business Organisation, Administration and Management,*** Kalyani Publishers: New Delhi (Volume 1, Chapter 8).

Singh, B.P., arid T.N. Chhabra, 1988. ***Business Organisation and Management,*** Kitab Mahal: Allahabad (Section Eight, Chapter 43).

17.9 ANSWERS TO CHECK YOUR PROGRESS

A 3) i) False ii) False iii) True iv) True v) True vi) False vii) True viii) False

B 3) i) Government ii) Special Act of legislature iii) Board of Directors

4) i) False ii) False iii) True iv) False v) False vi) True

C 2) i) Government, the Comptroller and Auditor-General of India

ii) 51%

iii) Joint stock companies

iv) Indian companies

v) Board of Directors

3) i) True ii) True iii) False iv) False v) True vi) True vii) True

D l) i) Statutory corporation, government company

ii) Departmental organisation

iii) Government company

iv) Departmental

2) i) True ii) True iii) False iv) False v) True

17.10 TERMINAL QUESTIONS

1 What are the forms of organisation in public enterprises? Explain the features of each form.

2 What is a statutory corporation? Explain its features, merits and limitations.

3 What is a government company? List the differences between a government company and a non-government company.

4 What are the main features of the government company? How are they different from those of the statutory corporation?

5 What is a government company? Explain its features, merits and limitations.

6 What is a departmental form of organisation? Give the main features of this form of organisation and comment on the lack of its popularity.

7 Compare the company form of organisntion with the statutory corporation. Which of the two would you recommend for managing public enterprises and why?

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

UNIT 18 PUBLIC UTILITIES

Structure

18.0 Objectives
18.1 Introduction
18.2 What is a Public Utility?
18.3 Features of Public Utilities
18.4 Organisation and Management of Public Utilities
18.5 Pricing Policy of Public Utilities
18.6 Sales Policy of Public Utilities
18.7 Public Control and State Regulation
18.8 Let Us Sum Up
18.9 Key Words
18.10 Some Useful Books
18.1 l Answers to Check Your Progress
18.12 Terminal Questions

18.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and features of public utilities
- describe the forms of organisation and management of public utilities
- explain the pricing and sales policies of public utilities
- justify the need for control and regulation of public utilities.

18.1 INTRODUCTION

In our day-to-day life, directly or indirectly, we require a number of essential services. In the cities you have tap-water. Similarly various means of transport help you in undertaking your journey everyday. You need. electricity for lighting, air-conditioning, etc. Electricity is also used for running factories, trams, railways, irrigating crops, etc. Have you ever thought how they are provided? All these services are called public utility services and the organisations which provide these services are known as public utility undertakings. In this unit we shall discuss the meaning, features, forms of organisation, management, pricing policies and sales policies of public utility undertakings, We shall also discuss about the need for state regulation and control of public utilities.

18.2 WHAT IS A PUBLIC UTILITY?

Water, gas, electricity, transport, communication, etc., are needed by the public in their daily life. Whenever there is any interruption in the supply of such goods or services, the normal life of people is disturbed. Suppose, if the water-taps go dry, you do not gel water. To fetch water you have to go to nearby wells or hand-pumps. In this process you may get late for your office or place of work. Similarly, If the electricity supply or transport services are not available, public life and activities are severely upset. Therefore, these services have a great significance to the community. Hence they are termed as essential services or indispensable necessities, The business enterprises established basically to provide efficient and uninterrupted supply of the goods that are absolutely indispensable for a civilised community are referred to as public utility organisations. We can say that the public utilities are clothed with public interests. Thus, public utilities are the business undertakings engaged in supplying essential goods and/or services of daily necessity for the general public. The institutions which undertake certain essential services like the supply of gas, water, electricity, urban transport, etc., are examples of public utility undertakings. All the public utility undertakings have an obligation to supply the essential goods and services to everyone in the community without any discrimination at reasonable prices.

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18.3 FEATURES OF PUBLIC UTILITIES

You have learnt that the public utility undertakings deal with essential goods and services. Because of this reason, these undertakings are quite distinct from other business enterprises. Now let us study the distinctive features of the public utilities.

1) Indispensability: Public utilities deal with essential services such as water, gas, light, power, transport, telephone, telegraph, postal services, etc. These services are required to meet basic needs of the community and to provide a civilised and comfortable life to every citizen irrespective of caste and creed. Therefore, these services must be made available regularly, uniformly and adequately. That is why these public utilities are indispensable in all modem societies.

2) Field of operation: The field of operation of public utility undertakings is mostly local. Such concerns fulfil the needs of the citizens, usually of a city, town or at the most of a district. For example, Delhi Milk Supply Undertaking or Mother Dairy supplies milk through its booths at various localities to the people living in Delhi only.

3) Monopolistic or semi-monopolistic position: Undertakings supplying essential public services by nature assume the position of a monopoly. They do not have competitors. You can take the example of Delhi Electric Supply Company. It does not have any competitor for supplying electricity to the residents of Delhi. It is viewed that competition in the supply of essential products or services may lead to unnecessary duplication and social waste. For example take the supply of drinking water in a town. It involves heavy expenditure in digging the well, installing the plant and laying down the distribution pipe line. This is, normally, under the control of the concemed municipality. If another undertaking is involved in the same operation in the same town, equal amount of money is required which is a waste. To avoid any such wasteful expenditure, monopoly is given to public utilities. However, some public utilities may have a few competitors. Take the case of milk supply in Delhi. Mother Dairy supplies the milk. But Delhi Milk Supply Undertaking or Nanak Milk Supply Cornpany also supplies milk in Delhi. Therefore the position enjoyed by Mother Dairy is semi-monopolistic.

4) Regulation and control : As you know these undertakings enjoy a monopolistic or semi-monopolistic position. So, they are in a position to misuse it and exploit the customers. For instance they may supply poor quality goods, services may be irregular, may charge high prices, etc. The government has to ensure the quality of the products or services at reasonable prices. Public is to be assured of regular and adequate supply of services and goods without discrimination. Therefore, it is essential to regulate their working as well as the price and supply policies of public utilities. Regulatory powers of the government in respect of these undertakings are provided in Special Acts of the legislature.

5) Franchise: Public utilities operate under franchise i.e. the right to interfere with public property (land, buildings, roads, etc.) for proper functioning. For example, the railways which is a public utility undertaking, can put up barriers on roads restricting movement of traffic across railway track at level crossings. Similarly, water supply undertakings can dig pits across the roads while laying water pipes, and so on. The government grants special rights as well as casts duties and responsibilities on these concerns through a charter which is called franchise. The franchise or charter contains the powers, privileges and rights granted to these undertakings as well as duties and liabilities for which these undertakings are accountable. This is done to ensure their working efficiently'and satisfactorily. The franchise can be withdrawn if the undertaking does not comply with the regulations and restrictions subject lo which the franchise is issued.

6) **Huge** capital investment: These undertakings require huge capital investment in fixed assets. Take the case of Mother Dairy which supplies milk in Delhi. For supply of milk to its consumers it has to set up a milk plant, storage plant, and large fleet of vans/tankers. It has also to construct depots for distribution of milk at various places in different localities of Delhi. Then, it has to monitor the distribution of milk to its consumers properly. Thus, all the public utilities invest huge amount of capital in fixed assets.

7) Inelastic demand: The demand of public utility services is more or less inelastic. It means that there will be no change in demand with rise or fall in the price of that service. Take the example of electricity for domestic use. With the rise or fall in the rate of electricity per unit, the consumption of electricity remains more or less the same. Thus, the demand for electricity is inelastic. Demand for public utilities has also the following special features:

   a) These services cannot be shared and, therefore, their demand has been increasing day-by-day.

   b) These services sell themselves. There is no need for advertisement or salesmen for creation of demand for such services.

   c) These services have **both** direct and derived demand. When electricity is used for domestic lighting, cooling, heating, cooking, etc, it is a direct demand. But when it is used by a factory for manufacturing or production purposes, it is a derived demand. Thus, direct demand arises from the requirements for direct and immediate consumption. Derived demand is created by the utilisation of these services for industrial and commercial purposes.

   d) The derived demand for such services is generally elastic. Derived demand for these public utility services is particularly elastic and direct demand is normally inelastic. Demand for gas or electricity by a housewife is usually inelastic. Demand for electricity in factories may decline if the cost of electricity is too high.

8) Non-transferable demand by the consumer: The demand of the consumer is non-transferable. If a consumer is provided electricity at his house, he cannot transfer his right of using electricity to his neighbour. Every consumer is to obtain the supply separately after fulfilling the rules and regulations of the undertakings.

9) Risk involved: The degree of risk involved in the business carried out by the public utilities is less as compared with other industries. This is because the demand for essential goods and services is not likely to fall, rather it is likely to increase over time. For instance, the demand for water, gas, milk, electricity, etc., is not likely to fall but increase since the population is increasing continuously year after year.

10) Size of the undertaking: These undertakings are required to be set up on a sufficiently large scale so as to meet the demand of the public of that locality. Moreover, the size of the unit must be large enough to make it possible for the undertakings to supply the service continuously at economical rates.

11) Choice **of** site: The promoters of public utilities do not have much choice in the selection of site for the undertaking. They have to locate their enterprise as per the permission granted to them by the concerned authorities. They have to operate as per the prescribed locål conditions and regulations.

'Check Your Progress A

1) Define Public Utility Undertaking.

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2) Which of the following services are called public utility services? Indicate with a tick mark.
   a) Supply of water
   b) Supply of newspaper
   c) Manufacture and supply of bread
   d) Supply of electricity
   e) Supply of milk.
   f) Manufacture and supply of cloth
   g) Transportation by rail

3) Which of the following characteristics apply to public utilities?
   a) Inelastic demand for service provided

b) Franchise
c) Nation-wide operation
d) Many competitors

4) Which of the following statements are True and which are False?
   a) Public utility services must be advertised to create demand
   b) Public utility services cannot be shared.
   c) Direct demand for public utility services is elastic.
   d) The demand for electricity of a consumer is non-transferable.

18.4 ORGANISATION AND MANAGEMENT OF PUBLIC UTILITIES

You have learnt about the meaning and features of public utility undertakings. Now let us study about the organisation and management of these undertakings. Public utility undertakings are organised in any of the following three forms: i) a public or private limited company, ii) statutory corporation, and iii) departmental undertakings of the government or any public authority like municipality. When organised as a private limited company, the ownership and management rest with the private parties. When organised as a public limited company, the ownership and management rest with the government. Large public utilities are often organised as statutory corporations under a special act of the legislature. The act lays down the bye-laws and rules which are part of the constitution of the undertaking. The ownership and management rest with the corporation and its governing board. Comparatively smaller concerns are registered under the Companies Act, 1956, having their Memorandum and Articles of Associztion. If a public utility is established as a department of the government or any local authority, it is naturally owned by the government or municipality and managed by their officials.

Every public utility undertaking has to take a licence from the concerned government, This licence confers monopoly and franchise rights upon them. The licence is to be renewed from time to time depending upon the satisfactory working of the undertaking. The franchise empowers these undertakings to acquire private property and interfere with public property (land, buildings, roads, etc.) whenever it is necessary for them to do so. Each of the above forms of organisation and management has got its own merits and limitations. However. since public interest is involved, the government has control directly or indirectly over the management and working of all these undertakings. As a matter of prudence, governments, central or state or local bodies such as municipalities, run most of such undertakings. Let us study briefly the merits and limitations of each of the above forms of organisation.

Private Limited Company: As you know a private limited company is a form of business organisation registered under the Companies Act, 1956, with a minimum number of two persons and a maximum number of 50 persons. It has its Memorandum and Articles of Association. It has certain privileges and is subject to certain restrictions. You have earlier studied the features and formation of private limited companies in Units 2 and 4. Usually, goods transport by road is operated by private limited companies. But other public utility services may also be organised as private limited companies. The important merit of this form of organisation is the maintenance of quality of product or service. But the major limitation of this form of organisation is the lack of public accountability.

Public Limited Company: As you know, a public limited company is formed by at least seven persons, without any limit to its maximum nuniber of members. Unlike a private company, it is free from restrictions of transferability of shares and issue of its prospectus to the public. You have studied in detail the features and formation of public limited companies in Units 2 and 4. A number of public utility services have been provided by these companies in the past in Europe and the USA as well as in India. Indian Railways and Electricity Supply Undertakings in various cities are some examples. Such companies however, suffer from the shortcoming of public accountability and social responsibility. Most of these undertakings have been nationalised now.

Dep'artmental Management: Some public utility undertakings arc run by government departments, under the control and direction of Ministries headed by ministers. Examples of such undertakings are: Railways run by the Ministry of Railways through the Railway Board, Posts and Telegraphs run by the Ministry of Conimunications, etc. You have studied about the departmental form of organisation in detail in Unit 17. The chief advantages of organising public utilities under this form of organisation are as follows.

1) It ensures control by responsible officials of the government.
2) Finances are provided by the government through annual budget grants which are passed by the Parliament or State Legislature of the respective State Government.
3) The revenue goes to the public exchequer.
4) Public accountability is maintained, since report on their working is presented and discussed in the Parliament/State Assembly.

The major shortcoming of departmental management is that of red-tapism and bureaucracy. Efficiency of operations suffer due to lack of proper attitude of workers towards public service.

Some of the public utility concerns owned and managed by local authorities are: the Bombay Electric Supply & Transport Undertaking (BEST) owned and managed by the Bombay Municipal Corporation and the Delhi Electric Supply Undertaking (DESU) owned and managed by the Delhi Municipal Corporation and so on. In these cases, they are managed by elected committees of the Municipalities. Municipal management is justified because it provides the elected representatives an opportunity to manage the affairs of public utilities. However, municipal control has the following limitations:

1) The elected members of such bodies may not possess necessary skill and competence.
2) Sometimes the political wrangling may only add to the miseries of the people.
3) Local areas are sometimes too small for the economic conduct of certain utilities. Due to the restricted area of operation, sometimes plants may not work to their maximum capacity resulting in higher operational costs.

Public Corporations: As you 'know, public corporations are autonomous bodies set up under the special Acts of Parliament or State Legislatures. Such corporations derive their rights and powers through the special acts and the area of operation is also fixed by the Act. The corporation is not completely controlled by the Government. It has its own finances and Board of Management. It works like a joint stock company. However, it is accountable to the Parliament or State Legislatures, since its audited annual report is placed before the Parliament or State Assembly, as the case may be. You have studied in detail about public corporations in Unit 17. Public utility concerns. organised as public corporations, have the following merits:

1) They possess the efficiency and flexibility of private enterprises.
2) They are directly accountable to the Parliament/State Legislature. Thus the broader interest of community at large, is safeguarded.

However, the public utilities organised in the form of public corporations suffer from the following limitations:

1) Indirect interference of the leaders of the ruling party in the functioning.
2) The Managing Directors or the Executive Directors are usually appointed from among the civil servants or the politicians, who hardly have any knowledge or acumen of business dealings.

Check Your Progress B

1) Name the alternative forms of organisation and management of public utilities.

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2) Which of the following statements are True and which are False?

a) Public corporations are established by government in order to operate public utilities.

b) Management of public utilities by municipal corporation is just like management as a govemment department.

c) The revenue earned by public utilities run by government department is set aside as a reserve of the public utility undertaking.

d) The major limitations of the public utilities organised as private limited companies is the lack of public accountability.

18.5 PRICING POLICY OF PUBLIC UTILITIES

Price of a commodity is usually determined by two factors: 1) demand, and 2) supply. This does not apply in the case of all goods and services supplied by the public utility undertakings. There are other considerations which play a more important role in fixing the price. In the case of public utility concerns, price is not fixed on the basis of cost involved in the production or supply of such services i.e. cost of service principle. It is determined on the basis of the purchasing capacity of the consumers, which is called the principle of what the traffic will bear. You must be eager to know why it is so. Let us now discuss about it.

As you know, the goods and services provided by public utility concerns are **essential** services or goods. These products or services are used by the poor and the rich alike. The rich can pay higher price to avail of these services, while the poor may not be able to pay for it if prices are fixed on cost basis. Hence the government takes care of and safeguards the interests of the poor by regulating the prices of such goods and services so that the poorer people may also be able to use them. Normally, the consumer would like to pay a fair price. But what is a fair price, is a question which cannot be easily answered. Determination of a fair price involves a number of considerations like cost of production, cost of supply, a reasonable rate of profit, paying capacity of the customers, changes in the general price level, and so on. Thus, price determination is not a simple matter. It is to be determined after due consideration and consultation with various interests. However, the following three broad aspects of the price policy of public utility undertakings can be kept in mind.

1) Promotional aspect: This aspect is concerned with the promotion of demand of the services provided by the public utility undertakings. Promotional aspect refers to increasing demand for the products or services. Promotion of demand is necessary to ensure full utilisation of the production capacity of the undertaking. This helps in spreading the overhead costs over large output. You may have seen that transport services such as roadways and railways issue monthly tickets (Season tickets) as a concessional rates to a large number of regular passengers.

2) Price discrimination: As you have learnt, the demand for the products of a public utility undertaking is elastic in some markets and inelastic in other markets. Take the case of transport services. In the case of general public or tourists the demand for bus service is elastic, since these persons do not depend upon public buses alone. They may hire three wheelers or taxis. But most of the regular office-goers or students depend mainly upon public buses only. For them the demand is inelastic. Here the undertakings have to charge less from the students and office-goers, and more from the tourists and the general public. Take another example of electric supply undertakings. They charge more for supply of electricity for domestic purposes than for agricultural purposes. In some cases, public utilities can demand lower price in one market and higher price in others, or may charge lower price from one category ot consumers ana higher price from the other category of consumer.

3) Social considerations: Some of the public utility undertakings touch everyday life of the people and are "affected with public interests". In such cases the price of the product is not fixed purely on economic basis. Considerations of social welfare play an important role in the price fixation, Consumers with low incomes or poor people get the services at concessional or subsidised rates.

18.6 SALES POLICY OF PUBLIC UTILITIES

You have learnt that the pricing policy of the public utilities are different'from other business firms. Similarly, the marketing strategy of public utility undertakings is also somewhat different from the other commercial undertakings. Let us now study the sales policies of public utilities.

1) The products or services offered by public utilities are 'essential' requirements of the public and have usually large demand from the public.
2) The public utilities do not generally have rivals or competitors. A particular product is supplied by one undertaking in a particular area. So there is no possibility of different

rates being charged by different producers in the same area. So there is no necessity for price discount.

3) These undertakings are granted franchise by the government. They had the right to interfere with private property as well as right to use publibproperty (roads, land, buildings, etc.).
4) There are no middlemen or intermediaries for sale of their products or services. They sell directly to their consumers or sell through their own distribution network. For example water supply, electric supply, and transport undertakings come in direct contract with the consumers. Therefore, they have to offer best possible terms to users of these services.
5) Unlike other commercial concerns, public utility undertakings do not have the problems of credit collection from the customers. In some cases, as in electricity undertakings, the supply is stopped if there is default in payment of bills by a specified date. In some cases, the dealings are on cash basis, as in railways and road transport undertakings.
6) There is no necessity for the public utility undertakings to advertise their goods and services like other business units. I-Iowever, they have to inform the public about the service which they provide. For example, a transport undertaking has to keep the public informed about the new services introduced from time to time on different routes, changes in the routes, changes in the timings, etc. Such information facilitates the customers in utilising the service which ultimately leads to utilisation of full capacity.

18.7 PUBLIC CONTROL AND STATE REGULATION

As you have learnt, the public utility undertakings are engaged in the supply of essential goods and services to the public. The products and services are to be supplied regularly. They should be of a standard quality and reasonably priced. You have also learnt that the public utility undertakings assume the position of monopolies or semi-monopolies. What will happen if they misuse this monopolistic position? Suppose if the water supply undertaking supplies impure water, what will be the result? Epidemics like cholera, gastro-enteritis, jaundice, etc., will spread. Similarly, if the railways do not run the trains in time, the normal life shall be disturbed. Offices, schools, business houses will be hampered for some time. Sometimes taking advantage of the monopoly position, public utilities may charge higher prices which the general public may not be able to pay. For all these reasons, it is necessary to regulate and control the functioning of public utility undertakings.

The Central or State Governments or the local authorities regulate the functioning of public utilities. The objectives of such regulation are as follows:

i) To ensure quality and regular supply of the goods and services.
ii) Fixation of reasonable prices.in the public interest.
iii) To assure proper maintenance of equipment and machinery so as to avoid breakdowns and prevent inconvenience to the public.

Public utilities are being regulated by the government in different ways. Private promoters of public utilities are required to obtain a licence from the government. The licence stipulates the controlling powers of the government. Besides, rates may be also framed to ensure that the unde taking adopts its policies in the interest of the public consumers. The government may also nationalise public utilities run by the private undertakings and manage them through public corporations or boards having sufficient representation of the public: Establishing public utilities directly as a departmental undertaking of the government is often preferred as it enables direct control by government. Thus, public utility undertakings are accountable to the public as they deal with the utilities or services of public interest. In most of the countries, therefore, they are manned by public authority

Check Your Progress C

1) Enumerate the broad aspects of price policy of public utility undertakings.

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2) Fill in the blanks.
   a) Prices of public utility services are fixed on the principle of ....
   b) The demand for public utility services is .... in some markets and .... in others.
   c) Demand for water for domestic use is....................
   d) When different prices are charged in different markets for the same product or service, it is known as ....

3) Which of the following statements are True and which are False'?
   a) Demand for electric power for industrial purposes is inelastic.
   b) Problems of credit recovery do not arise in the case of public utility concerns.
   c) Regulation and control of public utilities are not necessary if they are run by government departments.
   d) Controlling powers of the government are included in the licence granted to private parties which promote the public utilities.

18.8 LET US SUM UP

Public utilities are the enterprises which supply essential goods and services to the public. They are expected to supply the essential goods and services to everyone in the community without discrimination. The institutions which undertake certain essential services like the supply of water, gas, electricity, rail and road transport, postal service, milk supply, etc., are some examples of public utility undertakings. Public utilities are distinct from other commercial undertakings. They are endowed with certain characteristics. They are:

I) indispensability of product or service, 2) restricted area of operation, 3) monopolistic or semi-monopolistic position, 4) regulation and control by government, 5) franchise, 6) huge capital investment, 7) inelastic demand, 8) non-transferability of supply by the consumer, 9) lower risk, and 10) limited choice of size and of site.

Public utility undertakings are accountable to public authorities since they are entrusted with public interests. Therefore, their ownership and management are usually vested in public authority. There are four alternative forms of organisation and management of public utilities: 1) public or private limited company, 2) public corporation, **3)** government department, and 4) a local authority such as municipality or board or council.

Price fixation of public utility products and services is not done on the basis of demand and supply of these products/services. It is determined on the principle of "what the traffic will bear". However, other considerations like cost of service, price discrimination, promotional aspect and social considerations also play important role in the price fixation. Marketing strategy of the public utilities is different from the other 'commercial undertakings. These undertakings need not necessarily advertise their products or services. Problems of credit collection do not arise in the case of public utilities. The products or services of some public utilities are sold on cash basis. Therefore, these undertakings do not suffer much loss on account of bad debts. In some cases the supply on credit is stopped if bills are not paid by a specified time. Normally, there are no intermediaries for the sale of their products. They sell directly to their consumers.

Public utility undertakings are subject to government regulation and control since they deal in products and services essential to the public. The objective of government regulation is to ensure quality of service and uninterrupted supply at a reasonable price.

18.9 KEY WORDS

Cost of Service Principle: The principle of fixing the price of a product or service on the basis of cost incurred by the organisation for providing that service or product.

Franchise: A charter issued by government to the public utility undertakings granting powers, privileges and rights as well as assigning duties and responsibilities for which the undertakings are accountable to the Government.

Monopolistic or Semi-monopolistic Position: Absence of competition from rival enterprises or the existence'of one or two competitors.

Price Discrimination: Charging different prices for the same product or service in different markets or from different customers in the same market.

Principle of "What the Traffic Will Bear": The principle of fixation of price of a product or service on the basis of what the consumer may be able to pay.

Public Accountability: The accountability of public utilities to the Parliament or State Legislatures for their performance.

Public Utilities: Business undertakings which deal with essential goods and services like gas, water, electricity, etc., and are 'clothed with public interests'.

18.10 SOME USEFUL BOOKS

Bhushan Y.K., 1987. *Fundamentals of Business Organisation and Management,* Sultan Chand: New Delhi. (Part Nine, Chapter 6).

Ramesh, M.S., 1985. *Principles and Practice of Modern Business Organisation, Administration & Management*, Kalyani Publishers: New Delhi. (Volume I, Chapter 2).

Sinha, J.C., and Mugali, V.N., 1988. *Principles and Practice of Business Organisation and Management*, R. Chand & Co: New Delhi. (Chapter 2.4).

18.11 ANSWERS TO CHECK YOUR PROGRESS

A 2) a, d, c, g are public utility services.
3) Characteristics of public utilities: a, b
4) a) False b) True c) False d) True

B 2) a) False b) True c) False d) True

C 2) a) What the traffic will bear b) elastic, inelastic c) inclastic d) price discrimination
3) a) False b) True c) False d) True

18.12 TERMINAL QUESTIONS

1) What is a public utility undertaking? State its essential characteristics.
2) Discuss the various aspects of price policy of public utilities.
3) "Selling and pricing strategies of public utilities are different from other organisations". Discuss.
4) Do you advocate private ownership and inanagement of public utility undertakings? If so, why?
5) Explain the following brietly:
   a) Public utility undertakings
   b) Moriopolistic positioq of public utilities
   c) Franchise
   d) Problems faced by public utility undertakings

Note : Thcse Questions will help you to understand the unit better. Try to write answers for them. But do not send pour answers to thc university. Thcsc arc for your practice only.