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Indira Gandhi National Open University
School of Tourism and Hospitality
Services Management

BTMC-132
Fundamentals of Management

Block

1

BASIC CONCEPTS, FORMS AND FINANCING OF BUSINESS

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BLOCK I BASIC CONCEPTS, FORMS AND FINANCING OF BUSINESS

This is an introductory block for a Core Disciple course, BTMC-132 Fundamentals of Management, offered in the B. (Voc). Tourism Management programme. The block deals with the nature and objectives of business, classification of business activities, definition and characteristic of an entrepreneur, the different forms of business organisation, factors affecting choice of business organisation and the methods of raising finance.

Unit 1 describes the nature and objectives of business, the classification of business activities, relationship between various business activities and the meaning of business organisation and also defines who an entrepreneur is.

Unit 2 explains various forms of business organisation and discusses the features, merits and limitations of each form

Unit 3 compares all forms of business organisation and analyses the factors affecting the choice of form of business organisation

Unit 4 describes the types of financial needs and the various methods of raising finance

UNIT 1 NATURE AND SCOPE OF BUSINESS

Structure

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 and their inter-relationship
- explain the nature of business organisation
- explain who is an entrepreneur

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.

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 earning 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 learn in detail about business later in this unit.

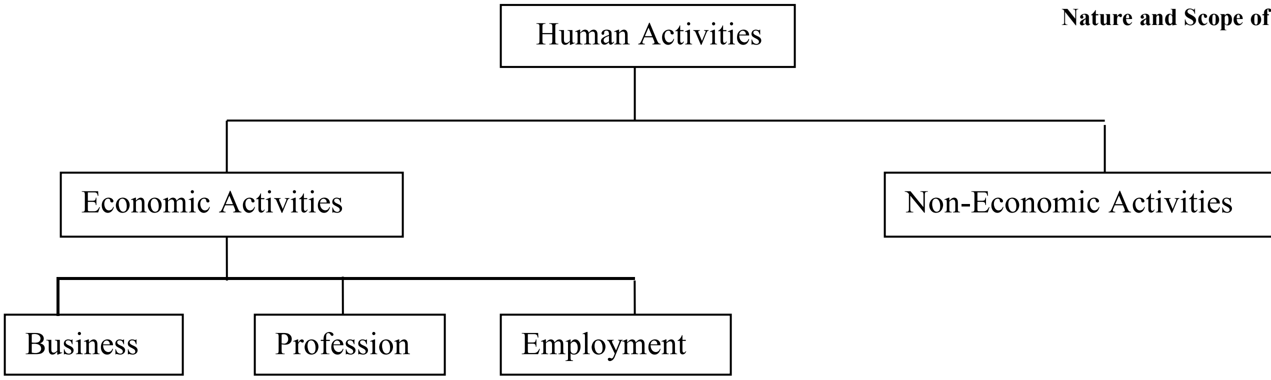

Figure 1.1: Classification of Human Activities

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.

1.3 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 when 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 activity. 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:

1) 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 custo -mers 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:

1) 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 price
4) Ensure fair returns to investors
5) Avoidance 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 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 started 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 continuously 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/services 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 industry and a genetic 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.

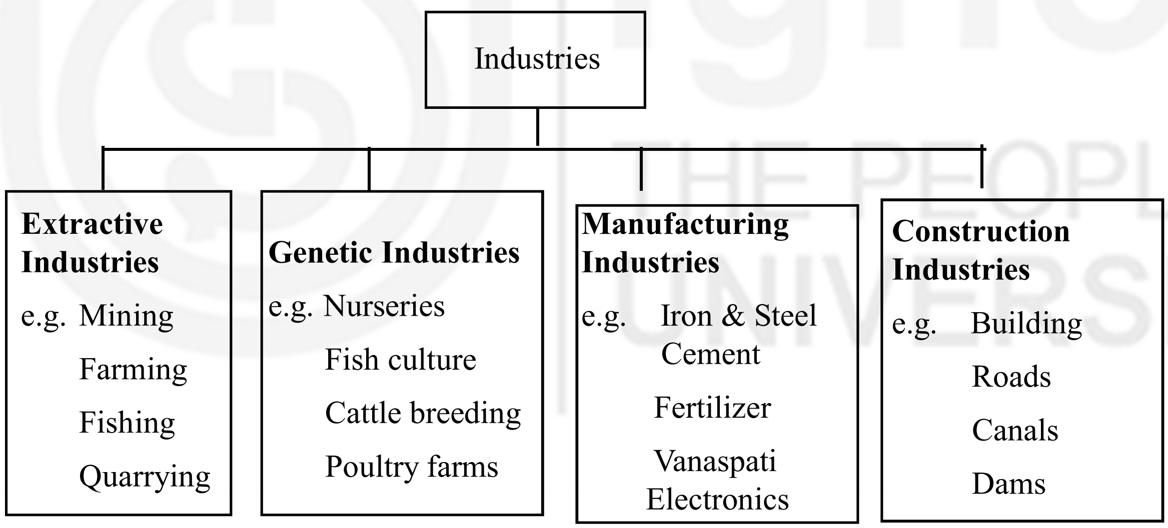

Figure 1.2: Classification of Industries Based on the Nature of the Activity

When we talk of the nature of activity, we can also include the Service Industry. These are the industries which do not produce any tangible products but provides a service like tourism industry, entertainment industry etc.

Check Your Progress B

1) Distinguish between business and industry.

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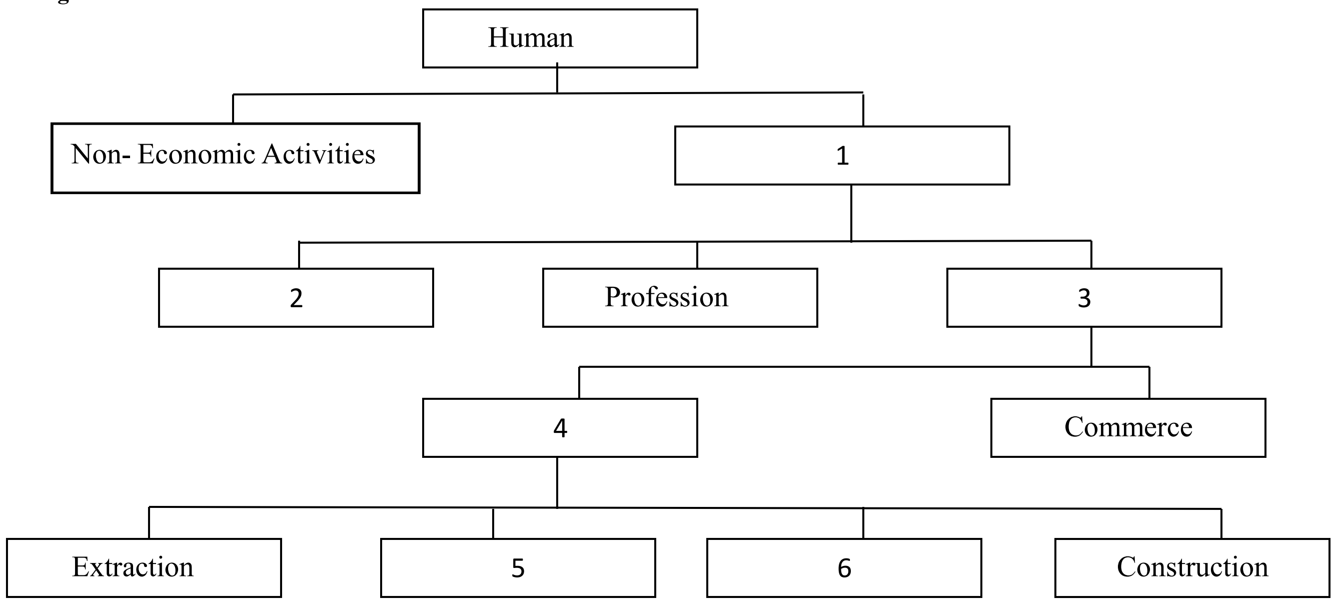
2) Fill in the blank columns.



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) Preparing 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 goods, 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 county. Payment for the same is generally made in national currency. This internal trade is also termed as inland trade or national trade or home 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, sell 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 retailers 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'.

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 Russia, and tea to USA. For India such selling of goods shall be termed as 'Export 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 neighboring countries. Such countries import large quantities of goods and re-export the same to the neighboring countries.

1.5.2 Aids to Trade

Activities which facilitate 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: 1) 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 information "about their goods to the prospective consumers' 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, wall posters, etc.

5) **Banking:** Banking facilitates the flow 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.

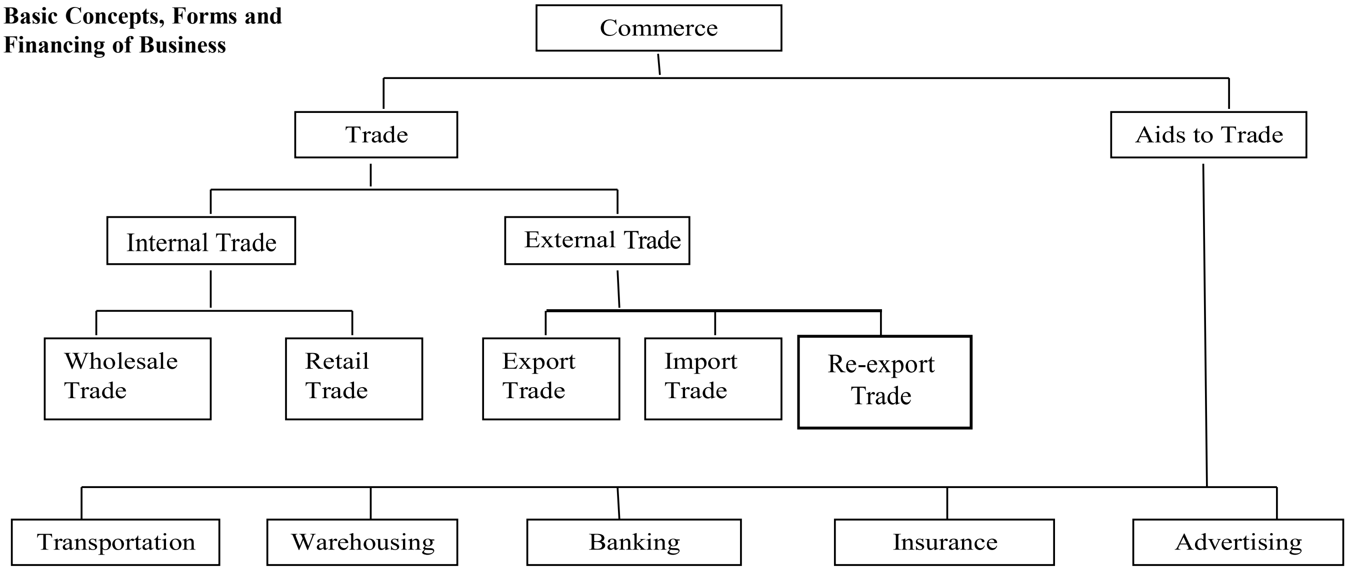


Figure 1.3: Classification of Commerce

Check Your Progress C

1) 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 RELATIONSHIP BETWEEN TRADE, INDUSTRY AND COMMERCE

You have learnt that business is concerned with production and/or exchange of 'want satisfying' goods and services with the intention of earning profit. Further, you have also learnt that the production aspect of business activities comes under 'Industry' while the exchange aspect comes under 'Commerce'. Commerce again has two main aspects- Trade (activities of purchase and sale) and Aids to Trade (activities which facilitate the smooth flow of goods). All these branches and sub-branches of business activity are closely related to one another and any one of them cannot function in isolation.

Industry makes available the goods and services ready for selling and distribution but commerce more particularly 'trade' enables industry to function through purchase of material required for production. This supporting role of commerce continues in the after-production stage also through sale of the finished products. Commerce is the link between the producer of goods and services and the consumers of these goods and services. Commerce thus serves as the backbone of industry while industry provides the base for commerce to operate. If you recollect, we have also mentioned that a smooth and uninterrupted flow of goods and services from producer to consumer is beset with many barriers and hindrances and that a major aspect of commerce is the elimination of these barriers and hindrances though various activities called 'Aids to Trade' which include transportation, warehousing, insurance, advertising etc. Thus all of them-industry, commerce, trade and aid to trade are part of the whole business system, supplementing and supporting each other for seamless production and delivery of goods and services.

1.7 ORGANISATION

You have learnt what is a business activity and various types of business activities like industry, trade, transportation, banking, etc and their relationship. 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 install them in the buildings, employ labour and technicians to work on the machinery, buy raw-materials (cotton, dyes, etc.), 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 form) may be called non-corporate forms of organisations. The remaining two categories (company form and cooperative society) may be called as corporate forms of organisation. About these forms of organisation, you will study in details in Unit 2 and 3.

1.8 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 somebody who may conceive the idea of doing a particular type of business, mobilize the resources and bring the organisation into existence. Such 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, carries on the business activity and is prepared to bear the risk of loss.

1.8.1 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 directions. 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 are 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 and 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 starting 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 product to meet the demands of consumers. Some of our industrialists like Tata, Birla, Kirloskar, etc. have established their own research centres.

1.9 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) genetic industries, 3) manufacturing industries, and 4) construction industries.

Commerce is classified into: 1) 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 are four basic forms of business organisation: 1) sole proprietorship, 2) partnership, 3) company, and 4) cooperative society. All business starts with an idea. A person who conceives the idea of doing a particular type of business, mobilize the resources and bring the organisation into existence is called an entrepreneur. Certain common elements in the character of entrepreneurs include independence, hard work, desire to achieve goals, open-mindedness, optimistic outlook etc.

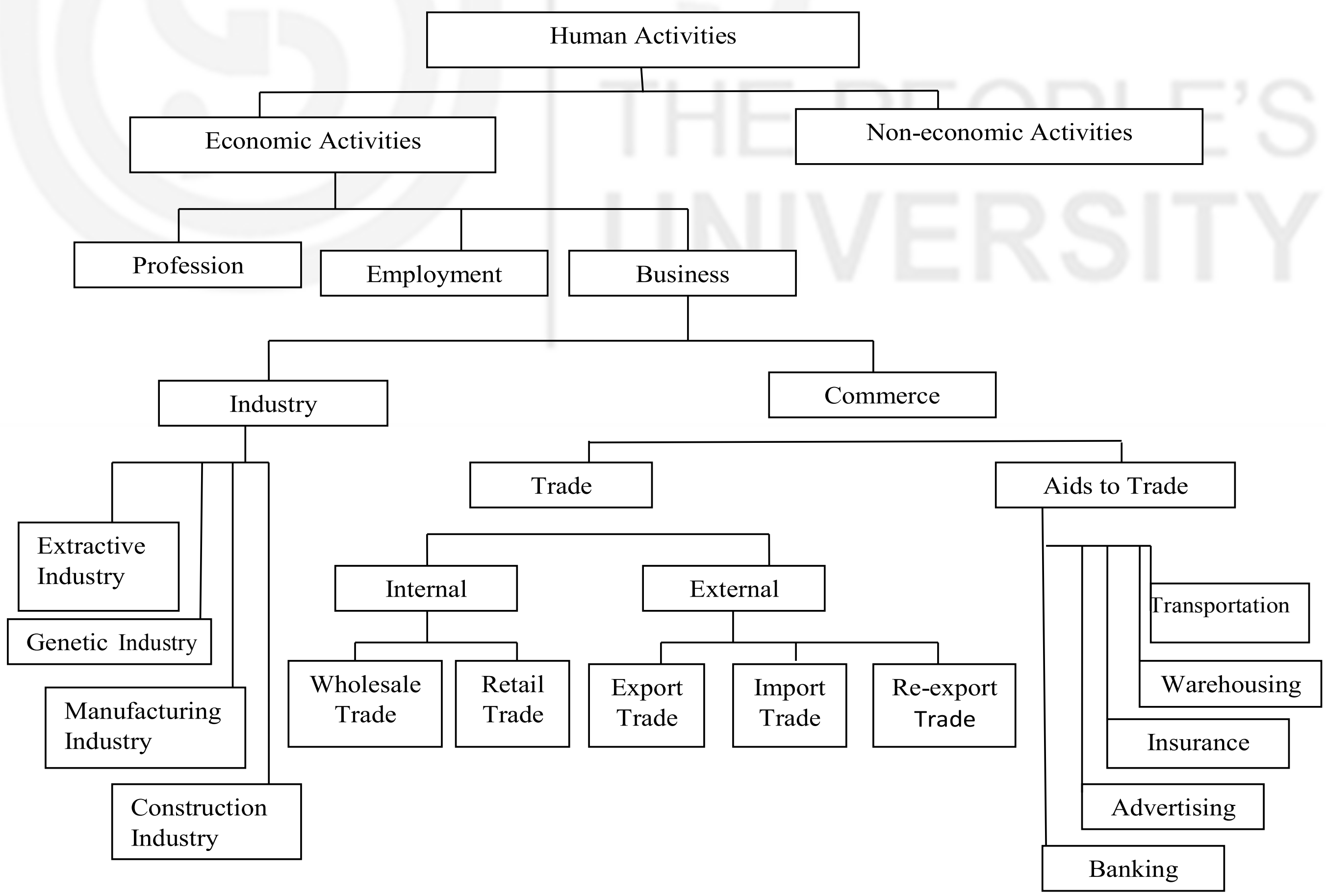

Figure 1.4: Classification of Human Activities

1.10 KEY WORDS

Advertising: An activity by which the product and its qualities are made known to the public for 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.

1.11 SOME USEFUL BOOKS

Bhushan, Y.K., 1987, *Fundamentals of Business Organisation and Management,* Sultan Chand: New Delhi. (Part One, Chapters 1 & 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).

1.12 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

1.13 QUESTIONS FOR PRACTICE

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 classification of commerce with suitable examples.
5) What do you understand by organisation? What are the basic forms of business organisation?

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 OBJECTIVE

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 limitation of each form of business organisation

2.1 INTRODUCTION

In the pervious 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 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 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.

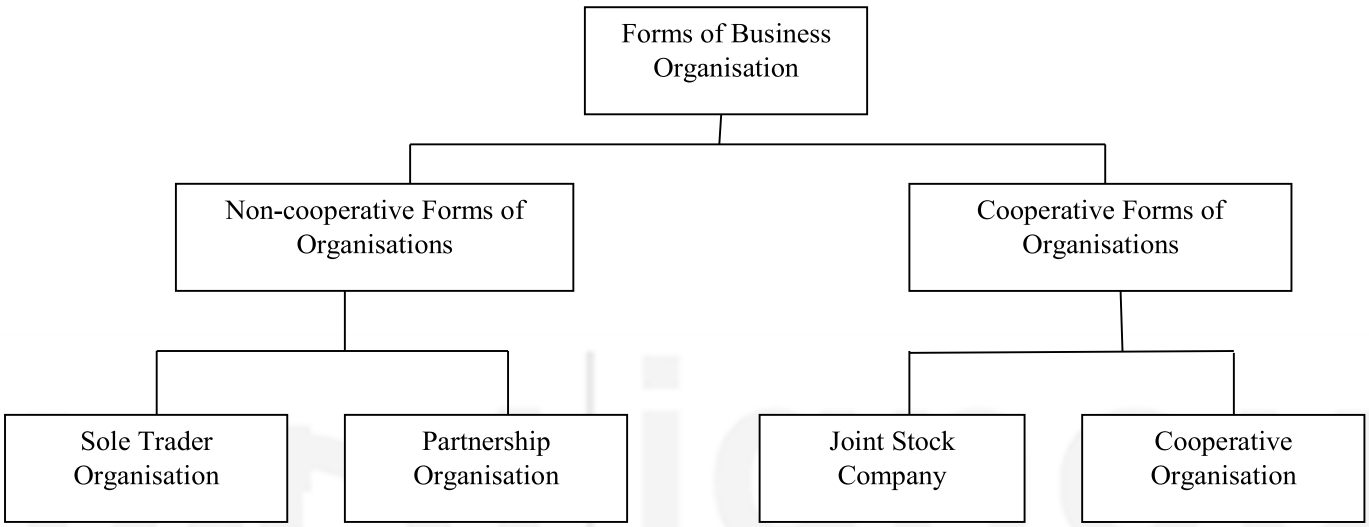

Figure 2.1: Various Forms of Business Organisations

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 case 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 economic 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 fulfill 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.

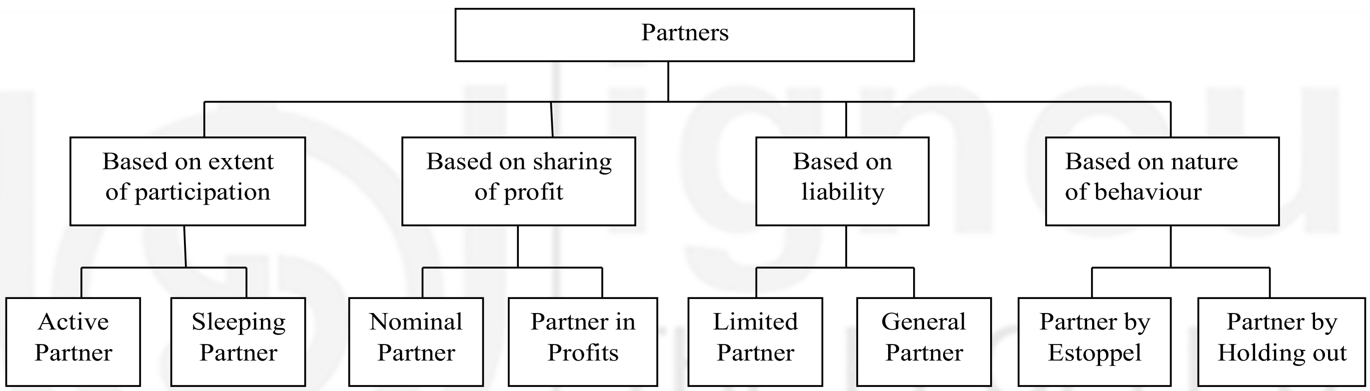

Fig. 2.2: Classification of Partners

Based on the extent of participation in the functioning of the business, we can classify partners into: (a) 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 firm is called a partner by estoppel. Such partners are not entitled to profits but are fully liable as regards the firm's 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.

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 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 like 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 decreased 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 the 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 has 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 partnership 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, the partnership business is also owned and run by the partners themselves. They can easily appreciate and quickly respond to the 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 protected. If a partner is dissatisfied with the working of firm, he can ask for dissolution of the firm and withdraw from the 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 shard by all the partners. Hence, the share of loss in the case of each partner will be 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 company.

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 publicized, 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.

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 the 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 False.

   i) Partnership agreement must be in writing. True ☐ False ☐

   ii) There is no maximum limit for membership in a partnership organisation. True ☐ False ☐

   iii) Members of a partnership firm are called partners. True ☐ False ☐

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

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

   vi) A sleeping partner actively participates in the working of the firm. True ☐ False ☐

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

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

2.4 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 Karta, 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:

1) 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.

2.5 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".

In a joint stock company, 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 about the company form of organisation, its main features, classification and formation in detail in Block II (Unit 5-9). Here we list the merits and limitations of the company form of organisation.

2.5.1 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 forms of organisation 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 are 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 registration. 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**: A 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) **Fradulent 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) 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☐

   viii) Company is separate from its owners and it has an entity of its own True ☐ False☐

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

2.6 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.

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

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

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

Based on these definitions we can state that the cooperative 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 disability arising out of the want of adequate financial resources. The basic objective of such an organisation is self-help and mutual help.

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

Like the company form of organisation, the members of the society are the owners. They contribute the required capital and get a share in the profit, which is known as dividend. The liability of the members is limited.

Management is vested in the hands of the managing committee which is elected by the members in the annual general meeting.

2.6.1 Main Features

Based on the above discussion we can identify the following distinctive features of cooperative organisations.

1) **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.

2) **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.

3) **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.

4) **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.

5) **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' society, bonus is paid in the proportion of the goods delivered for sale to the society.

2.6.2 Classification of Cooperatives

Cooperatives were started in different fields to promote the well being of different section 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 good 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 society, 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 cooperative because the principle of cooperation is extended to a large number of activities and operations. There are cooperatives such as processing cooperatives, construction cooperatives, transport cooperatives, auto rickshaw cooperatives, washer men cooperatives, fishery cooperatives, dairy cooperatives, sugarcane growers cooperatives, oilseeds growers cooperatives, etc. The aim of all these societies is to promote the welfare of their members.

2.6.3 Merits and Limitations

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

Merits

1) **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.

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

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

4) **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.

5) **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.

6) **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.

Limitations

1) **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.

2) **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.

3) **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.

4) **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.

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

6) **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.

7) **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 ....

2.7 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) behavior and conduct exhibited, and (d) liability shared. Partnership organisation 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. 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 of 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 the instability 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 liabllity, government assistance, op membership, etc. Disadvantages include lack of business acumen, absence of mutual interest, lack of secrecy, rivalry among members, etc.

2.8 KEY WORDS

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

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.

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.

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 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.

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.

2.9 SOME USEFUL BOOKS

Bhushan, Y.K. 1987, *Fundamentals of Business Organisation & Management,* Sultan C & 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 M Allahabad, (Part One, Chapters 4 & 5)

2.10 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 estopped (vii) limited partner

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

C) 1 (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%*

2.11 QUESTIONS FOR PRACTICE

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 answer for them. But do not send your answers to the University. These are for your practice only.

UNIT 3 FORMS OF BUSINESS ORGANISATION II

Structure

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 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 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 forms of organisation 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 licences, 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 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. However, 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 attracts the minimum amount of this tax liability is considered as an ideal form. 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.	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	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
4	Capital	Very limited capital	Limited capital	Larger capital resources	Any amount of capital can be raised	No substantial
5	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
6	Managerial expertise	Very limited expertise	Limited expertise	Scope for expertise	Very wide scope for expertise	Scope for expertise
7	Owner's liability	Unlimited	Unlimited	Limited	Limited	Limited subject to By-laws
8	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
9	Ownership transfer	At will and relatively easy	Restricted and relatively difficult	Restricted and relatively difficult	At will and very easy	Restricted
10	Business stability	Depends upon the life of owner	Depends upon the life, insolvency, retirement of partners	Perpetual existence Death , insolvency of the members does not effect the life	Perpetual existence. Death , insolvency of the members does not effect the life	Death , insolvency of its members does not effect the life
11	Business secrets	Full secrecy	Secret shared by the partners	Secrets shared by the members	Exposed to public	Exposed to members
12	State regulations	Almost nil	Very little	Considerable regulations	Excessive regulations	Considerable regulations
13	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
14	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.
15	Auditing of accounts	Not required	Not required	Compulsory	Compulsory	Compulsory
16	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 find 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 government 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 form of business organisation.

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2) State whether the following statements are True or False

   i) An ideal form 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 businesses conditions ....

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

   v) An ideal form of organisation should ensure .table 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 .... from is the most difficult in formation.

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

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

iv) Income is exempted from tax for .... from 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 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 quite suitable. But if the volume is large, you need more capital and 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 requires 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 capacity to bear the risk involved, it can be 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 or 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 communication, 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 private company, you have the choice of converting it into a public limited company or not.

3.5 CHOICE OF FORM OF ORGANISATION

On the basis of the above discussion, we can conclude that the small business 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 shoes, 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, experience, 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.

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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 form ....

   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 proprietorship/ 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, flexibility, 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 flexibility. 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.

Based 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 USEFULE BOOKS

Bhushan, Y.K., 1987. *Fundamentals 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!, 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) 1. See Section 3.2

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

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

3.9 QUESTIONS FOR PRACTICE

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.

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 METHODS OF RAISING FINANCE

Structure

4.0 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

4.1 INTRODUCTION

In the previous Units you have learnt about the nature of business activities, the types of business in which individuals may be engaged, and the different forms in which business activities may be organised. You know that adequate capital is necessary for financing various activities of the business, and, therefore, raising of finance is a pre-requisite for setting up any business unit. 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.

4.2 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 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 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 day 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 processes have become more complex than in the past. Factory production requires expensive machinery, equipment and tools, and many men. It requires large quantities of material 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 realization 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.

4.3 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 4.1 for the classification of financial needs.

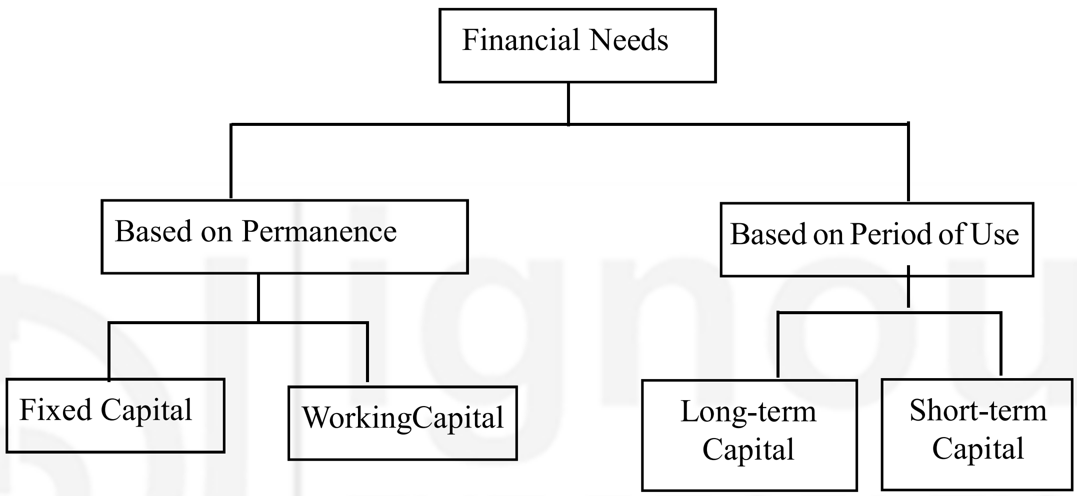

Figure 4.1:Classification of Financial Needs

4.3.1 Fixed Capital and Working Capital

Fixed Capital: In every business concern money has to be invested in some fixed or durable assets like 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.

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 credits 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 fund invested in current assets are continuously recovered through realization 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 gain. 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 required 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 relatively smaller in the case of hotels and restaurants because they mostly have cash sales, and only small amount 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.

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.

4.3.2 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 or sold within a year, and dues from customers are usually realised within three to six month. The main difference between long-term capital and short-term capital is that the former is required for a longer period, (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.

4.4 CAPITAL STRUCTURE

The fund 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.

4.4.1 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. It 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.

4.4.2 Borrowed Capital

The financial requirements of the business are often met by raising loans. Loans 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 terms 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 personal 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, rising 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 lenders 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 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 amounts 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 borrowing? Obviously not. Let us examine. Since no interest would be payable, tax would amount to Rs. 15,000 (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 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'.

4.4.3 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 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-tern 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).

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 works.

   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.

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	ii)	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

4.5 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:

1) Trades credit

2) Factoring

3) Discounting bills of exchange

4) Bank overdraft and cash credit

5) Public deposits

Look at Figure 4.2 for various methods adopted by companies for raising finance.

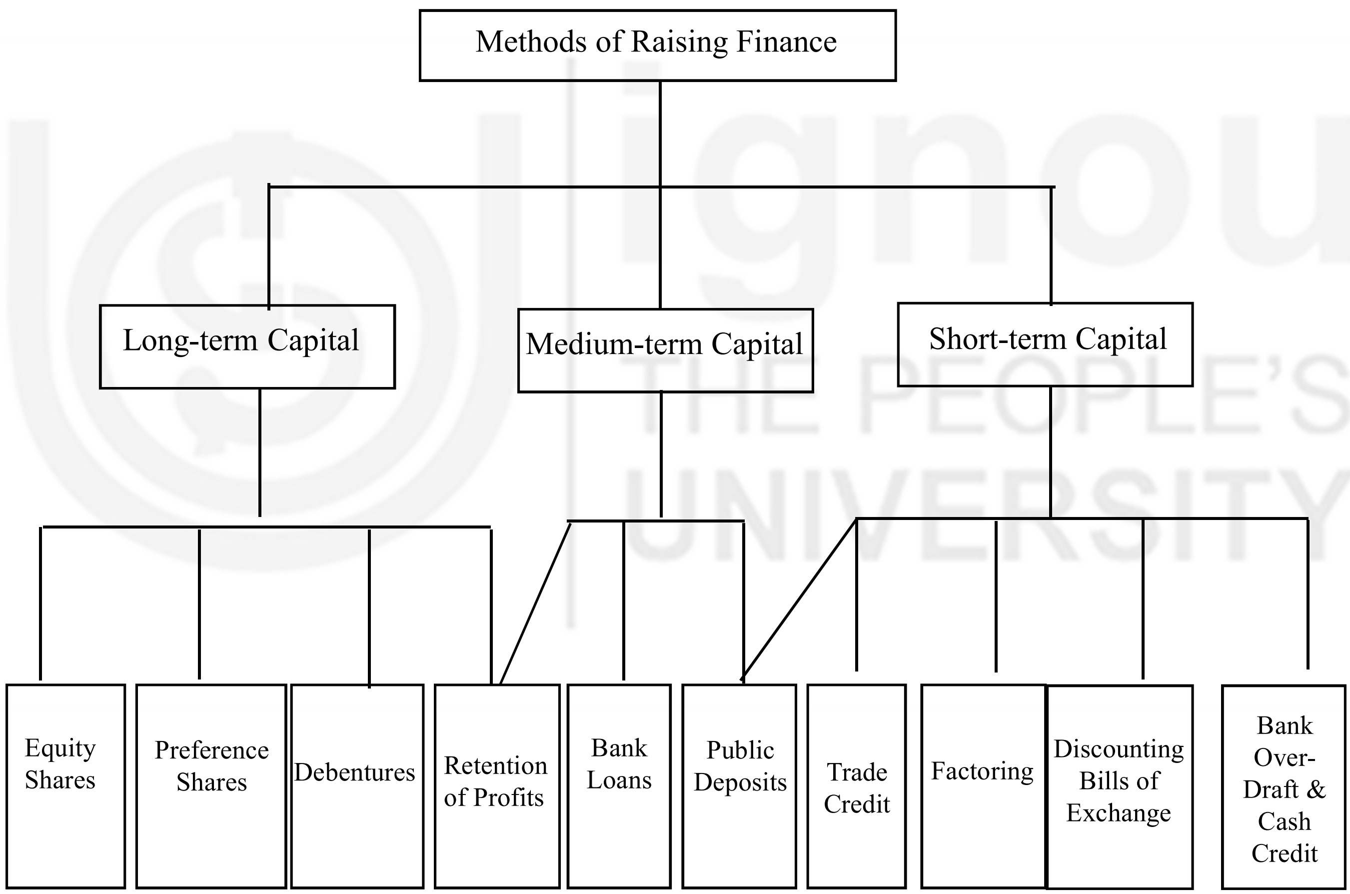

Figure 4.2 Methods of Raising Finance by Companies

Note: 1. Public deposit 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.

4.5.1 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 share, 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 share to a limited number of persons not exceeding fifty. Also share 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 high 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 share do not require mortgaging of the company's assets. Additional funds can be raise 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 share 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 promoters. 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.

4.5.2 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.

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 principle. 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 principle, 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 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 institution like the Industrial Finance Corporation of India, Industrial Credit and Investment Corporation, State-level Industrial Development Corporation, etc. 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 Director 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 market rate. But there is a close security of the investment project before loans is sanctioned. 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 is 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 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 personnel 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 saving 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 a 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. But companies are not permitted to raise unlimited amounts of fund through public 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 have 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 up to 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 provide 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 (account 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 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 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 favor 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 time 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 dishonored 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.

4.5.10 Bank Overdraft and 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 be 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 granted against securities as in the case of cash credit. Interest is charged on the actual amount 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.

   i) Issue of debentures

   ii) Cash credit

   iii) Public deposit

   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 shares 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 ……….. (fixed assets, goods in stock bank balance)

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)

4.6 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 capital and 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 shares. Borrowed capital is often used to drive 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 medium-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 has certain advantages as well as disadvantages.

4.7 KEY WORKS

Borrowed Capital: Fund 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.

Medium-term Finance: Fund 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 then 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.

Morking Capital: Funds required for holding current assets like stock of raw materials, finished goods, book debts, bills receivable, etc.

4.8 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 Publishing 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).

4.9 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) Trueiii) 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) iv) loss of cash discount

v) short-term finance

4.10 QUESTIONS FOR PRACTICE

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

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 answers to the university. They are for your practice.