POWER POINT PRESENTATION
ON
MANAGERIAL ECONOMICS AND FINANCIAL ANALYSIS

By

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UNIT-I

INTRODUCTION TO MANAGERIAL ECONOMICS

AND

DEMAND ANALYSIS

Micro and Macro Economics

Micro Economics

➢ **The study of an individual consumer or a firm is called Micro Economics. It is also called the theory of Firm.**

➢ **Micro means one millionth. Micro Economics deals with behaviour and problems of single individual and of micro organisation.**

Managerial Economics

➢ **Managerial Economics has its roots in micro economics and it deals with the micro or individual enterprises.**

➢ **It is concerned with the application of concepts such as Price Theory, Law of Demand and Theories of market structure and so on.**

Micro and Macro Economics

Macro Economics

- **The study of aggregate or total level of economic activity in a country is called Macro Economics.**
- **It studies the flow of economic resources or factors of production (such as land, labour, capital, organisation and technology) from the resource owner to the business firms and then from the business firms to the households.**
- **It deals with the total aggregates. For instance, total national income, total employment, total output and total investment.**
- **It studies the interrelations among various aggregates and examines their nature and behaviour, their determination and causes of their fluctuations in them.**

Micro and Macro Economics

Macro Economics

- **It deals with the price level in general, instead of studying the prices of individual commodities.**
- **It is concerned with the level of employment in the economy.**
- **It discusses aggregate consumption , aggregate investment, price level and national income.**
- **The important tools of macro economics include national income analysis, balance of payments and theories of employment and so on.**

INTRODUCTION

- **Managerial Economics as a subject gained popularity in USA after the publication of book "Managerial Economics " by Joel Dean in 1951.**
- **Managerial Economics refers to the firm's decision making process.**
- **It could be also interpreted as " Economics of Management".**
- **Managerial Economics is also called as "Industrial Economics" or "Business Economics".**
- **Joel Dean observes managerial economics shows how economic analysis can be used in formulating policies.**

Definitions of Managerial Economics

M.H.SPENCER AND L. SIEGELMAN

- **Managerial Economics defined as "the integration of economic theory with business practice for the purpose of facilitating decision making and forward planning by management".**

BRIGHAM AND PAPPAS believe that managerial economics is "the application of economic theory and methodology to business administration practice".

C.I.SAVAGE AND T.R.SMALL therefore believes that managerial economics is concerned with business efficiency.

Definitions of Managerial Economics

HAGUE observes that

- **"Managerial Economics is a fundamental academic subject which seeks to understand and to analyse the problems of business decision-making".**

In the words of PAPPAS AND HIRSHEY

"Managerial Economics applies economic theory and methods to business and administrative decision-making. Because it uses the tools and techniques of economic analysis to solve managerial problems, managerial economics links traditional economics with decision sciences to develop important tools for managerial decision-making".

Definitions of Managerial Economics

MICHAEL R.BAYE defines

- **Managerial Economics as "the study of how to direct scarce resources in a way that most efficiently achieves a managerial goal".**

HAYNES, MOTE AND PAUL define

Managerial Economics as "economics applied in decision-making. They consider this as a bridge between the abstract theory and the managerial practice".

Managerial Economics ,therefore, focuses on those tools and techniques, which are useful in decision-making.

NATURE OF MANAGERIAL ECONOMICS

- Managerial Economics is perhaps, the youngest of all the social sciences.
- Since it originates from economics, it has the basic features of economics , such as assuming that other things remaining same.
- This assumption is made to simplify the complexity of the managerial phenomenon under study in a dynamic business environment – so many things are changing simultaneously.
- This sets a limitation that we cannot really hold other things remaining the same.
- The other features of managerial economics are explained as follows:

1. Close to Micro Economics

- **Managerial Economics is concerned with finding the solutions for different managerial problems of a particular firm.**
- **Thus it is more close to micro economics.**

2. Operates against the backdrop of Macro Economics

- **The macro economic conditions of the economy are also seen as limiting factors for the firm to operate.**
- **In other words, the managerial economics has to be aware of the limits set by the macro economic conditions such as government industrial policy, Inflation and so on**

3. Normative Statements

- **A Normative Statement usually includes or implies the words ‘ought’ or ‘should’.**
- **They reflect people’s moral attitudes and expressions of what a team of people ought to do.**
- **For instance, it deals with statements such as ‘Government of India should open up the economy ‘ such statements are based on value judgements and express views of what is ‘good’ or ‘bad’ , ‘right’ or ‘wrong’ .**
- **One problem with normative statements is that they cannot be verified by looking at the facts, because they mostly deal with the future.**
- **Disagreements about such statements are usually settled by voting on them.**

4. Prescriptive Actions

- Prescriptive action is goal oriented . Given a problem and the objectives of the firm , it suggests the course of action from the available alternatives for optimum solution.
- It does not merely mention the concept , it also explains whether the concept can be applied in a given context or not.
- For instance, the fact that variable costs or managerial costs can be used to judge the feasibility of an export order.

5. Applied in Nature

- **Models are built to reflect the real life complex business situations and these models are of immense help to managers for decision making.**
- **The different areas where models are extensively used include inventory control, optimisation, project management etc.**
- **In managerial economics, we also employ case study method to conceptualise the problem , identify the alternatives and determine the best course of action.**

6. Offers Scope to Evaluate each alternative

- Managerial economics provides an opportunity to evaluate each alternative in terms of its costs and revenues.
- The managerial economist can decide which is the better alternative to maximise the profits for the firm.

7. Interdisciplinary

- The content, tools and techniques of managerial economics are drawn from different subjects such as economics, management, mathematics, statistics, accountancy, psychology, organisational behaviour, sociology etc.

8. Assumptions and Limitations

- Every concept and theory of managerial economics is based on certain assumptions and as such their validity is not universal.
- where there is change in assumptions , the theory may not hold good at all.

SCOPE OF MANAGERIAL ECONOMICS

- The scope of managerial economics refers its area of study.
- Managerial economics is primarily concerned with the application of economic principles and theories to five types of resource decisions made by all types of business organizations.

1. The selection of product or service to be produced.
2. The choice of production methods and resource combinations.
3. The determination of the best price and quantity combination.
4. Promotional strategy and activities.
5. The selection of the location from which to produce and sell goods or services to consumer.

- **The production department, marketing and sales department and the finance department usually handle these five types of decisions.**
- **The scope of managerial economics covers two areas of decision-making.**

I) OPERATIONAL ISSUES OR INTERNAL ISSUES.

II) ENVIRONMENTAL ISSUES OR EXTERNAL ISSUES.

I. OPERATIONAL ISSUES:

Operational issues refer to those , which wise within the business organization and they are under the control of the management. These are as follows:

1. Theory of Demand and Demand Forecasting

2. Pricing and competitive strategy

3. Production cost Analysis.

4. Resource Allocation.

5. Profit Analysis.

6. Capital or Investment Analysis. 7. Strategic Planning.

1. DEMAND ANALYSES AND FORECASTING:

- **A firm can survive only it it is able to demand for its product at the right time, within the right quantity.**
- **Understanding the basic concepts of demand is essential for demand forecasting.**
- **Demand Analysis should be the basic activity of the firm because many of the other activities of the firms depend upon the outcome of the demand forecast.**
- **Demand Analysis provides :**

1. The basis for analysing market influences on the firms; products and thus helps in the adaption to those influences.

2. Demand Analysis also highlights for factors, which influence the demand for a product.

This helps to manipulate demand.

- **Thus demand analysis studies not only the price elasticity but also income elasticity, cross elasticity as well as the influence of advertising expenditure with the advent of computers, demand forecasting has become an increasingly important function of managerial economics.**

2. PRICING AND COMPETITIVE STRATEGY

- **Pricing decisions have been always within the preview of managerial economics.**
- **Pricing policies are merely a subset of broader class of managerial economic problems.**
- **Price theory helps to explain how prices are determined under different types of market conditions.**
- **Competitions analysis includes the anticipation of the response of competitions the firm's pricing, advertising and marketing strategies.**
- **Product line pricing and price forecasting occupy an important place here.**

3. PRODUCTION AND COST ANALYSIS

- **Production analysis is in physical terms.**
- **While the cost analysis is in monetary terms cost concepts and classifications , cost-out-put relationships, economies and diseconomies of scale and production functions are some of the points constituting cost and production analysis.**

4. RESOURCE ALLOCATION:

- **Managerial economics is the traditional economic theory that is concerned with the problem of optimum allocation of scarce resources.**
- **Marginal Analysis is applied to the problem of determining the level of output , which maximises profit.**
- **In this respect linear programming techniques have been used to solve optimization of problems.**
- **In fact Linear programming is one of the most practical and powerful managerial decision making tools currently available.**

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5. PROFIT ANALYSIS

- **Profit making is the major goal of firms.**
- **there are several constraints here an account of competition from other products, changing input prices and business environment .**
- **Hence in spite of careful planning, there is always certain risk involved.**
- **Managerial economics deals with techniques of averting of minimizing skills.**
- **Profit theory guides in the measurement and management of profit, in calculating the pure return on capital, besides future profit planning .**

6. CAPITAL OR INVESTMENT ANALYSIS

- **Capital is the foundation of business.**
- **Lack of capital may result in small size of operations.**
- **Availability of capital from various sources like equity capital, institutional finance etc. may help to undertake large scale operations.**
- **Hence efficient allocation and management of capital is one of the most important tasks of the managers.**

6. CAPITAL OR INVESTMENT ANALYSIS

The major issues related to capital analysis are:

1. **The choice of investment project.**
2. **Evaluation of the efficiency of capital.**
3. **Most efficient allocation of capital.**

Knowledge of capital theory can help very much in taking investment decisions. This involves capital budgeting, feasibility studies, analysis of cost of capital etc.

7. STRATEGIC PLANNING

- **Strategic planning provides management with a frame work on which long-term decisions can be made which has an impact on the behaviour of the firm.**
- **The firm sets certain long-term goals and objectives and selects the strategies to achieve the same.**
- **Strategic planning is now a new addition to the scope of managerial economics with the emergence of multinational corporations.**

7. STRATEGIC PLANNING

- **The perspective of strategic planning is global.**
- **It is in contrast to project planning which focuses on a specific project or activity**
- **In fact the integration of managerial economics and strategic planning has given rise to be new area of study called corporate economics .**

II. ENVIRONMENTAL OR EXTERNAL ISSUES

- **An environmental issue in managerial economics refers to the general business environment in which the firm operates.**
- **They refer to general economic, social and political atmosphere within which the firm operates.**
- **A study of economic environment system in the country should include:**
- **1. The type of economic system in the country.**
- **2. The general trends in production, employment, income, prices, saving and investment.**

- **3. Trends in the working of financial institutions like banks, financial corporations, insurance companies.**
- **4. Magnitude and trends in foreign trade.**
- **5. Trends in labour and capital markets.**
- **6. Government's economic policies viz. Industrial policy, monetary policy, fiscal policy, price policy etc.**

- **The social environment refers to social structure as well as social organization like trade unions, consumer's co-operative etc.**
- **The political environment refers to the nature of state activity, chiefly states' attitude towards private business, political stability etc.**
- **The environmental issues highlight the social objective of a firm i.e, the firm owes a responsibility to the society.**
- **Private gains of the firm alone cannot be the goal.**

- **The environmental or external issues relate managerial economics to macro economic theory while operational issues relate the scope to micro economic theory.**
- **The scope of managerial economics is ever widening with the dynamic role of big firms in a society.**

The main Areas covered under the scope of Managerial Economics

1. Demand Decision:

- The analysis and forecasting of demand for a given product and service is the first task of the managerial economist.
- The behavioural implications such as the needs of the customers responses to a given change in the price or supply are analysed in a scientific manner.
- The impact of changes in prices, income levels and prices of alternative products / services are assessed and accordingly the decisions are taken to maximise the profits.
- Demand at different price levels at different points of time as forecast to plan the supply accordingly and initiate changes in price, if necessary, to enlarge the customer base and gain more profits.
- Determination of elasticity of demand and demand forecasting constitute the strategic issues that the managerial economist handles in a scientific way.

2.Input-Output Decision:

- Here, the costs of inputs in relation to output are studied to optimise the profits.
- Production function and cost function are estimated given certain parameters.
- The behaviour of costs at different levels of production is assessed here.
- some costs are fixed, some are semi-variable and others are perfectly variable.
- The quantity of production increases remains constant or decreases with additional increase in outputs.
- This decision deals with changes in the production following changes in inputs which could be substitutes or complementary.
- The entire focus of this decision is to optimise(maximise) the output at minimum cost.
- If it is necessary for the manager to know the relationship between the cost and output both in the short-run and long-run to position his products amidst the competitive environment.

3.Price-Output Decision:

- **Here, the production is ready and the task is to determine the price these in different market situations such as perfect market and imperfect markets ranging from monopoly, monopolistic competition, duopoly and oligopoly.**
- **The features of these markets and how price is determined in each of these competitive situations is studied here.**
- **The pricing policies, methods, strategies and practices constitute crucial part of the study of managerial economics.**

4. Profit -related Decisions:

- Here we employ the techniques such as Break even analysis, cost reduction and cost control and ratio analysis to ascertain the level of profits.
- We determine break even point beyond which firm start getting profits.
- In other words, if the firm produces less than break even point, it loses.
- we can also plan the production needed to attain a given level of profits in short-run.
- cost reduction and cost control deal with the strategies to reduce the wastage and thereby reduce the costs.
- These indirectly enhance the level of profits.
- Ratio analysis helps to determine the liquidity, solvency, profitability of the activities of the firm.
- There are certain ratios used to analyse and interpret the profitability of the firm given a set of accounting data.

5. Investment Decisions

- Investment decisions are also called capital budgeting decisions.
- These involve commitment of large funds, which determine the fate of the firm.
- These decisions are irreversible.
- Hence the manager needs to be more attentive while committing his scarce funds, which have alternative uses.
- The allocation and utilisation of investments is paramount importance.
- Capital has a cost. It is expensive. Hence, it is to be utilised in such a way as to maximise the return on capital invested.
- It is necessary to study the cost of capital structure and investment projects before the funds are committed.

6.Economic Forecasting and Forward Planning

- Economic forecasting leads to forward planning.
- The firm operates in an environment which is dominated by the external and internal factors.
- The external factors include major forces such as government policy, competition, employment , labour, price and income levels and so on.
- These influence its decision relating to production, human resources, finance and marketing.
- The internal factors include its policies and procedures relating to finance, people, market and products.
- It is necessary to forecast the trends in the economy to plan for the future in terms of investments, profits, products and markets. This will minimise the risk and uncertainty about the future.

DEMAND ANALYSIS

INTRODUCTION OF DEMAND:

- **Demand in common practice / ordinary language means the desire for an object. Suppose a person desires to have a car. It is called demand in ordinary usage.**
- **But in economics demand has a separate meaning which is quite distinct from the above meaning.**
- **A mere desire cannot become demand in Economics.**
- **A desire which is backed up by (i) ability to buy and (ii) willingness to pay the price, is called demand. Unless the desire is accompanied by ability to buy and willingness to pay, it cannot be called demand in Economics.**

DEFINITIONS OF DEMAND

1. According to Stonier and Hague,

" Demand in economics means demand backed up by enough money to pay for the goods demanded".

This means that the demand becomes effective only if it is backed by purchasing power in addition to this there must be willingness to buy a commodity.

Thus demand in economics means the desire backed by the willingness to buy a commodity and the purchasing power to pay.

2. In the words of Benham

"The demand for anything at a given price is the amount of it which will be bought per unit of time at that price ". (Thus demand is always at a price for a definite quantity at a specified time.)

Thus demand has three essentials i.e., price, quantity and time. Without these three demand has no significance in economics.

DEFINITIONS OF LAW OF DEMAND

1. ALFRED MARSHALL stated that Law of Demand as

“a rise in the price of commodity or service is followed by a reduction in demand and fall in price is followed by an increase in demand, if the conditions of demand remain constant.”

Marshall stated that the Law of Demand basing on the law of Diminishing Marginal Utility.

2. In the words of SAMUELSON

the Law of Demand may be stated as

"Other things being equal, the quantity demanded increases with a fall in price and decreases with a rise in price."

.Law of Demand

A rise in the price of a commodity is followed by a fall in demand and a fall in price is followed by a rise in demand, if a condition of demand remains constant.

The Law of Demand may be explained with the help of the following Demand Schedule.

PRICE OF MANGOES (in Rupees.)	QUANTITY DEMAND ED
1	25
2	20
3	15
4	10
5	5

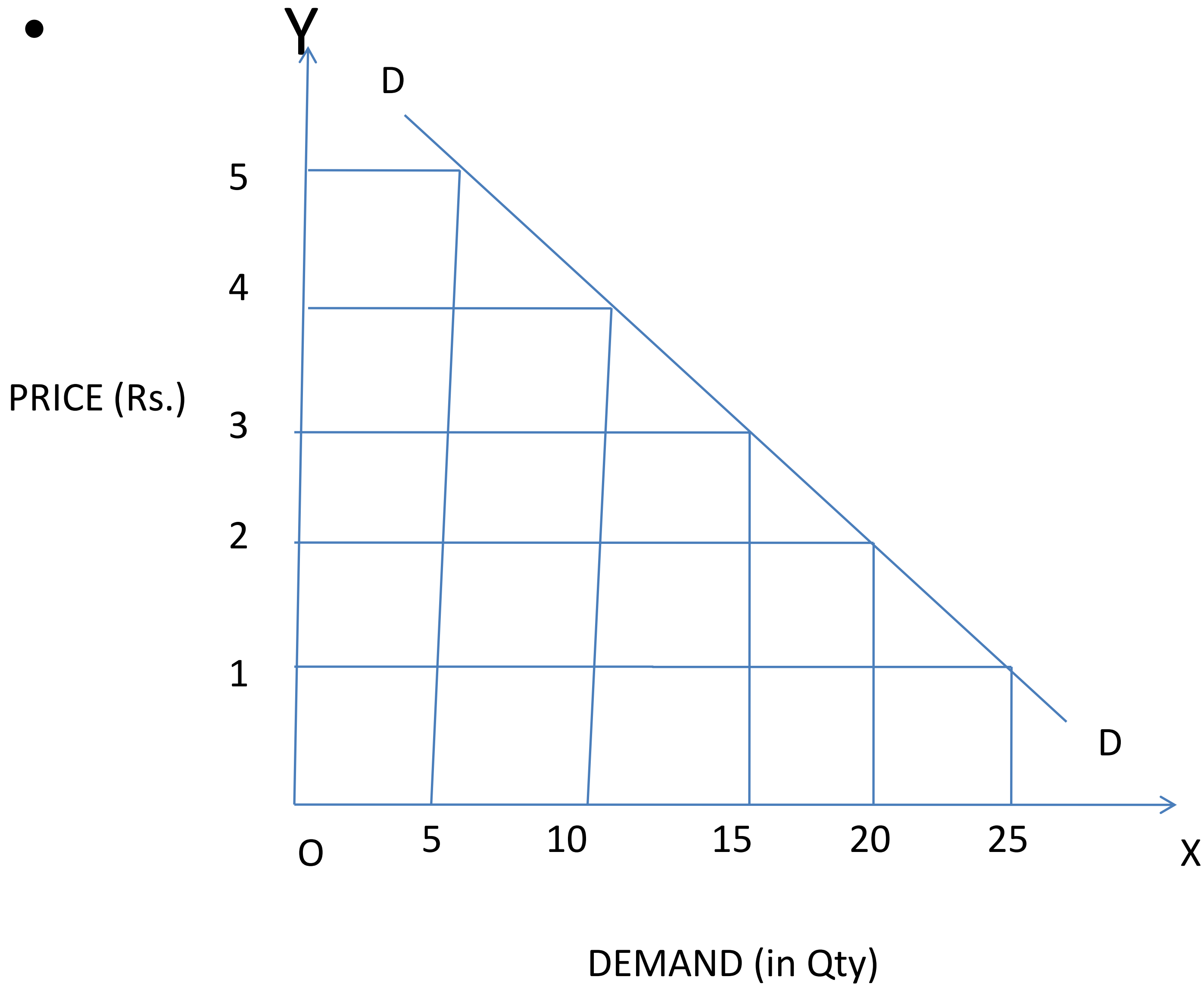
From the above table it is clear that as price of Mangoes rises from Rs.1 to Rs.2 demand falls from 25 to 20.

When the price of Mangoes rises to Rs.5 quantity demand falls to 5 Mangoes.

In the same way as price rises , quantity demand falls on the basis of demand schedule.

We can draw a demand curve from the above Demand Schedule as follows.

DEMAND CURVE

- 

- In the above Diagram, demand is shown on OX –axis and price is shown on OY-axis.
- DD is the demand curve.
- The demand curve DD shows the inverse relation between price and quantity demand of Mangoes.
- The demand curve slopes downward from left to right.

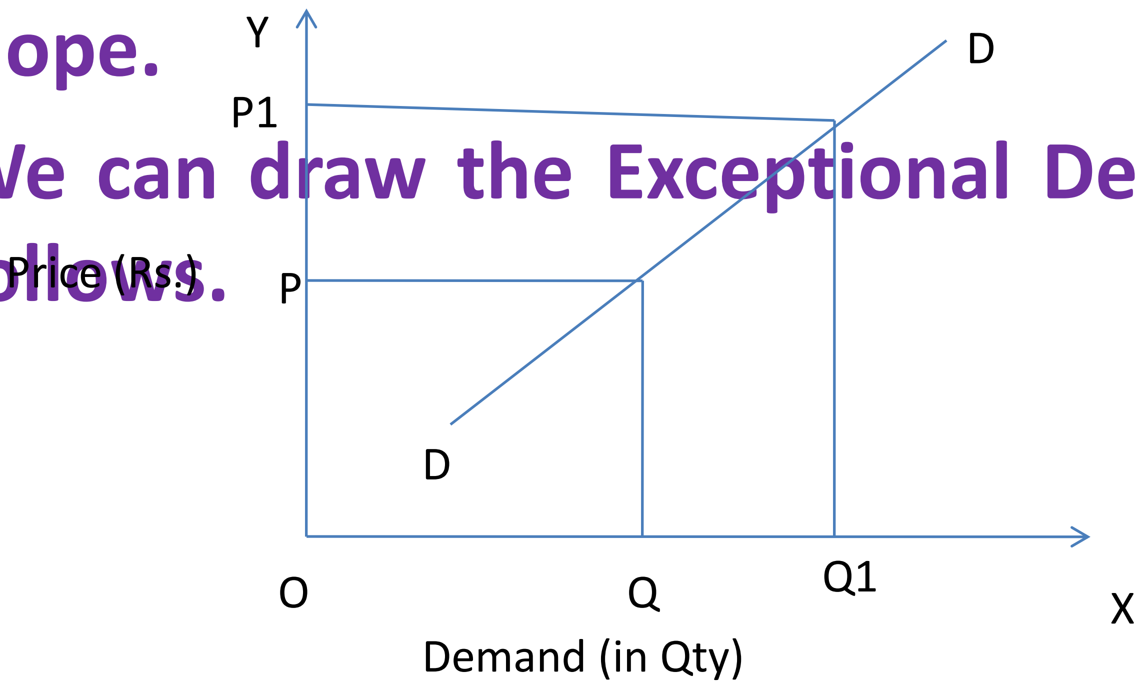
The Assumptions of Law of Demand

- Law of Demand is based on the following assumptions. The Law will hold good only if the following assumptions are fulfilled.

1. That the tastes and fashions of the people remain unchanged.
2. That the people's income remains unchanged / constant.
3. That the prices of related goods remain unchanged / same.
4. That there are no substitutes for the commodity in the market.
5. That the commodity is not the one which has prestige value such as diamonds etc.
6. That the demand for the commodity should be continuous.
7. That the people should not expect any change in the price of the commodity.

Exceptions to the Law of Demand

- Some times in case of some commodities demand curve slopes upwards from left to right.
- It shows that when price rises demand also rises and when price falls demand also falls.
- In this case the demand curve has a positive slope.
- We can draw the Exceptional Demand Curve as follows.



- In the above Diagram, demand is shown on OX –axis and price is shown on OY-axis.
- DD is the demand curve.
- When price increases from OP to OP1 quantity demand also increases from OQ to OQ1 and the price falls down from OP1 to OP quantity demand also falls down from OQ1 to OQ.
- Hence the exceptional demand curve slopes upwards from left to right in this diagram.
- **The following are the important exceptions to the Law of Demand.**

1. Giffen Paradox 2. Prestige goods 3. Speculation 4. Trade Cycles 5. Ignorance of price changes (Changes in Expectations) 6. Where there is shortage of necessities feared.

1. GIFFEN PARADOX

- In the early part of the 19th Century, Sir Robbert Giffen, a British Economist observed that the Low paid British workers were purchasing more bread, when its price increased.
- This is some thing contrary to the law of demand.
- He observed that the people spend a major portion of their incomes on bread only a small part on meat.
- Meat is more costly but less essential than bread.
- When the price of the bread increased, they reduced the expenditure on meat.
- With the money thus saved they purchased more bread to compensate for the loss of meat.
- Thus where the price of bread is increases, its demand is also increased. This is the against law of demand.

1. GIFFEN PARADOX

- This paradox was stated by Sir Robbert Giffen. Therefore, it is called Giffen Paradox.
- Marshall could not explain this. It appeared to be a paradox to him.
- The Demand Curve for Giffen goods(Inferior goods) goes upward from left to right as shown in the above diagram.

2. PRESTIGE GOODS:

- This exception is explained by Veblen. Costly goods like Diamonds, cars etc., are called prestige goods or as Veblen goods.
- Generally rich people purchase those goods for the sake of prestige.

- The use of such articles increases the prestige of owners.
- So rich people may buy more of such goods when their prices rise.
- Thus the amount demanded rises instead of falling, when the prices fall they do not purchase them because their value is reduced.
- Therefore the demand decreases when the price falls.
- This is against to the Law of Demand.
- Since this exception is stated by Veblen, it is called Veblen effect.

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3. SPECULATION:

- When the price of a commodity rises and people expect that it will rise still further.
- Hence they buy more of that commodity.
- Similarly, if they expect that there is going to be a further fall in the price, demand may not expand.
- This is contrary to the Law of Demand.

4. TRADE CYCLES:

- During the periods of economic prosperity, people buy more even when the prices rise.
- This happens because the incomes of the people have gone up.
- During times of depression, people buy less and less even when prices fall.

5.IGNORANCE OF PRICE CHANGES / CHANGES IN EXPECTATIONS :

- At times, the customer may not keep track of changes in price. In such a case, he tends to buy more, even if there is an increase in price.
- When people expect a further rise in prices, people buy more when prices rise.
- They want avoid paying more in future.
- Similarly, when people expect the prices to fall in further, they buy less and less as prices fall.
- They may be expecting a further in prices.

6.Where there is a shortage of necessities feared:

- If the customers fear that there could be a shortage of necessities, then this law does not hold good.
- They may tend to buy more than what they require immediately , even if the price of the product increases.

SIGNIFICANCE OF THE LAW OF DEMAND

1. The law of demand is the primary law in consumption theory in Economics.
2. It indicates the consumer behaviour for a given change in the variables in the study.
3. Despite the assumption that other things remaining same, the results of the law of demand are time tested and have been the basis for further decisions relating to costs, output, investment appraisals and so on. This provides the basis for analysis of other economic law

4. To sum up, organizations spend huge amount of resources to understand the consumer behaviour and to know where demand exists for what products and services.
5. Demand analysis forms the first step to know about consumer behaviour which is very complex and how economic decisions are taken based on the concepts of demand and supply.

DEMAND FUNCTION

- **Demand function is a function which describes a relationship between one variable and its determinants.**
- **It describes how much quantity of goods is bought at alternative prices of goods and related goods, alternative income levels and alternative values of other variables affecting demand.**
- **Mathematically, the demand function for a product A can be expressed as follows:**

DEMAND FUNCTION

- $Qd = f(P, I, T, PR, EP, EI, SP, Dc, A, O)$
- Where Qd refers to Quantity of demand and it is a function of the following variables:
- P refers to price of the product.
- I refers to Income level of consumer.
- T refers to tastes and preferences of the consumer.
- PR refers to price of related goods.
- EP refers to Expectations about the prices in future.
- EI refers to Expectations about the incomes in future.

DEMAND FUNCTION

- SP refers to size of population.
- Dc refers to distribution of consumers over different regions.
- A refers to Advertising efforts.
- O refers to any other factors capable of affecting the demand.
- The law of demand states other things remaining the same, the amount of the quantity demanded increases with every fall in the price and vice versa.

DEMAND FUNCTION

- It has certain exceptions.
- They are
- (i) when there is a shortage of necessities feared.
- (ii)Prestige goods
- (iii) Giffen goods
- (iv) Speculation
- (v) Trade cycles (vi) Ignorance of Price Changes.
- Increase in demand and decrease in demand are different from extension and contraction of demand.
- Change in demand result in a shift in demand curve to the right or left.
- In case of extension or contraction of demand, there is a change in the movement (upwards or downwards) along with a given demand curve.

DETERMINANTS OF DEMAND

- **There are so many factors on which the demand for a commodity depends. These factors are Economic, Social as well as Political factors.**
- **The affect of all these factors on the amount of demanded for the commodity is called Demand Function.**
- **The following are some of the factors that cause a change in demand other than price factor.**

1. PRICE OF THE COMMODITY:

- **The most important factor affecting on demand is the price of the commodity.**
- **The amount of the commodity demanded at a particular price is more popularly called price demand. The relation between price and demand is called the Law of Demand.**
- **It is not only the existing price but also expected changes in price, which affect demand.**

2. PRICES OF RELATED GOODS

i) CHANGE IN THE PRICES OF SUBSTITUTES:

- **In case of substitutes like tea and coffee an increase in price of one commodity leads to an increase in the demand for other commodity and vice versa.**
- **The rise in price of coffee shall rise the demand for tea.**

ii) CHANGE IN THE PRICES OF COMPLEMENTARIES:

In case of complementariness like car and petrol a fall in price of one commodity leads to an increase in the demand for other commodity and vice versa.

If the price of pens goes up , their demand is less as a result of which the demand for ink is also less. The price and demand go in opposite direction. The effect of changes in price a commodity on amounts demanded of related commodities is called cross demand.

3. INCOME OF THE CONSUMER

- The third most important factor influencing demand is consumer income.
- In fact we can establish a relationship between the consumer income and demand at different levels of income, price and other things remaining same.
- The demand for a normal commodity goes up and falls down when income rises and falls down.
- But in case of Giffen goods the relationship is opposite.
- Demand always changes with a change in the incomes of the people.
- When income increases the demand for several commodities increases and vice versa.

4. TASTES AND FASHIONS OF CONSUMERS

- **The fourth most important factor influencing demand is consumers tastes and fashions.**
- **The demand also depends on consumer's taste. Tastes include fashion, habit, customs etc.**
- **A customer taste is also affected by advertisement.**
- **If the taste for a commodity goes up, its amount demanded is more even at the same price.**
- **This is called increase in demand. The opposite is called decrease in demand.**
- **A change in the tastes and fashions brings about a change in demand for a commodity.**
- **When commodity goes out of fashion , the demand for it will decrease even though the price remains the same. Demand curve shifts to the left.**

5. AFFECT OF WEALTH

- **The amount demanded of the commodity is also affected by the amount of wealth as well as its distribution.**
- **When the wealth of the people is more, demand for the normal commodities is also more.**
- **If wealth is more equally distributed, the demand for necessaries and comforts is more.**
- **On the other hand, if some people are rich , while the majorities are poor, the demand for luxuries is generally higher.**

6. CHANGE IN POPULATION

- **Increase in population increases demand for necessaries of life.**
- **The composition of population also affect demand.**
- **Composition of population means the proportion of young and old and children as well as the ratio of men and women.**
- **A change in composition of population has an affect on the nature of demand for different commodities.**
- **A change in size as well as composition of population will effect the demand for certain commodities.**
- **For example: An increase in size of population will increase the demand for food grains. Similarly, an increase in percentage of women increases the demand for bangles and sarees.**

7. CHANGES IN CLIMATE AND WEATHER

- **Demand always changes with a change in weather or climate even though price remains unchanged.**
- **In summer the demand for cool drinks increases and in winter it decreases.**
- **The climate of an area and the weather prevailing there has a decisive effect on consumer's demand.**
- **In cold areas woollen cloth is demanded. During hot summer days , ice is very much in demand. On a rainy day , ice cream is not so much demanded.**

8. CHANGES IN GOVERNMENT POLICY

- Government policy affects the demand for commodities through taxation.
- Taxing a commodity increases its price and demand goes down.
- similarly, financial help from government increases the demand for a commodity while lowering its price.

9. EXPECTATIONS REGARDING THE FUTURE

- **If consumers expect changes in price of commodity in future, they will change the demand at present even when the present price remains the same.**
- **Similarly, if consumers expect their incomes to rise in the near future they may increase the demand for a commodity just now.**

10. STATE OF BUSINESS:

- The level of demand for different commodities also depends upon the business conditions in the country.
- If the country is passing through boom conditions, there will be a marked increase in demand.
- On the other hand, the level of demand goes down during depression conditions.

11. ADVERTISEMENT:

- **Advertisement has become the most popular means in changing the demand for a commodity in the modern world.**
- **By a regular advertisement the preference of the consumers can be influenced.**

12. TECHNICAL PROGRESS

- Due to technical progress new commodities will enter into the market and demand for the old commodities will decrease.
- For example, Due to the introduction of electronic watches the demand for ordinary watches has decreased.

ELASTICITY OF DEMAND

- **Elasticity of demand explains the relationship between a change in price and consequent change in amount demanded.**
- **Marshall introduced the concept of Elasticity of Demand.**
- **Elasticity of Demand shows the extent of change in quantity demanded to a change in price.**

DEFINITIONS OF ELASTICITY OF DEMAND

- **In the words of Alfred Marshall,**

" The elasticity of demand in a market is great or small according to the amount demanded increases much or little for a given fall in the price and diminishes much or little for a given rise in price".

DEFINITIONS OF ELASTICITY OF DEMAND

In the words of Stonier and Hague,

" Elasticity of demand describes the degree of responsiveness of the demand for a commodity to a fall in its price".

According to Samuelson,

"Elasticity is the degree of change in demand as a result of change in price".

DEFINITIONS OF ELASTICITY OF DEMAND

- **Elastic Demand:**

A small change in price may lead to a great change in quantity demanded. In this case, demand is elastic.

In-elastic Demand:

If a big change in price is followed by a small change in demanded then the demand in inelastic.

TYPES OF ELASTICITY OF DEMAND

- There are three types of elasticity of demand. They are

I. PRICE ELASTICITY OF DEMAND

II. INCOME ELASTICITY OF DEMAND

III. CROSS ELASTICITY OF DEMAND

I. PRICE ELASTICITY OF DEMAND:

- Marshall was the first economist to define price elasticity of demand.
- Price elasticity of demand measures changes in quantity demand to a change in price.
- It is the ratio of percentage of change in demand to percentage of change in price.

I. PRICE ELASTICITY OF DEMAND:

- The relationship between the percentage in price and the percentage change in demand is known as price elasticity of demand.
- It explains the rate of change in demand for a given change in the price of the commodity.
- To measure the price elasticity of demand the following formula is adopted.
- Price elasticity of demand = Percentage of change in demand / percentage of change in the price.

I. KINDS OF PRICE ELASTICITY OF DEMAND

- **There are five types of price elasticity of demand.**
- **They are**

1. Perfectly elastic demand

2. Perfectly inelastic demand

3. Relatively elastic demand

4. Relatively inelastic demand

5. Unit elasticity of demand

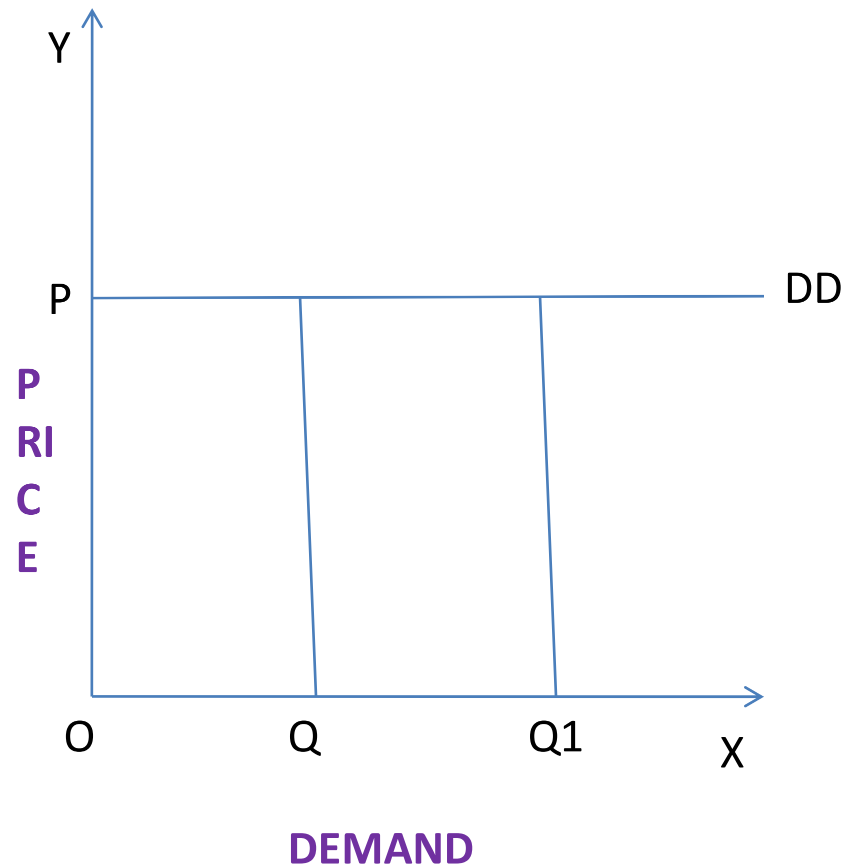
1. Perfectly Elastic demand

- Demand is to be perfectly elastic when infinite quantity can be purchased at the same price.
- A slight change in in price will bring about an infinite change in demand.
- The value of elasticity of demand is infinite.
- The demand curve is a horizontal straight parallel to X-axis. This is shown in the diagram given.

Perfectly Elastic demand curve

- In this diagram demand is shown on X-axis and price on Y- axis.
- DD is horizontal straight line parallel to X-axis. This is shown in this diagram.
- It shows at OP price any amount is demanded and if price increases, the consumer will not purchase the commodity.
- Here, the demand has increased from OQ to OQ1 even enough there is no change in price.

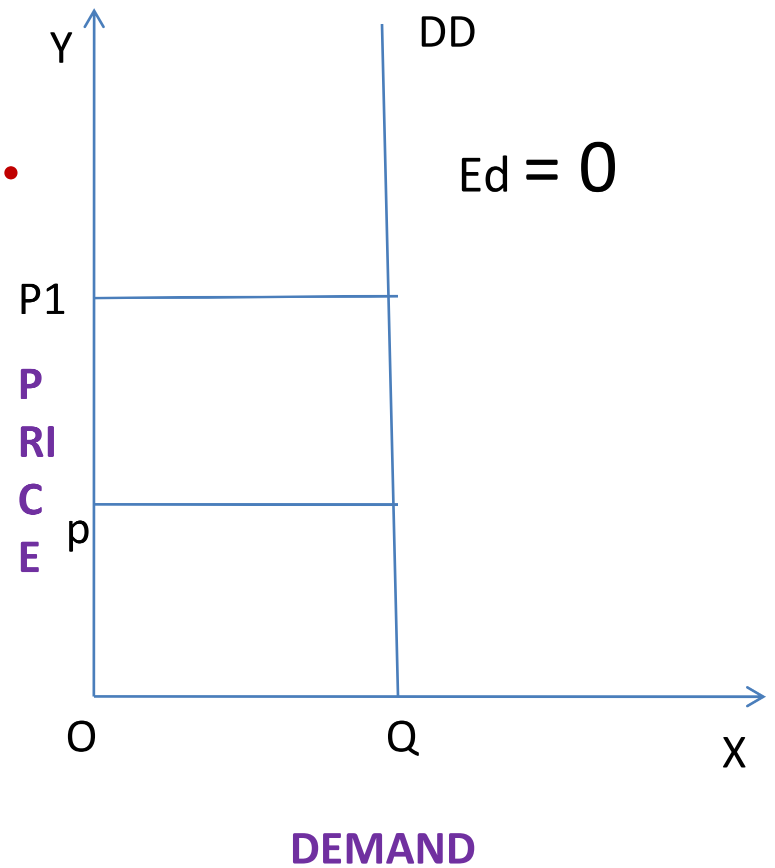
- **Perfectly Elastic demand Curve**
- **Ed = Infinitive.**



Perfectly Inelastic demand Curve

- If a change in price does not bring about any change in the demand, then it is called perfectly inelastic demand.
- The quantity demanded remains fixed, whatever the price might be.
- In this case DD demand curve will be vertical straight line parallel to Y-axis as shown in this diagram.
- In this diagram even though the price has increased from OP to OP1 the demand remained constant.
- Hence this diagram represents constant demand.
- When price increases from OP to OP1 the demand remains same. In other words the response of demand to change in price is nil. In this case Ed= 0

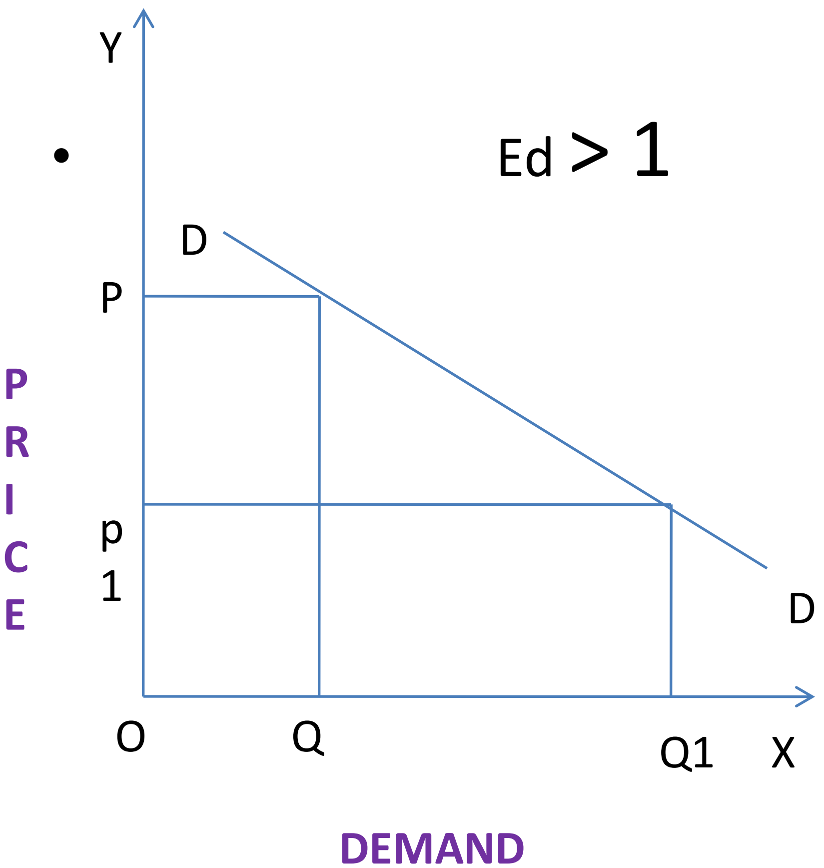
- Perfectly inelastic Curve



Relatively elastic demand Curve

- If the proportionate change in the demand is more than the proportionate change in the price, it is called relatively elastic demand.
- Here Ed > 1. Demand curve DD will be flatter.
- This is shown in this diagram.
- In this diagram the change in demand (QQ1) is more than the change in price(PP1).
- When price falls from OP to OP1 amount demanded increases from OQ to OQ1

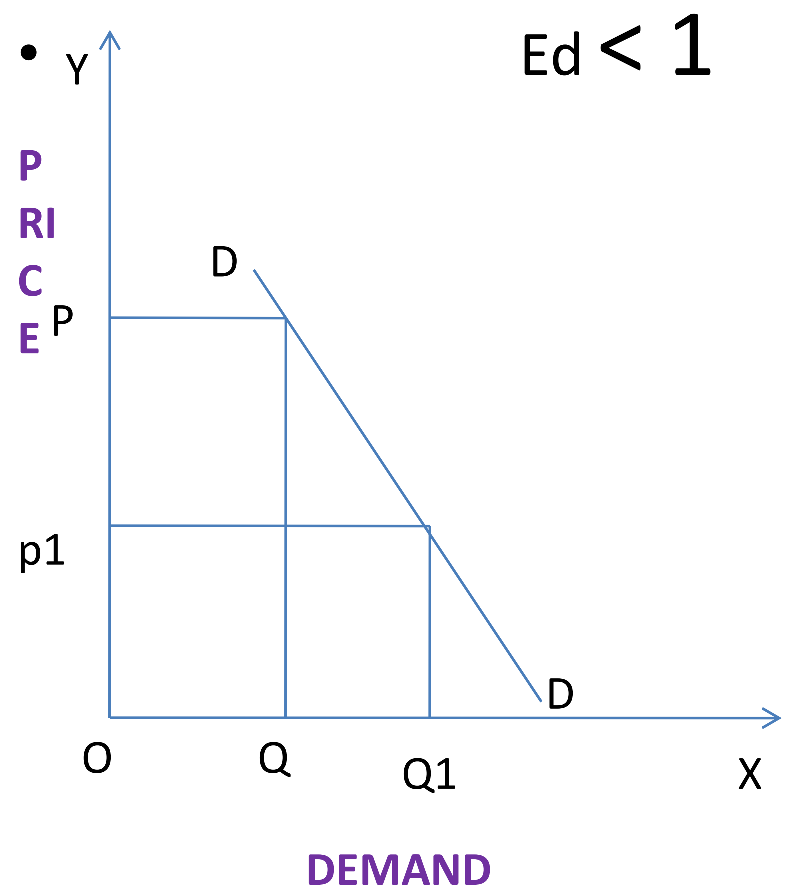
- Relatively elastic Curve



Relatively inelastic demand

- If the proportionate change in the demand is less than the proportionate change in the price .
- It is called relatively inelastic demand.
- This is shown in this diagram. In this diagram, the change in the demand (QQ1) is less than the change in the price (PP1).
- A large change in price leads to small change in demand. Here Ed< 1 .
- Demand curve will be steeper. When price falls from OP to OP1 demand increases from OQ to OQ1, which is smaller than the change in price.

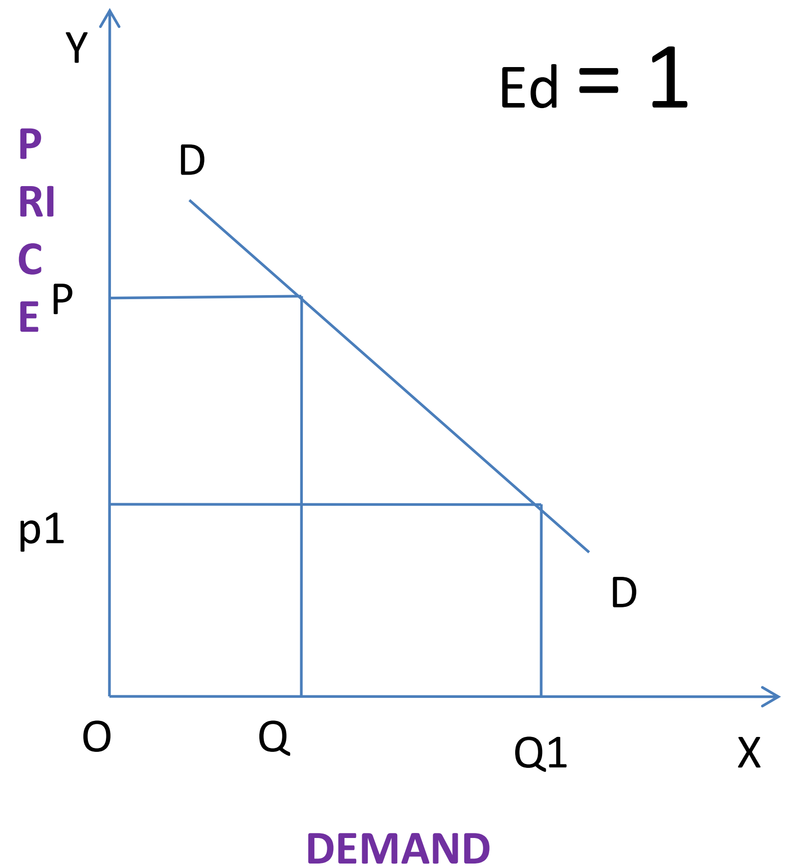
- **Relatively inelastic Curve**



Unit Elasticity of Demand

- The change in demand is exactly equal to the change in price. It is known as unit elasticity of demand.
- when both change in price and change in demand are equal Ed=1 and elasticity if said to be unitary.
- When price falls from OP to OP1 demand increases from OQ to OQ1.
- Thus a change in price has resulted in an equal change in demand so price elasticity of demand is equal to unity.

- **Unit elasticity of Demand Curve**



II. INCOME ELASTICITY OF DEMAND

Income Elasticity of demand shows the change in quantity demanded as a result of change in income. Income Elasticity of demand may be stated in the form the following formula.

Income Elasticity =

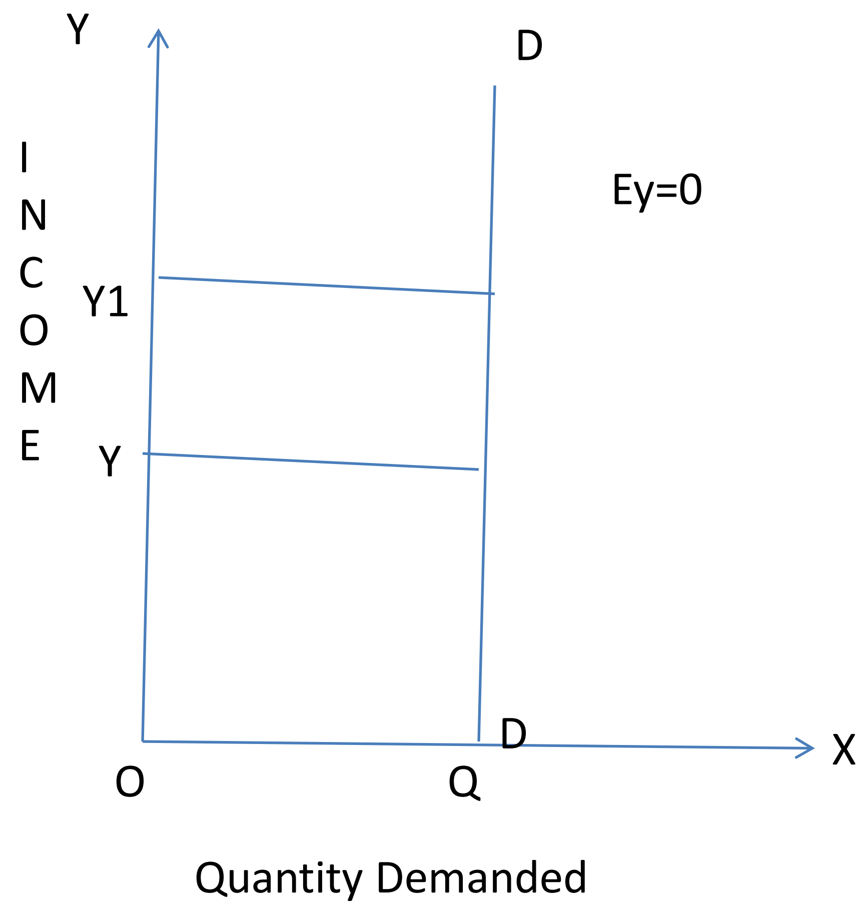
$$\frac{\text{Proportionate change in the quantity demanded of commodity}}{\text{proportionate change in the income of the people}}$$

Income Elasticity of demand may be classified into five types.

They are 1. Zero Income Elasticity 2. Negative Income Elasticity 3. Unit Income Elasticity 4. Income Elasticity greater than unity 5. Income Elasticity Less than Unity

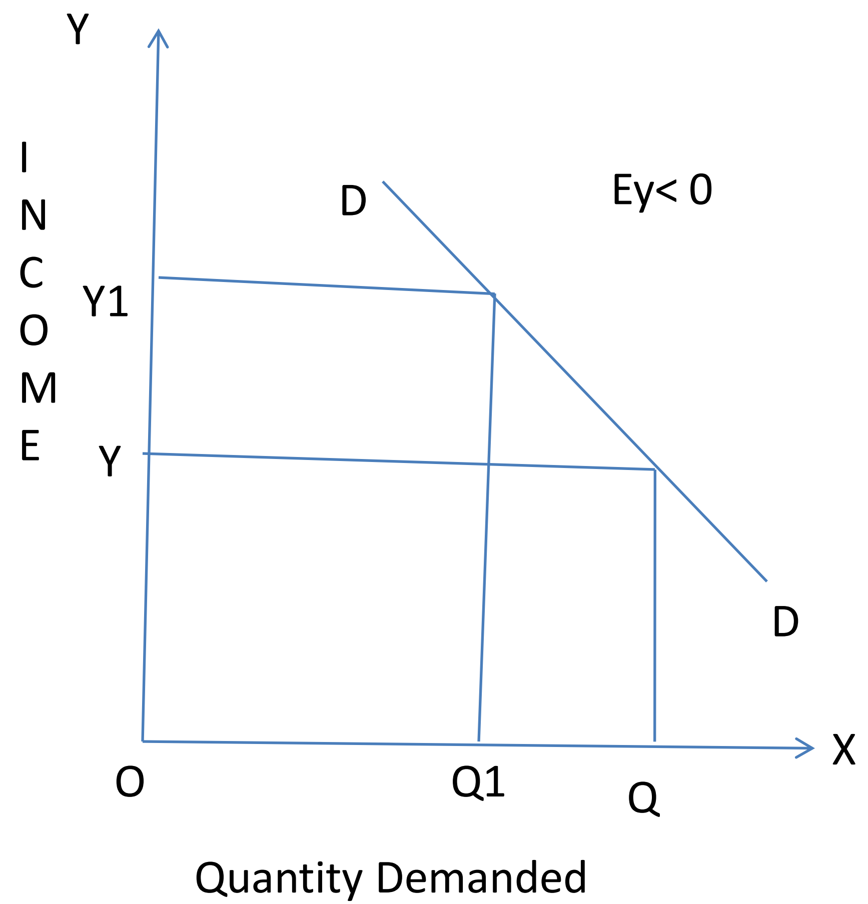
1. ZERO INCOME ELASTICITY

- **Quantity demanded remains the same, even though money income increases.**
- **Symbolically, it can be expressed as Ey=0.**
- **It can be depicted in the following way.**
- **An income increases from OY to OY1, Quantity demanded never changes.**



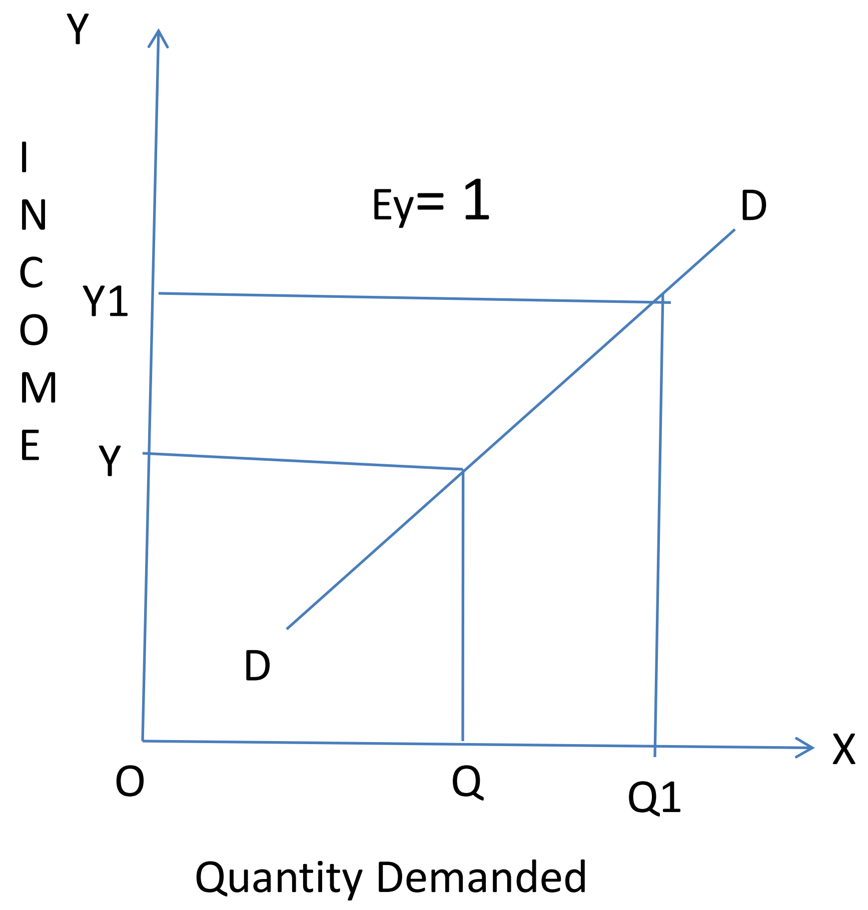
2. NEGATIVE INCOME ELASTICITY

- **When Income increases, Quantity demanded falls.**
- **When Income falls down , Quantity demanded increases.**
- **In this case, Income elasticity of demand is negative. i.e., Ey < 0**
- **When income increases from OY to OY1, Demand falls from OQ to OQ1.**



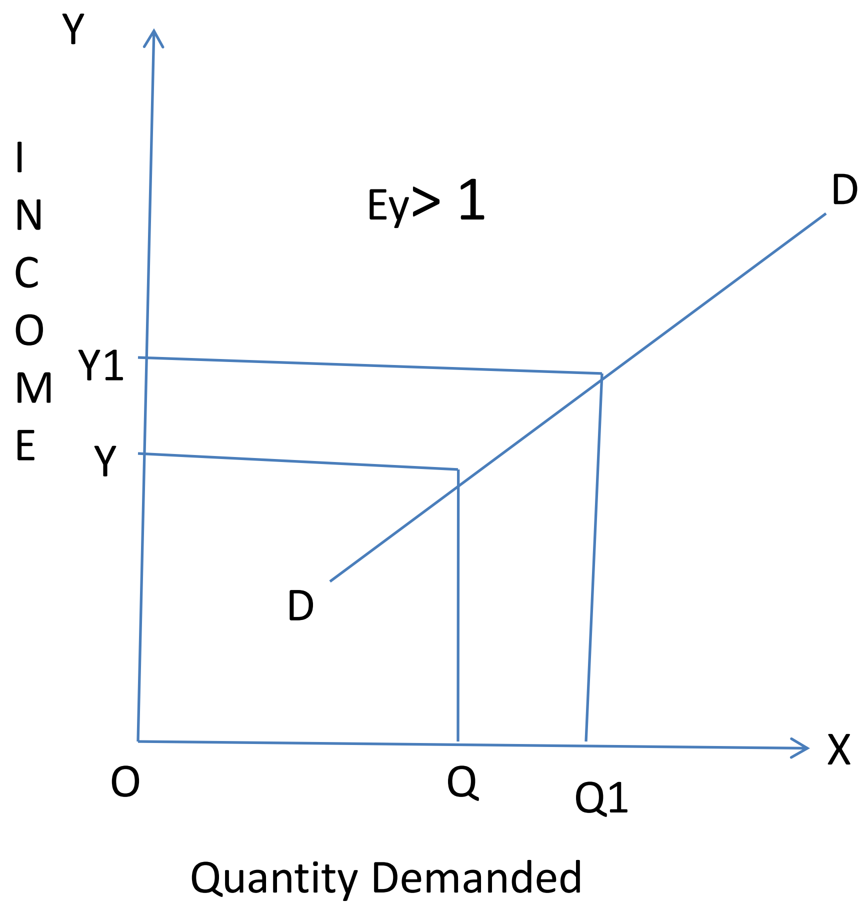
3. UNIT INCOME ELASTICITY

- **When an increase in income brings about a proportionate increase in Quantity demanded.**
- **And then income elasticity of demand is equal to one.**
- **Ey = 1**
- **When income increases from OY to OY1, Demand also increases from OQ to OQ1.**



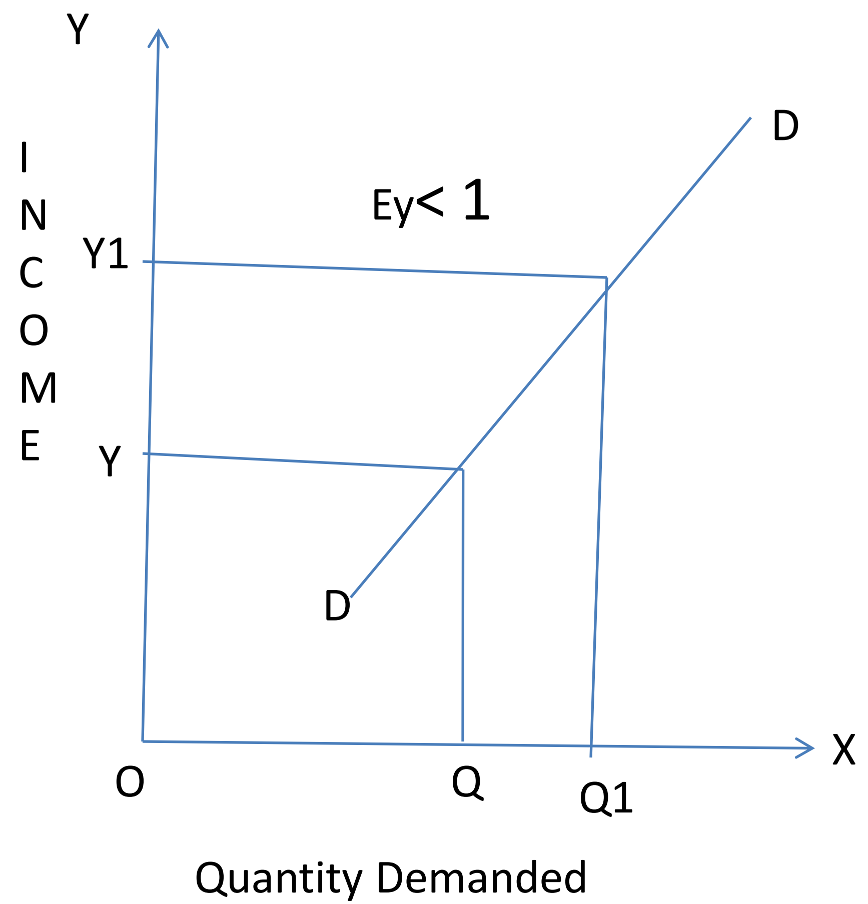
4. INCOME ELASTICITY GREATER THAN UNITY

- In this case, an increase in income brings about a more than proportionate increase in quantity demanded.
- Symbolically it can be written as Ey > 1
- It shows high income elasticity of demand.
- When income increases from OY to OY1, Quantity demanded increases from OQ to OQ1



5. INCOME ELASTICITY LESS THAN UNITY

- **When income increases quantity demanded also increases but less than proportionately. In this case Ey < 1**
- **An increase in Income from OY to OY1 brings what an increase in Quantity demanded from OQ to OQ1.**
- **But the increase in quantity demanded is smaller than the increase in income. Hence, income elasticity of demand is less than one.**



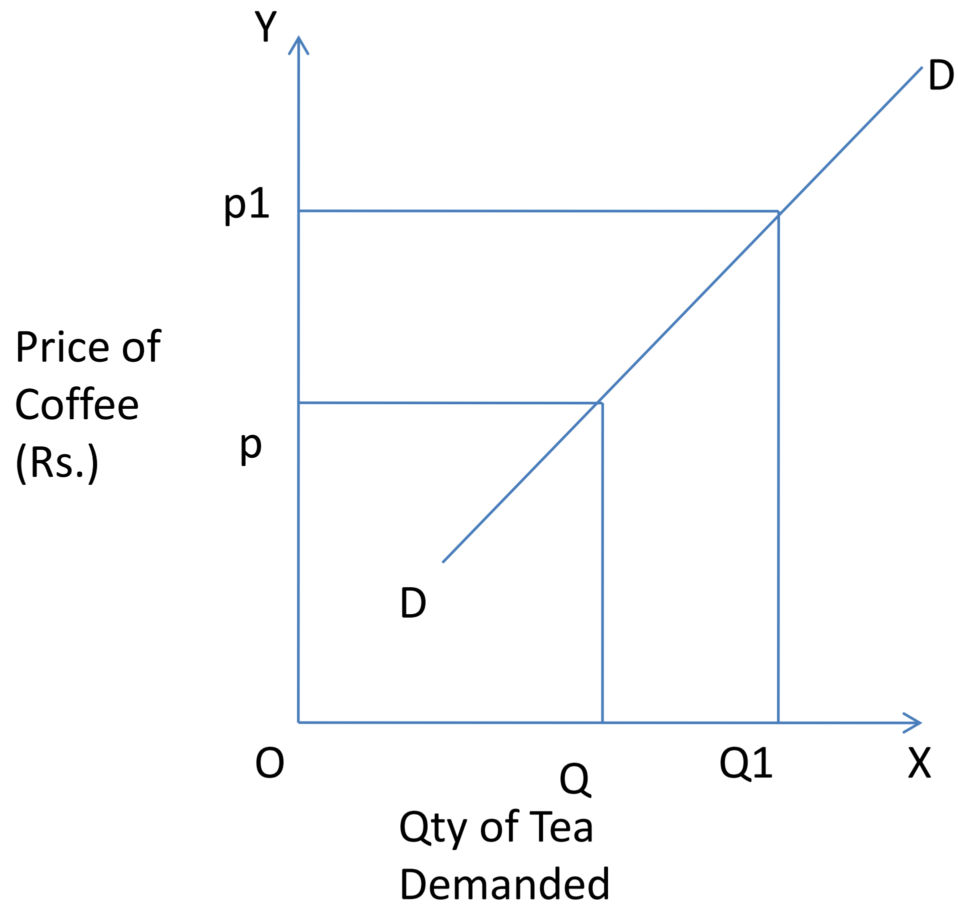
III. CROSS ELASTICITY OF DEMAND

- A change in the price of one commodity leads to a change in the quality demanded of another commodity.
- This is called a cross elasticity of demand.
- The formula for cross elasticity of demand is given as follows:
- Cross Elasticity =

Proportionate change in the demanded of commodity X / proportionate change in the price of commodity Y

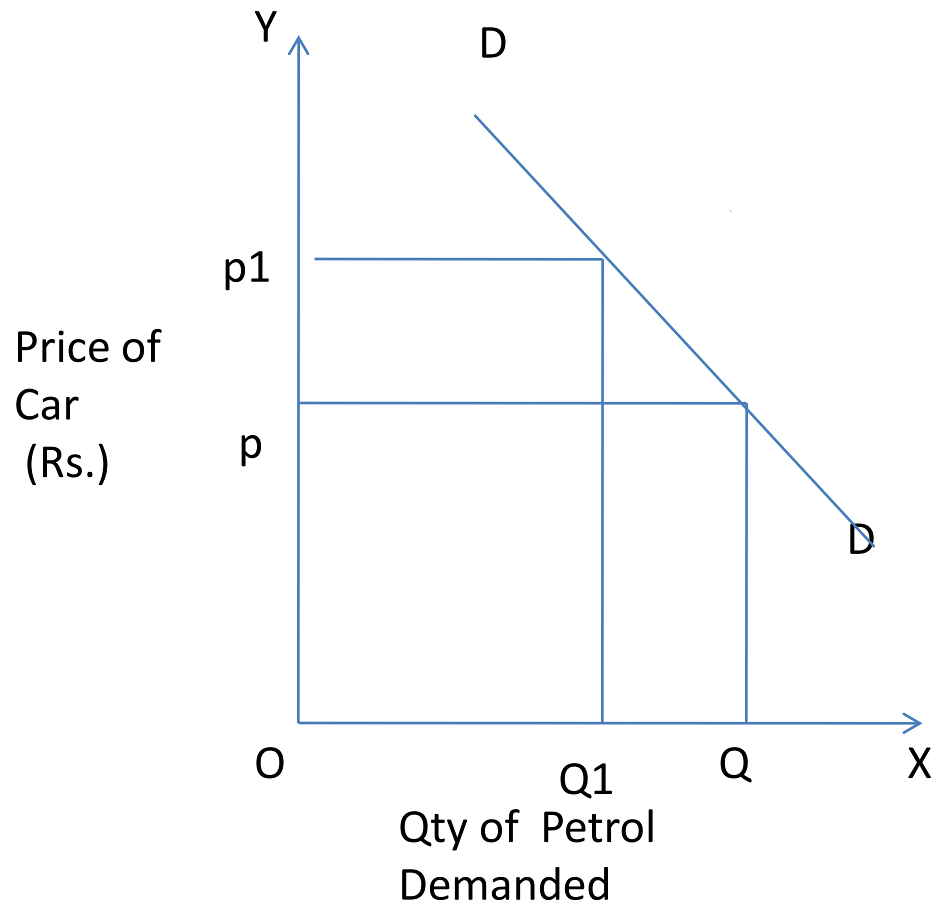
i) IN CASE OF SUBSTITUTES

- **Cross elasticity of demand is positive in case of Substitutes.**
- **Eg. Coffee and Tea**
- **When the price of Coffee increases, quantity demanded of Tea increases. Both are substitutes.**



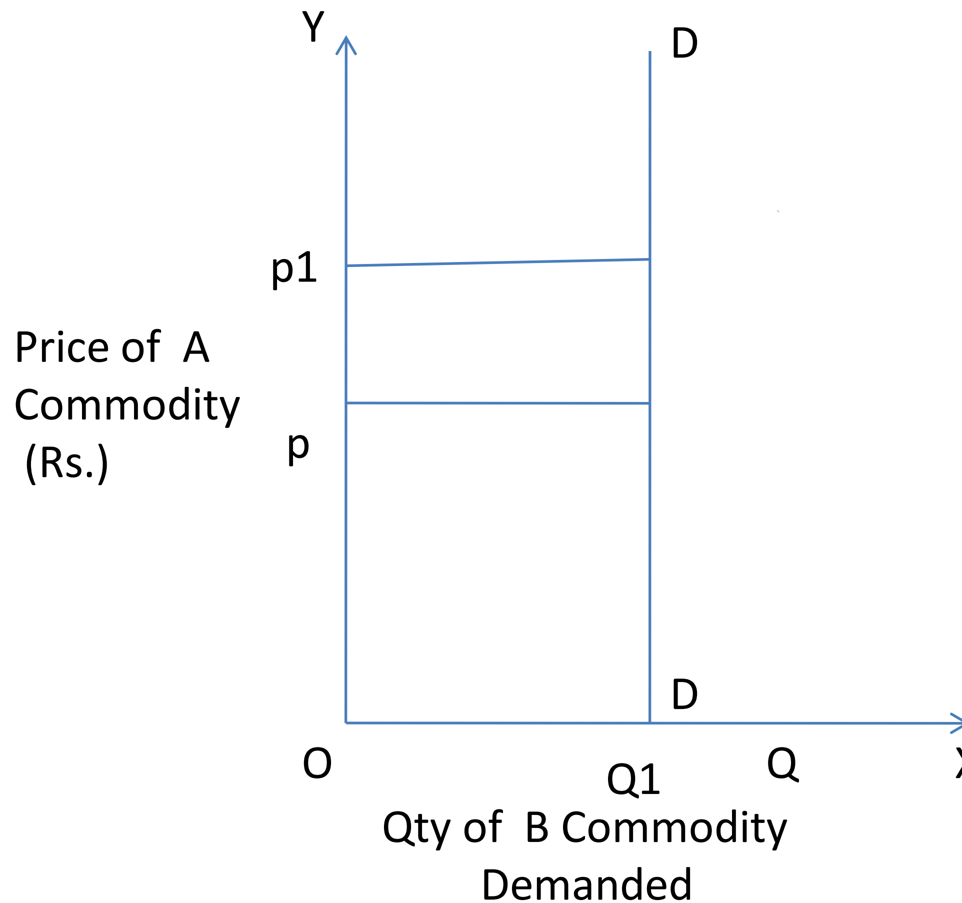
ii) IN CASE OF COMPLIMENTS

- Cross elasticity of demand is negative in case of Compliments.
- Eg. Car and Petrol.
- If increase in the price of one commodity leads to a decrease in the quantity demanded of another commodity and vice-versa.
- When price of Car goes up from OP to OP1 , the Quantity demanded of Petrol decreases from OQ to OQ 1.
- Hence the Cross Demanded curve has negative slope.



ii) IN CASE OF UNRELATED COMMODITIES

- Cross elasticity of demand is Zero.
- A change in the price of one commodity will not affect the quantity demanded of another.
- Quantity demanded of commodity “B” remains unchanged due to a change in the price of “A” as both are unrelated goods.



IMPORTANCE OF ELASTICITY OF DEMAND

The concept of Elasticity of demand has a great practical significance. The knowledge of this concept is useful for different types of persons.

1. PRICE FIXATION:

- **Each seller under monopoly and perfect competition has to take into account elasticity of demand while fixing the price for product. If the demand for the product is inelastic.**
- **Monopolist should study the elasticity of demand for his commodity before fixing the price. If the demand for his commodity is inelastic, he fixes higher price as demand will not fall much.**
- **On the other hand, if the demand is elastic he fixes a low price in order to increase the demand for his commodity.**

2. FINANCE MINISTER or PUBLIC FINANCE

- **The concept of elasticity is useful to finance minister in imposing taxes on goods.**
- **The finance minister studies the elasticity of commodities before he imposes new taxes.**
- **If a tax is levied/charged on the commodity whose demand is elastic, the demand for it will fall greatly.**
- **As a result, the Government would get less revenue.**
- **On the other hand, if a tax is levied on goods having inelastic demand.**
- **Government can be sure of good revenue as the demand will not fall much as a result of rise in price.**

3. PRODUCTION

- Producers generally decide their production level on the basis of demand for the product.
- Hence elasticity of demand helps the producers to take correct decision regarding the level of cut output to be produced.

4. DISTRIBUTION

- Elasticity of demand also helps in the determination of rewards (prices) for factors of production .
- For Example, if the demand for the labour is inelastic , trade unions will be successful in raising wages.
- It is application to other factors of production.
- The concept of demand is useful in determining the relative prices of factors of production.
- The factors which are having inelastic demand will be paid higher prices than those with elastic demand.

5. INTERNATIONAL TRADE

- **Elasticity of demand helps in finding out the terms of trade between two countries/ international trade.**
- **Terms of trade refers to the rate at which domestic commodity is exchanged for foreign commodities.**
- **The terms of trade depends upon the elasticity of demand for exports and imports.**
- **If the exports have elastic demand export prices have to fall very much to increase exports and vice-versa.**
- **Terms of trade depends upon the elasticity of demand of the two countries for each other goods.**

6. NATIONALIZATION / MINISTER OF INDUSTRIES

- **The concept of elasticity of demand enables the government to decide about nationalization of industries.**
- **Before nationalising an industry , minister must know about the elasticity of demand for the product of the industry.**
- **Generally, he will nationalise those industries whose products are having inelastic demand.**
- **Eg. Electricity, Postage and Telegraphs etc.**

7. DETERMINATION OF WAGES:

- Before asking for higher wages , trade union leaders must know about the elasticity of demand for the product produced by them.
- Trade union leaders can demand higher wages only when the goods produced by them have inelastic demand.

8. GRANTING PROTECTION

- **The concept of elasticity of demand is useful in granting protection to the industries also.**
- **Generally protection is granted to those industries whose products have elastic demand.**
- **Thus the concept of elasticity of demand has got both theoretical as well as practical importance.**

Measurement of Price Elasticity of Demand

- **To know the exact rate of change in demand for a change in price , elasticity of demand has to be measured.**
- **Generally, the following three methods are used for the measurement of elasticity of demand.**
- **I. PERCENTAGE METHOD**
- **II. PROPORTIONAL METHOD**
- **III. TOTAL OUTLAY / TOTAL EXPENDITURE METHOD**
- **IV. POINT ELACITY METHOD**

Measurement of Price Elasticity of Demand

I.PERCENTAGE METHOD:

Under this method, elasticity of demand is measured as percentage change in the quantity divided by percentage change in price of the commodity.

Point Ed = (Delta Q/Delta P) X (P1/Q1)

Arc Ed = (Delta Q/Delta P) X (P1+P2)/(Q1+Q2)

II. PROPORTIONAL METHOD

- This is also called percentage method.
- Under this method, the percentage change in the price and percentage change in the demand are calculated and compared.
- If the percentage change in the demand is more than percentage change in the price, demand is said to be elastic.
- If the percentage change in the demand is less than percentage change in the price, demand is said to be inelastic.
- If the percentage change in the demand is equal to the percentage change in the price, demand is said to be unitary.

- **In this method to measure elasticity the following formula is used.**
- **Elasticity of Demand =**

$$\frac{\text{Percentage of change in Demand}}{\text{percentage of change in the price}}$$

- **If the coefficient is one it is called unitary elasticity.**
- **If the coefficient is less than one, it is called inelastic.**
- **If the coefficient is more than one, it is called elastic.**

➢ III. TOTAL EXPENDITURE METHOD:

➢ This method was suggested by Marshall to measure elasticity of demand.

➢ In this method elasticity can be measured by comparing the total expenditure on commodity before and after the change in price.

➢ According to this method the elasticity is of three types.

➢ 1) when the total expenditure increases as the price falls and decreases as the prices,

➢ In this case the demand is said to be elastic. In this case Ed>1

II. TOTAL EXPENDITURE METHOD:

2) When the total expenditure increases as the price rises and decreases as the price falls, then the demand is said to be inelastic.

- **In this case Ed< 1**

3) When the total expenditure remains unchanged after a change in the price, demand is said to be unitary. In this case Ed= 1

This method is also called as Total Outlay method.

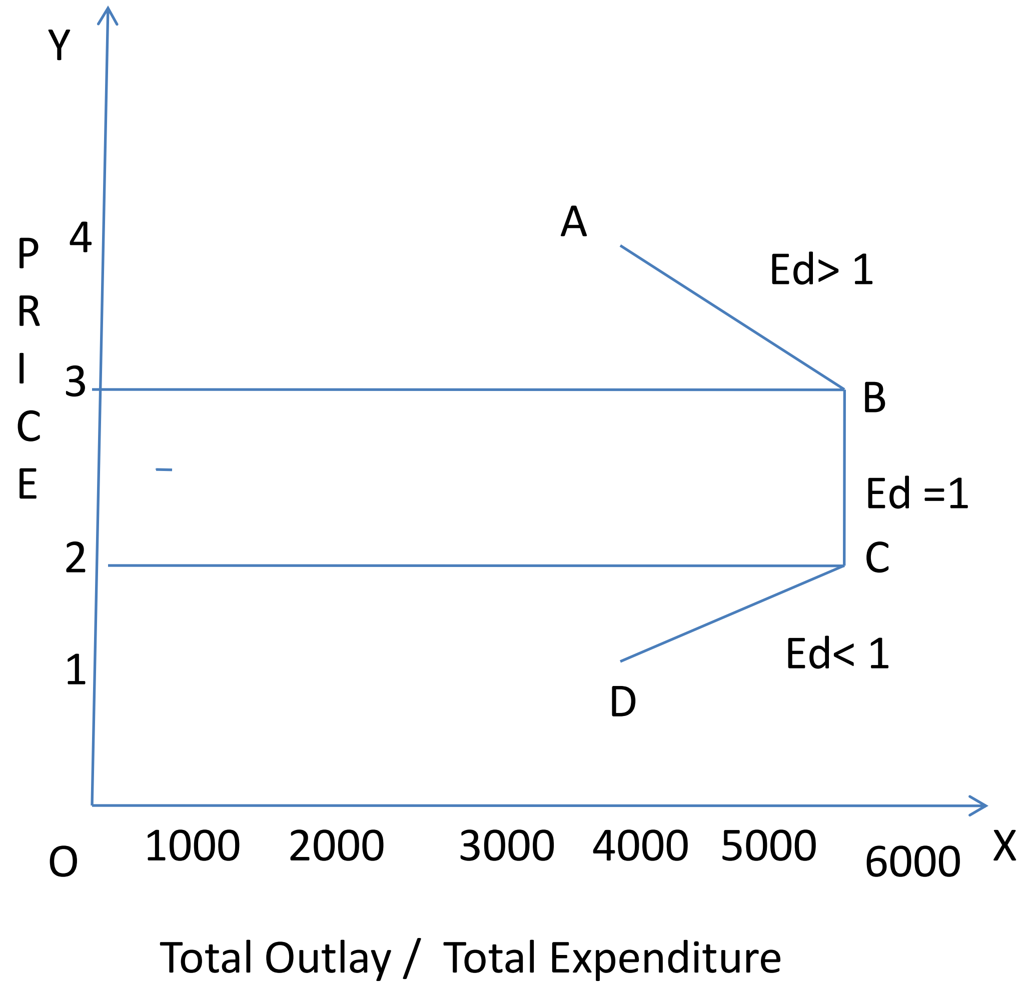
II. TOTAL EXPENDITURE METHOD:

This method can also be illustrated with the help of the following table

PRICE (Rs.)	DEMAND	TOTAL EXPENDITURE (Rs) (Demand Price)	NATURE OF ELASTICITY
4	1000	4,000	Elastic Demand
3	2000	6,000	Unitary Elastic
2	3000	6,000	
1	4000	4,000	Inelastic Demand

- **When price falls from Rs.4 to Rs.3 , the total expenditure has increased from Rs.4,000 to Rs. 6,000. Hence, the demand is said to be elastic between the prices Rs.4 and Rs.3.**
- **When price falls from Rs. 3 to Rs.2 , there is no change in the total expenditure. It remains constant. Hence the demand is said to be unitary elastic between the prices Rs.3 and Rs.2.**
- **When the price falls from Rs.2 to Rs.1 , the total expenditure has fallen from Rs.6,000 to Rs.4,000. Hence the demand is said to be inelastic between the prices Rs.2 to Rs.1.**

- The total outlay method can also be explained with help of a diagram.
- In this diagram ABCD is the total outlay curve. Between the prices 4 and 3 or over the range A TO B Demand is elastic as with a fall in price total outlay has increased.



- **Between the prices Rs.3 and Rs.2 or over the range B to C demand is said to be unitary as there is no change in the total outlay / total expenditure even though price falls.**
- **Between the prices Rs. 2 and Rs.1 or over the range C to D demand is said to be inelastic as with a fall in price the total expenditure also falls.**

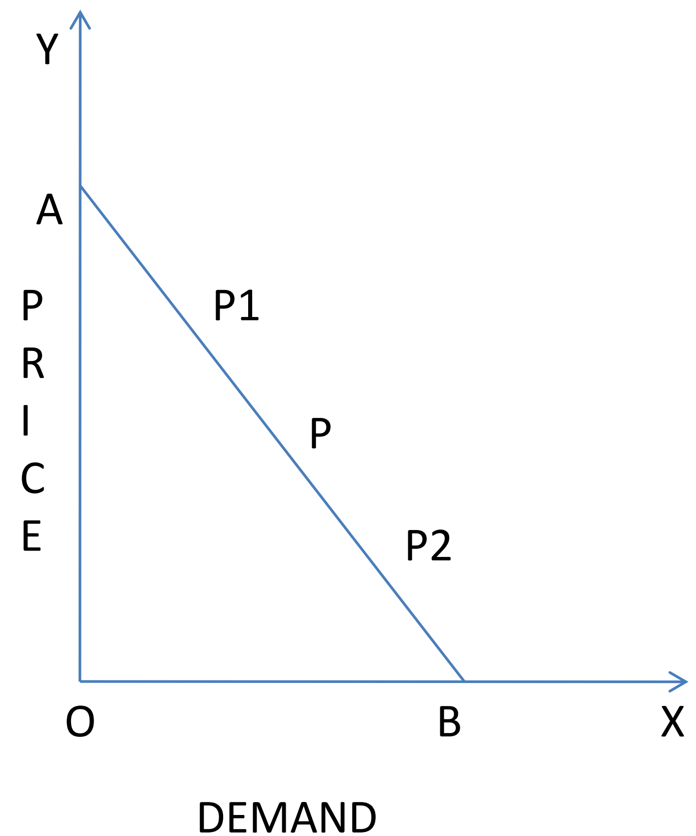
IV. POINT ELASTICITY METHOD :

- This method was suggested by marshall.
- According to this method, we measure elasticity of demand at different points on the demand curve.
- When the elasticity is measured at a particular point on a demand curve, it is called point method.
- This method is also known as Geometrical method.
- In this method, to measure elasticity at a point on a demand line the following formula is applied.
- Elasticity of demand =

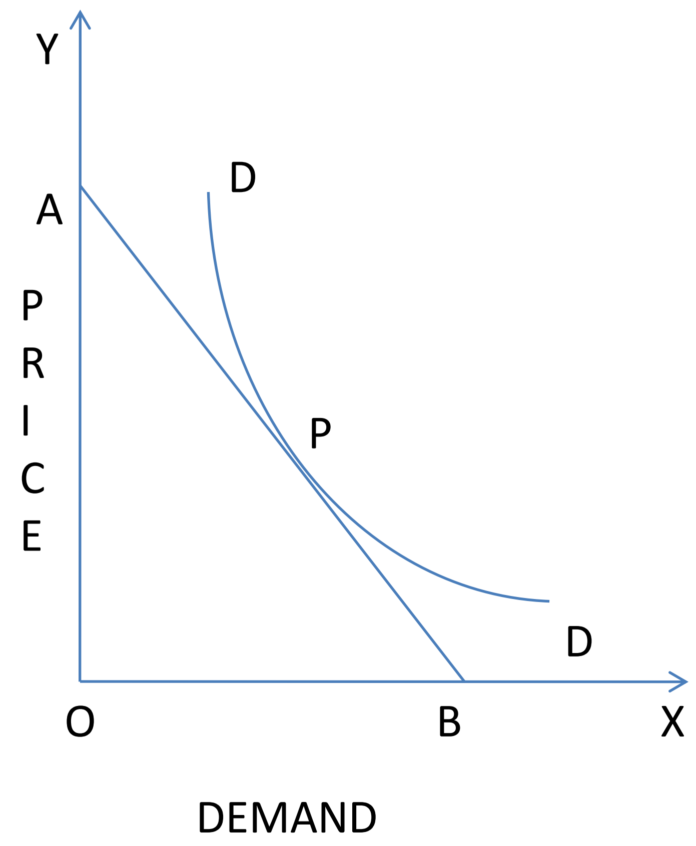
$$\frac{\text{Lower segment of the demand curve}}{\text{Upper segment of the demand curve}}$$

$= L/U = PB / PA$

- **Here the demand curve is a straight line AB.**
- **The elasticity at mid point (P) is unitary, because at a point P the lower segment of the demand line (PB) and upper segment of the demand line (PA) equal. Above the midpoint says P1 demand is elastic because P1 B is longer than P1A. Below the mid point says P2 demand is inelastic because P2B is shorter than the upper part P2A.**



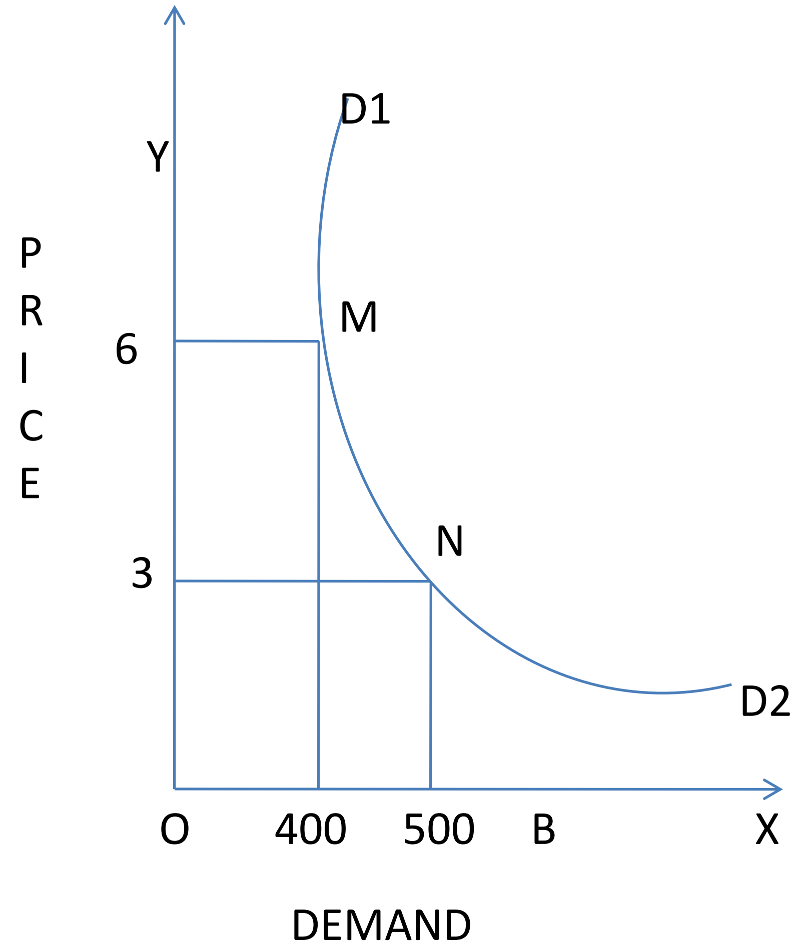
- **If the demand is a curve we draw a tangent to the point where elasticity has to be measured and apply the same formula i.e., lower segment/ upper segment (PB/PA). This method is shown in this diagram.**
- **In this diagram DD is demand curve. We have to measure elasticity at a point P. A is the tangent to P is drawn. AB is the tangent. Elasticity at any point is the ratio of the lower segment of the tangent to upper segment PB/PA. At the point P the lower segment (PB) is equal to upper segment(PA) . So the elasticity of demand at the point P is unitary.**



➢ Arc Elasticity

➢ **Arc elasticity demand curve measures the average responsiveness to price change over a finite stretch on the demand curve.**

PRICE OF APPLE (Rs.)	QUANTITY DEMANDED
3	500
6	400



- **In the above diagram MN refers to the stretch on the demand curve D1D2.**
- **It is not clear whether point M or point N should be considered to determine elasticity of demand.**
- **It makes a difference from which point we start.**
- **Moving from point M to N is different from N to M.**
- **It is because the percentage changes in quantity and price is different, depending upon the price and quantity from which it is taken.**
- **The difference in the starting point reveals the different values of elasticity coefficients.**
- **If we move from M to N, we get** $Ep = \left\{\frac{\text{Delta Q}}{\text{Delta P}}\right\}(P/Q)$

$$= 100/3 \times 6/400 = 0.5$$

- If we move from N to M, we get Ep= Delta Q / Delta P P/Q

= 100/3 X 3/500 = 0.2

Now take the average of the two end values (0.5 +0.2)/2 = 0.35

Which means it is the price demand that is inelastic.

The Arc elasticity is defined as follows:

Arc Ep= ((Delta Q/Delta P) (P1+P2) /2) / (Q1+Q2) /2

OR

E= (Delta Q/Q1+Q2)/ (Delta P/P1+P2) / 2

Where P1 and P2 are prices before and after changes , Q1 and Q2 are Quantities Demanded before and after changes respectively.

- **Delta Q and Delta P refer to change in quantity demanded and change in the price respectively.**
- **To make the Arc Elasticity more meaningful , compute between the points on the demand curve that are close enough.**
- **To conclude , Elasticity of demand is a very important concept for decision makers whether it is a finance minister or a monopolist.**
- **The concept of elasticity of demand helps to measure changes in the quantity demanded in relation to changes in income or price and analyse how price or income can be a decisive factor to bring desired change in the quantity demanded.**

FACTORS INFLUENCING ELASTICITY OF DEMAND

- **The elasticity of demand varies with different commodities. For some commodities demand is elastic, while for some other s it is inelastic.**
- **If a change in the price brings about a great change in demand for commodity, it is called elastic demand.**
- **On the other hand , if a change in price brings about a small change in demand , it is called inelastic demand.**

1. NATURE OF COMMODITY:

- Elasticity or in-elasticity of demand depends on the nature of the commodity.

i) Necessaries:

- Generally the demand for necessaries is inelastic.
- In case of necessaries like food, clothing etc., We have to purchase almost a fixed quantity whether the price is high or low. Therefore, the demand for necessaries does not change very much when the price rises or falls. Hence , the demand for necessaries is inelastic.

ii) Comforts and Luxuries:

- In case of comforts and luxuries the demand is elastic.
- They are not essential goods.
- Therefore, when price rises people buy very less.
- When the price falls people buy more.
- Thus, the demand for comforts and luxuries very much.
- Hence the demand for them is elastic.

2. Availability and Non-Availability of Substitutes:

- Elasticity of demand depends on availability and non-availability of substitutes.
- When commodity is having substitutes the demand for it will be elastic.
- For example, Rin and Det soaps are substitutes. If the price of Rin soaps goes up people may buy Det soap instead of Rin soap.
- Therefore, the demand for Rin soap may fall very much if the price goes up. Hence, the demand for substitutes will be elastic.

Non availability of substitutes:

- When there are no substitutes for a commodity like salt the change in price will not cause any change in demand.
- people will not reduce usage of salt when its price rises or they will not buy more salt when its price falls.
- So the demand for it will not change. Hence, the demand for such goods is inelastic.

3. VARIETY OF USES:

i)SEVERAL USES:

- **When a commodity has several uses, its demand tends to be elastic.**
- **When the price of such commodities falls it will be put to many uses. Eg. Electricity.**
- **When the price of electricity per unit falls, it will be used for cooking, washing, heating , cooling, and ironing etc. As a result, its demand increases greatly. Hence demand for these goods will be elastic.**

3. VARIETY OF USES:

ii) SINGLE USE:

- **When a commodity has single use, its demand will tend to be inelastic.**
- **For example, Salt. It can be put to only single/one use.**
- **The demand for it will not change even though price rises or falls.**
- **Hence, the demand for such commodities will be inelastic.**

4. DEGREE OF POSTPONEMENT OF DEMAND

i) POSSIBILITY OF POSTPONEMENT

- If the consumption of a commodity can be postponed, then it will have elastic demand.
- on the contrary, if the consumption of the commodity cannot be postponed, then demand is inelastic.
- The demand for the rice or medicine cannot be postponed, while the demand for cycle or umbrella can be postponed.
- We can postpone the purchasing of some commodities. For example, shoes, Refrigerators , cycle, umbrella etc. If the prices of these commodities rise, people will postpone their purchases. Thus demand falls very much. So, demand for these goods will be elastic.

ii) URGENT

- **We cannot postpone the purchasing of some commodities.**
- **For example, Medicines, Text Books etc.**
- **When there is a rise in the price of these goods the demand will not fall.**
- **Hence the demand is inelastic.**

5. AMOUNT OF MONEY SPENT:

- Elasticity of demand depends on the amount of money spent on the commodity.
- If the consumer spends a smaller amount for example a consumer spends a little amount on salt and match boxes.
- Even when price of salt or match box goes up, demand will not fall. So the demand is in elastic
- Therefore, demand is in case of clothing a consumer spends a large proportion of his income and an increase in price will reduce the demand for clothing.
- So the demand is elastic.

6. RANGE OF PRICES:

i) High priced goods:

- The demand for high priced goods will be inelastic. These goods can be purchased by rich people only.
- Even if there is a rise in price, the rich people do not care much about it. The demand will not fall. So , the demand for these high priced goods will be inelastic.
- For example, rich man will not care if the price of a car increases from Rs. 5,00,000 to Rs. 5,50,000. Hence, demand for the goods whose prices are too high will be generally inelastic.

ii) Low- priced goods:

- The demand for low priced goods is inelastic.
- A change in the price of these goods causes no change in the demand for them. For example, Salt and Match boxes etc.
- If the price of salt or match boxes rises demand for them will not fall.
- Hence, demand for the goods which are having very low prices tends to be inelastic.

7. TIME FRAME

- **Elasticity of demand varies with time.**
- **Generally, demand is inelastic during short period because the consumers do not have enough time to know about the change in price.**
- **Even if they are aware of the price change, they may not immediately switch over to a new commodity, as they are accustomed to the old commodity.**

8. TASTES AND PREFERENCES OF THE CONSUMER

- Where the customer is particular about his taste and preferences, the product is said to be inelastic.
- For the customers who are particular or loyal to certain brands such as Colgate, Tata Products, Annapurna Atta and so on, price increases do not matter.
- They tend to buy that brand in spite of the price changes.

9.EXPECTATION OF PRICES:

- **Where people expect a fall in the price, the demand for the product is likely to be inelastic.**

10. DURABILITY OF THE PRODUCT

- **Where the product is durable in case of consumer durables such as TV, Air Conditioner, the demand is elastic.**
- **In the case of perishable goods such as milk, meat, vegetables etc., the demand is inelastic.**

11. GOVERNMENT POLICY:

- **Where the government policy is liberal, the product is likely to have elastic demand and vice-versa.**
- **Government, in the interest of the lower income group consumers, closely monitors the prices of certain products (such as ration of goods as sold in fair price shops are likely to have inelastic demand).**
- **Also, another example could be taxes.**
- **Government can raise tax collections with a little reduction in the tax rates.**

Factors Governing Demand Forecasting

Demand forecasting refers to an estimate of future demand for the product. It is an objective assessment of the future course of demand, in recent times, forecasting plays an important role in business decision – making.

The survival and prosperity of a business firm depend on its ability to meet the consumer's needs efficiently and adequately. Demand forecasting has an important influence on production planning. It is essential for a firm to produce the required quantities at the right time.

It is also essential to distinguish between forecasting of demand and forecast of sales, sales forecasts are important for estimating revenue, cash requirements and expenses whereas, demand forecasting relate to production, inventory control, timing, reliability of forecast etc. however, there is not much difference between these terms.

1.Functional Nature of Demand:

Market demand for a particular product or service is not a single number but it is a function of a number of factors, for instance, Higher volumes of sales can be realized with higher levels of advertising or promotion efforts.

2. Types of forecasting

Based on the period under forecast, the demand forecast can be of two types) 1)short run forecasting and

2) long run forecasting. Short run forecasts cover a period of one year whereas long- run forecasting any period ranging from one year to 20 years.

3. Forecasting level:

There are three types of forecasting. They are (1)Firm level(2) Industry level (3)National level or at the global level.

1)Firm level: Firm level means estimating the demand for the products and services offered by a single firm.

2)Industry level: The aggregate demand estimated for the good and service of all the firms constitutes the industry level forecast. The total estimate of different trade associations can also be view as industry level forecast.

3)National level : National level forecasting is for the whole economy, national level forecasts are worked out based on the levels of income, savings of the consumers.

4)Global level: Globalization and deregulation,the entrepreneurs have started exploring the foreign markets for which the global level forecasts are utilized.

4. Degree of orientation

- Demand forecasts can be worked out based on total sales or product or service wise sales for a given time period.
- Forecasting in terms of total sales can be viewed as general forecast whereas product or service wise or region or customer segment wise forecast is referred is referred to as specific forecast.

5. New product:

- It is relatively easy to forecast demand for established products or products which are currently in use.
- The new product in consideration can be analyzed as a substitute for some existing product.
- Assess the demand through a sampled or total survey of consumers' intentions over the new product features and price.

5. Nature of goods :

The goods are classified into producer goods, consumer goods, consumer durables and services. The patterns of forecasting in each of these differ.

6.Degree of competition:

There may be a single trader or a few traders depending upon the nature of goods and services.

METHODS OF DEMAND FORECASTING

There are six important methods of demand forecasting. They are

1. Survey methods
2. Statistical methods
3. Expert opinion methods
4. Test marketing
5. Controlled experiments
6. Judgmental approach

1.Survey methods

Under this method, information about the desires of the consumers and opinions of experts are collected by interviewing them. Survey method can be classifieds into four types.

They are i) Opinion survey method

ii)Expert opinion method iii) Delphi method

iv) Consumers interview method.

i) OPINION SURVEY METHOD

- **This method is also known as sales force composite method or collective opinion method.**
- **Under this method, the company asks its salesmen to submit estimate of future sales in their respective territories.**
- **Since the forecasts of the salesmen are biased due to their optimistic and pessimistic attitude, ignorance about economic developments etc.**
- **These estimates are consolidated, reviewed and adjusted by the top executives . In case of wide differences , an average is struck to make the forecasts realistic. This method is more useful and appropriate because the salesmen have knowledge. They can be important source of information. They are cooperative. The implementation within unbiased or their basic can be corrected.**

ii)EXPERT OPINION METHOD:

- Apart from salesmen and consumers, distributors or outside experts may also be used for forecasting.
- In the United States of America, the Automobile companies get sales estimates directly from dealers.
- Firms in advanced countries make use of outside experts for estimating future demand.
- Various public and private agencies all periodic forecasts of short or long term business conditions may be used for forecasting.

iii)Delphi METHOD:

- A variant of the survey method is Delphi method. It is sophisticated method to arrive at a consensus.
- under this method, a panel is selected to give suggestions to solve the problems in hand.
- Both internal and external experts can be the members of the panel.
- Panel members one kept apart from each other and express their views in an anonymous manner.
- There is also a coordinator who acts as an intermediary among the panellists. He prepares a questionnaire and sends it to the panellist. At the end of each round, He prepares a summary report.
- On the basis of summary report the panel members have to give suggestions. This method has been used in the area of technological forecasting.
- It has proved more popular in forecasting. It has provided more popular in forecasting non-economic rather than economic variables.

iv) CONSUMERS INTERVIEW METHOD

- **In this method the consumers are contacted personally to know about their plans and preferences regarding the consumption of the product.**
- **A list of all potential buyers would be drawn and each buyer will be approached and asked how much he plans to buy the listed product in future.**
- **He would be asked the proportion in which he intends to buy. This method seems to be the most ideal method for forecasting demand.**

2. STATISTICAL METHODS:

Statistical method is used for long run forecasting. In this method, statistical and mathematical techniques are used to forecast demand. This relies on past data.

Trend projection method: These are generally based on analysis of past sales patterns.

These methods dispense with the need for costly market research because the necessary information is often already available in company files. This method is used in case the sales data of the firm under consideration relate to different time periods, i.e., it is a time series data. There are five main techniques of mechanical extrapolation.

Trend Projection Methods:

a)Trend line by observation: This method of forecasting trend is elementary, easy and quick. It involves merely the plotting of actual sales data on a chart and them estimating just by observation where the trend line lies. The line can be extended towards a future period and corresponding sales forecast is read form the graph.

b)Least squares methods: This technique uses statistical formulae to find the trend line which best fits the available data. The trend line is the estimating equation, which can be used for forecasting demand by extrapolating the line for future and reading the corresponding values of sales on the graph.

Trend Projection Methods:

c)Time series analysis:

Where the surveys or market tests are costly and time consuming, statistical and mathematical analysis of past sales data offers another methods to prepare the forecasts, that is, time series analysis.

d)Moving average method:

This method considers that the average of past events determine the future events. In other words, this method provides consistent results when the past events are consistent and unaffected by wide changes.

Trend Projection Methods:

e)Exponential smoothing: This is a more popular technique used for short run forecasts. This method is an improvement over moving averages method, unlike in moving averages method, all time periods here are given varying weight, that is , value of the given variable in the recent times are given higher weight and the values of the given variable in the distant past are given relatively lower weights for further processing.

f)Barometric Technique: Simple trend projections are not capable of forecasting turning paints. Under Barometric method, present events are used to predict the directions of change in future. This is done with the help of economics and statistical indicators. Those are (1) Construction Contracts awarded for building materials (2) Personal income (3) Agricultural Income. (4) Employment (5) Gross national income (6) Industrial Production (7) Bank Deposits etc.

Trend Projection Methods:

g) Simultaneous equation method: In this method, all variable are simultaneously considered, with the conviction that every variable influence the other variables in an economic environment. Hence, the set of equations equal the number of dependent variable which is also called endogenous variables.

***h)* Correlation and regression methods:** Correlation and regression methods are statistical techniques. Correlation describes the degree of association between two variable such as sales and advertisement expenditure. When the two variable tend to change together, then they are said to be correlated.

3.Expert opinion methods:

- Well informed persons are called experts. Experts constitute yet another source of information.
- These persons are generally the outside experts and they do not have any vested interest in the results of a particular survey.
- As expert is good at forecasting and analysis the future trend in a give product or service at a given level of technology.
- The service of an expert could be advantageously used when a firm uses general economic forecasting or special industry fore casting prepared outside the firm.

4. Test marketing: It is likely that opinions given by buyers, salesman or other experts may be, at times, misleading. This is the reason why most of the manufactures favour to test their product or service in a limited market as test run before they launch their product nationwide.

5.Controlled Experiments Method:

Controlled experiment refer to such exercise where some of the major determinants of demand are manipulated to suit to the customers with different tastes and preferences, income groups, and such others, it is further assumed that all other factors remain the same.

UNIT-II

PRODUCTION THEORY

AND

COST ANALYSIS

Classification of Cost for Managerial Use

The Cost may be classified into eight categories on the basis of managerial Decisions. They are

1. **Marginal cost**

2.Out of pocket costs

3. Differential cost 4. Sunk cost

5. Imputed or notional costs

6. Opportunity cost. 7. Replacement cost.

8. Avoidable and Unavoidable cost

1. Marginal Cost

- Marginal cost is the total of variable costs i.e., prime cost plus variable overheads.
- It is based on the distinction between fixed and variable costs.
- Fixed costs are ignored and only variable costs are taken into consideration for determining cost of products and value of work-in-progress and finished goods.

2. Out of Pocket Costs

- This is that portion of the costs which involves payment to outsiders i.e., gives rise to each expenditure as opposed to such costs as depreciation, which do not involve any cash expenditure.
- such costs are relevant for price fixation during recession or when make or buy decision is to be made.

3. Differential Cost

- The change in costs due to change in the level of activity or pattern or method of production is known as differential cost.
- If the change increases the cost, it will be called incremental cost.
- If there is decrease in cost resulting from decrease in output, the difference is known as decremental cost.

4. Sunk Cost

- A sunk cost is an irrecoverable cost and is caused by complete abandonment / rejection / leaving of a plant.
- It is written down value of the abandoned plant less its salvage value. Such costs are not relevant for decision-making and are not affected by increase or decrease in volume / size.
- Thus, expenditure which has taken place and is irrecoverable in a situation, is treated as sunk cost.

- For taking managerial decisions with future implications, a sunk cost is an irrelevant cost.
- If a decision has to be made for replacing the existing plant, the book value of the plant less salvage value(if any) will be a sunk cost and will be irrelevant cost for taking decision of the replacement of the existing plant.

5. Imputed Costs or Notional Costs

- Imputed costs or notional costs have the same meaning.
- The American , equivalent term of the British term 'notional cost' is imputed cost.
- These costs are notional in nature and do not involve any cash outlay.
- The Charted Accountants, London defines notional cost as " the value of a benefit where no actual cost is incurred."
- Even though such costs do not involve any cash outlay but are taken into consideration while making managerial decisions.

- Examples of such costs are: notional / unreal rent charged on business premises owned by the proprietor, interest on capital for which no interest has been paid.

- When alternative capital investment projects are being evaluated it is necessary to consider the imputed interest on capital before a decision is arrived as to which is the most profitable project.

6. Opportunity Cost

- It is the maximum possible alternative earning that might have been earned if the productive capacity or services had been put to some alternative use.
- in simple words, it is the advantage , in measurable terms which has been foregone due to not using the facility in the manner originally planned.
- For example, if an owned building is proposed to be used for a project, the likely rent of building is the opportunity cost which should be taken into consideration while evaluating the profitability of the project.

- **Similarly, if the fixed deposit in a bank is withdrawn for financing a new project, the loss of interest on such fixed deposit is the opportunity cost.**

7. Replacement Cost

- **It is the cost at which there could be purchase of an asset or material identical to that which is being replaced or revalued.**
- **It is the cost of replacement at current market price.**

8. Avoidable and Unavoidable Cost

- Avoidable costs are those which can be eliminated if a particular product or department with which they are directly related, is discontinued.
- For example, salary of the clerks employed in a particular department can be eliminated, if the department is discontinued.
- Unavoidable cost is that cost which will not be eliminated with the discontinuation of a product or department.
- For example, salary of factory manager or factory rent cannot be eliminated even if a product is eliminated.

BREAK-EVEN ANALYSIS

- **Break Even Analysis refers to analysis of the break-even point(BEP).**
- **The BEP is defined as no profit or no loss point.**
- **Why is it necessary to determine the BEP when there is neither profit nor loss?**
- **It is an important because it denotes the minimum volume of production to be undertaken to avoid losses.**
- **In other words, it points out how much minimum to be produced to see the profits.**
- **It is a technique for profit planning and control and therefore is considered a valuable managerial tool.**

- **Break-even analysis is defined as analysis of costs and their possible impact on revenues and volume / size of the firm.**
- **Hence, it is also called the cost-volume-profit analysis.**
- **A firm is said to attain the BEP when its total revenue is equal to total cost(TR=TC).**
- **Total cost comprises fixed cost and variable cost.**
- **The significant variables on which the BEP is based are fixed cost, variable cost and total revenue.**

- **The study of cost-volume-profit relationship is often referred as Break Even Analysis.**
- **The Break Even Analysis is interpreted in two senses.**
- **In its narrow sense, it is concerned with finding out Break Even Point.**
- **Break Even Point is the point at which total revenue is equal to total cost.**
- **It is the point of no profit , no loss.**
- **In its broad sense, BEP determines the probable profit at any level of production.**

Key Terms used in Break-Even-Analysis

1. Fixed Cost:

- Expenses that do not vary with the volume of production is known as fixed expenses.
- Fixed costs remain fixed in the short-run. It should be noted that fixed expenses are fixed only within a certain range of plant capacity.
- The concept of fixed overhead is most useful in formulating a price fixing policy. Fixed cost per unit is not fixed.
- Examples of fixed expenses are rent, Insurance, Depreciation, Factory supervisor’s salary, Director’s salaries , taxes, insurance and so on.

2. Variable Cost:

Expenses that vary almost in direct proportion to the volume of production of sales are called variable expenses.

- The variable cost per unit vary with volume of the production.
- It should be noted that variable cost per unit is fixed.
- The variable costs include cost of direct material, direct labour,direct expenses, Electric power, fuel, packing materials, consumable stores, operating supplies such as lubricating oil and so on.

3. Total Cost:

The total of fixed and variable costs.

4. Total Revenue:

The sales proceeds (selling price per unit x number of units sold)

5. Contribution margin:

The contribution margin is the difference between the selling price per unit and variable cost per unit. It is also determined as fixed cost per unit + profit per unit.

Contribution is the difference between sales and variable cost and it contributed towards fixed cost and profit. It helps in sales and pricing policies and measuring profitability of different proposals.

Contribution is a sure test to decide whether a product is worthwhile to be continued among different products.

Contribution = Sales – variable cost

Contribution = Fixed cost + profit

6. Profit:

Profit is the excess amount of sales over total cost.

Profit = contribution- fixed cost

or

sales – variable cost – fixed cost.

7. Contribution margin ratio:

It is the ratio between contribution per unit and selling price per unit.

8. Margin of Safety:

- Margin of safety is the excess of sales over the break even sales. It can be expressed in absolute sales amount or percentage.
- It indicates the extent to which the sales can be reduced without resulting in loss.
- A large margin of safety indicates the soundness of the business. The formula for the margin of safety is given as follows:

Margin of safety in units:

The excess of actual sales (in units) minus the break-even point (in units).

Margin of safety in sales volume:

The excess of sales(in Rupees) minus Break-even point (in Rupees).

Margin of Safety = Present sales- Break even sales

or

= Profit / P/V Ratio

Margin of safety can be improved by taking the following steps.

1. **Increasing production.**
2. **Increasing selling price**
3. **Reducing the fixed or variable costs or both.**
4. **Substituting unprofitable product with profitable one.**

9. Angle of Incidence:

The angle formed where total cost curve cuts the total revenue curve.

- **This is the angle between sales line and total cost line at the Break-even point.**
- **It indicates the profit earning capacity of the concern.**
- **Large angle of incidence indicates a high rate of profit.**
- **A small angle of incidence indicates a low rate of earnings.**
- **To improve this angle, contribution should be increased either by raising the selling price and/or by reducing variable cost.**
- **It also indicates as to what extent the output and sale price can be changed to attain a desired amount of profit.**

10. Profit and Volume Ratio (P/V Ratio):

- The ratio between the contribution and sales is known as P/V Ratio.
- It is one of the most useful ratios for studying the profitability of the business.
- The ratio of contribution to sales is the P/V Ratio . It may be expressed in percentage.
- Therefore, every organization tries to improve the P/V Ratio of each product by reducing the variable cost per unit or by increasing the selling price per unit. The concept of P/V Ratio helps in determining Break-Even Point , a desired amount of profit etc.
- P/V Ratio = (Contribution / Sales) X 100

11. Break-Even Point:

- If we divide the term into three words, then it does not require further explanation.

  Break-divide Even-equal Point-place or position

- Break-Even Point refers to the point where total cost is equal to total revenue.
- It is a point of no profit , no loss. This is also a minimum point of production where total costs are recovered. If sales go up beyond the Break-even point , organization makes profit. If they come down , the loss is incurred.

Break-Even Point is calculated as follows:

- **Break-even point(in Rupees)**

  = Fixed Cost / P/V Ratio

- **Break-even point(in Rupees)**

  = (Fixed Cost /Contribution)X Sales

- **Break-even point(in Units)**

  = Fixed Cost /Contribution Per Unit

- **Break-even point(in Rupees)**

  = Fixed Cost /Selling price per unit – Variable cost per unit

ASSUMPTIONS OF BREAK EVEN ANALYSIS:

1. Costs can perfectly be classified into fixed and variable costs.
2. Selling price per unit remains constant in spite of competition or change in the volume of production. It does not consider the price discounts or cash discounts.
3. Volume of sales and volume of production are equal(All the goods produced are sold). Hence there is no closing stock/ unsold stock.
4. There is only one product available for sale. In case of multi product firm, the product mix / Sales mix remains constant.

5. Fixed costs remain constant at all levels of output.
6. Variable cost fluctuates /vary proportionally with volume of production.
7. There is no opening or closing stock.
8. There will be no change in operating efficiency.
9. The volume of output or production is the only factor which affecting/influencing the cost.
10. There will be no change in general price level.

SIGNIFICANCE / IMPORTANCE OF BREAK-EVEN ANALYSIS

1. Information provided by Break-Even Chart can be understood more easily then those contained in profit and Loss Account and the cost statement.
2. Break Even Chart discloses the relationship between cost, volume and profit. It reveals how changes in the profit. So it helps management in decision-making.
3. It is very useful for forecasting costs and profits for a long-term planning and growth.
4. The Break Even Chart discloses profits at various levels of production.

SIGNIFICANCE / IMPORTANCE OF BREAK-EVEN ANALYSIS

5. It serves as very useful tool for cost control.
6. It can also be used to study the comparative plant efficiencies of the industry.
7. Analytical Break Even Chart presents the different elements in the costs i.e., direct material, direct labour, fixed overheads and variable overheads.

Break-even analysis is also a valuable tool

- to as certain the profit on a particular level of sales volume or a given capacity of production.
- to calculate sales required to earn a particular desired level of profit.
- to compare the product lines, sales area, methods of sale for individual company.
- to compare the efficiency of the different firms.
- to decide whether to add a particular product to the existing product line or drop one from it.
- to decide to 'make or buy' a given component or spare part.
- to decide what promotion mix will yield optimum sales.
- to assess the impact of changes in fixed cost, variable cost or selling price on BEP and profits during a given period.

LIMITATIONS OF BREAK-EVEN ANALYSIS

Break-even analysis has certain underlying assumptions which form its limitations.

1. Break-even point is based on fixed cost, variable cost and total revenue. A change in one variable is going to affect the BEP.
2. All costs cannot be classified into fixed and variable costs. We have semi-variable costs also.
3. In case of multi product firm, a single chart cannot be of any use. Series of charts have to be made use of.
4. It is based on fixed cost concept and hence holds good only in the short-run.
5. total cost and total revenue lines are not always straight as shown in the figure. The quantity and price discounts are the usual phenomena affecting the total revenue line.
6. Where the business conditions are volatile/ unstable BEP cannot give stable results.

7. Break-even chart represents only cost volume profits. It ignores other considerations such as capital amount, marketing aspects and effect of government policy etc., which are necessary in decision making.
8. It is assumed that sales, total cost and fixed cost can be represented as straight lines. In actual practice, this may not be so.
9. It assumes that profit is a function of output. This is not always true. The firm may increase the profit without increasing output.
10. A major draw back of Break Even Chart(BEC) is its inability to handle production and sale of multiple products.

11. **It is difficult to handle selling costs such as advertisement and sales promotion in BEC.**
12. **It ignores economies of scale in production.**
13. **Fixed costs do not remain constant in the long run.**
14. **Semi-variable costs are completely ignored.**
15. **It assumes production is equal to sale. It is not always true because generally there may be opening stock.**
16. **When production increases variable cost per unit may not remain constant but may reduce on account of bulk buying etc.**
17. **The assumption of static nature of business and economic activities is a well-known defect of Break Even Chart (BEC).**

UNIT-III

MARKETS AND

NEW ECONOMIC ENVIRONMENT

PERFECT MARKET-MEANING

- Market is defined as a place or point at which buyers and sellers negotiate their exchange of well-defined products or services.
- A market structure in which all firms in an industry are price takers and in which there is freedom of entry into and exit from the industry is called Perfect Market.
- The market with perfect competition conditions is known as perfect market.
- A market is said to be perfect if certain conditions are satisfied. Where the market is perfect the competition is said to be perfect.

- **According to Marshall** " the more nearly perfect market is, the stronger is the tendency for the same price to be paid for the same thing at the same time, in all parts of the market".
- Perfect competition in economic theory has a meaning diametrically opposite to the everyday use of the term.
- In practice, businessmen use the word competition as synonymous to rivalry.
- In theory, perfect competition implies no rivalry among firms.

- Perfect competition , therefore, can be defined as a market structure characterized by a complete absence of rivalry among the individual firms.

FEATURES OF PERFECT COMPETITON

1. LARGE NUMBER OF BUYERS AND SELLERS:

- There should be significantly large number of buyers and sellers in the market.
- The number should be so large that it should not make any difference in terms of price or quantity supplied even if one enters into the market or one leaves from the market.

2. PRODUCTS/SERVICES ARE HOMOGENEOUS/ IDENTICAL:

- In a perfect competition industry, the products of each seller should be homogeneous/identical.
- They cannot be differentiated from that of one another.
- It makes no difference to the buyer whether he buys from firm X or firm Z.
- In other words, the buyer does not have any particular preference to buy goods from a particular trader or supplier.

- **The price is one and the same in every firm.**
- **There are no concessions or discounts.**
- **The technical characteristics of the product as well as the services associated with its sale and delivery are identical.**

3. FREEDOM TO ENTER INTO MARKET AND LEAVE FROM THE MARKET:

- There should not be any restrictions on the part of the buyers and sellers to enter the market or leave the market.
- There should not be any barriers .
- The buyers can enter into the market or leave from the market whenever they want.
- If the industry earns abnormal profits, new firms will enter into industry to share these profits.
- Similarly, if firms in the industry are incurring losses some of them will quit/leave from the industry which will reduce the supply of the industry and will thus raise the price and the losses are wiped away.

4. PERFECT INFORMATION AVAILABLE TO THE BUYERS AND SELLERS:

- Each buyer and seller has total knowledge of the prices prevailing in the market at every given point of time, quantity supplied, costs, demand, nature of product and other relevant information.
- There is no need for any advertisement expenditure as the buyers and sellers are fully informed.

5. PERFECT MOBILITY OF FACTORS OF PRODUCTION:

- There should not be any restrictions on the utilization of factors of production such as land, labour, Capital and so on.
- In other words, the firm or buyer should have free access to the factors of production.
- Whenever, capital or labour is required, it should instantly be made available.

6. EACH FIRM IS A PRICE TAKER:

- An individual firm can alter its rate of production or sale without significantly affecting the market price of the product.
- A firm in a perfect market cannot influence the market through its own individual actions.
- It has no alternative other than selling its products at the price prevailing in the market.
- It cannot sell as much as it wants as its own set price.

- **Under such a market, no single buyer or seller can play a significant role in determining the price.**
- **In other words, the price is determined by the industry as a whole, which comprises both buyers and sellers.**
- **Here the industry demand curve represents the total demand from all the consumers at various prices.**
- **Similarly, the industry supply curve represents the total quantity supplied by all sellers at various prices.**

7. ABSENCE OF GOVERNMENT REGULATION :

- There is no government intervention in the form of tariffs, subsidies relationship of production or demand.
- If these assumptions are fulfilled, it is called pure competition, and to be called perfect competition some more following conditions are to be fulfilled.

8. ABSENCE OF TRANSPORT COSTS:

- There shall be no transport costs between sellers.
- In other words, we can say that the market price charged by different sellers does not differ due to the location of different sellers in the market.
- No seller is nearer or distant to any group of buyers.
- This will ensure that there will not be any transport cost from one part of the market to the other .

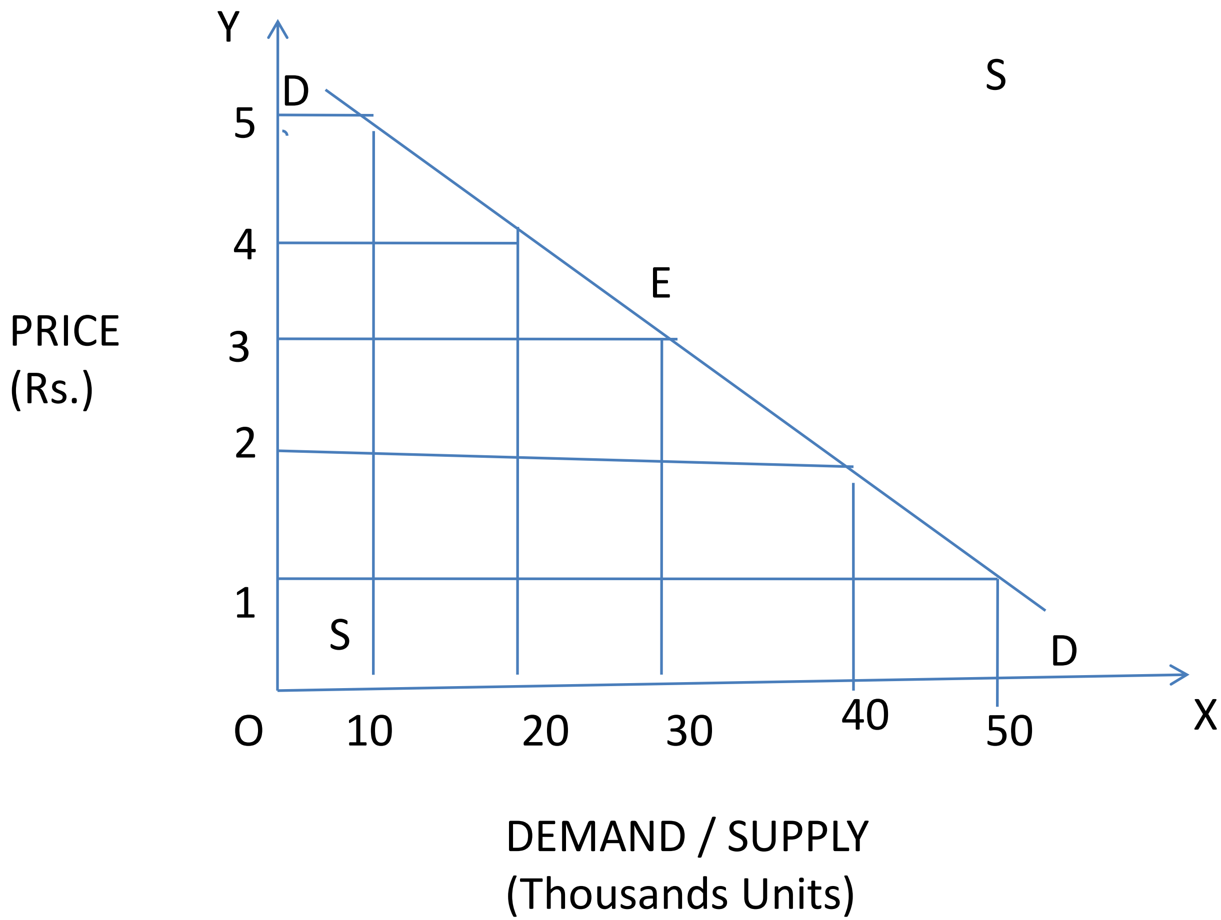
Price Determination Under Perfect Competition:

- **The price or value of a commodity under perfect competition is determined by the demand for and the supply of that commodity.**

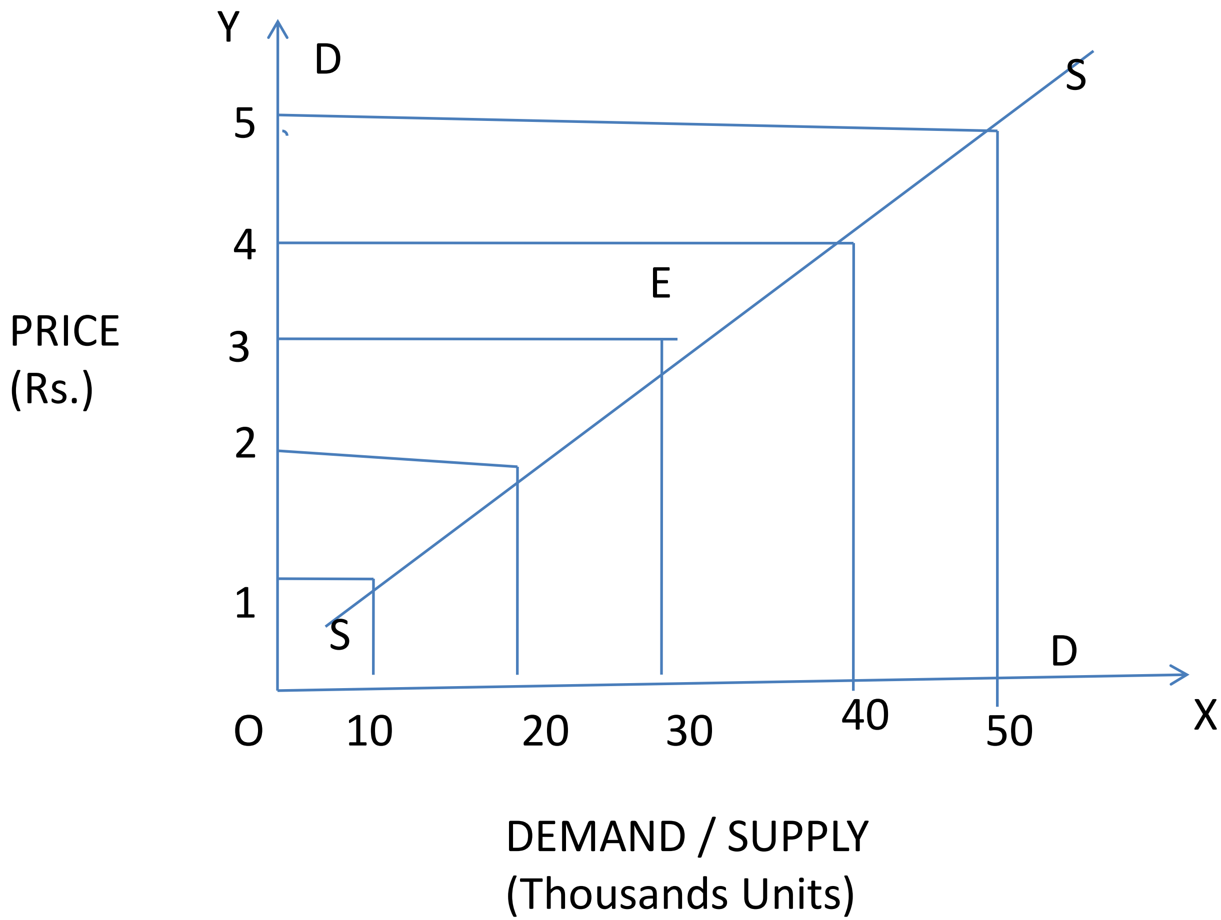
Price per unit (Rs.)	Demand (in thousands of Units)	Supply (in thousands of Units)
5	10	50
4	20	40
3	30	30
2	40	20
1	50	10

- The schedule explains the fact that as price goes on increasing, demand goes on contracting.
- In case of supply, lower price leads to contraction of supply.
- At Rs.3 the quantity demanded namely30 thousands, is equal to quantity supplied i.e., 30,000.
- At this price, suppliers are ready to offer exactly the same amount which is demanded in the market. It is only at this price that demand is equal to supply. Therefore, it is only the price which can prevail under conditions of perfect competition. This price is called the " Equilibrium Price" or "Market Price".

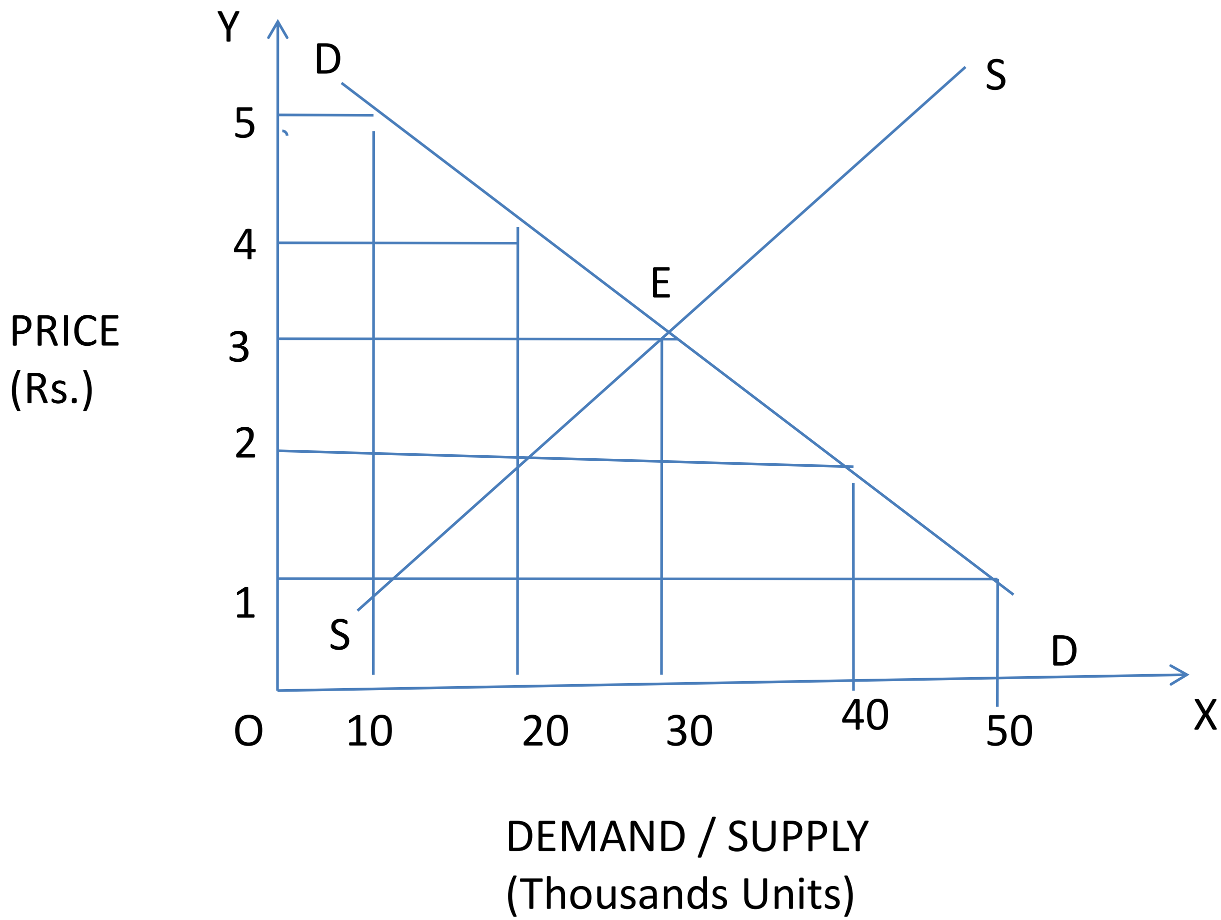
The Demand Curve can be explained with the help of a diagram as shown below(here).



The Supply Curve can be explained with the help of a diagram as shown below(here).



The determination of equilibrium price can be explained with the help of a diagram as shown below(here).



- **In the above diagram , along OX axis we measure the quantity of the commodity demanded and supplied.**
- **The vertical axis OY represents the price per unit.**
- **DD is the demand curve.**
- **SS is the supply curve.**
- **These two curves intersect at point E.**
- **This point shows that demand is equal to supply.**
- **The equilibrium price is Rs.3 and the quantity demanded and supplied is 30,000 units.**
- **At Rs. 4 the demand is 20,000 and supply is 40,000 units.**

- So suppliers will compete with one another and reduce the price to Rs.3.
- At Rs.2 Demand is 40,000 units and supply is 20,000 units.
- So consumers will compete with one another and bid the price at Rs.3.
- At Rs.3 the supply and demand are equal i.e., 30,000 units.
- Hence it is called equilibrium price.

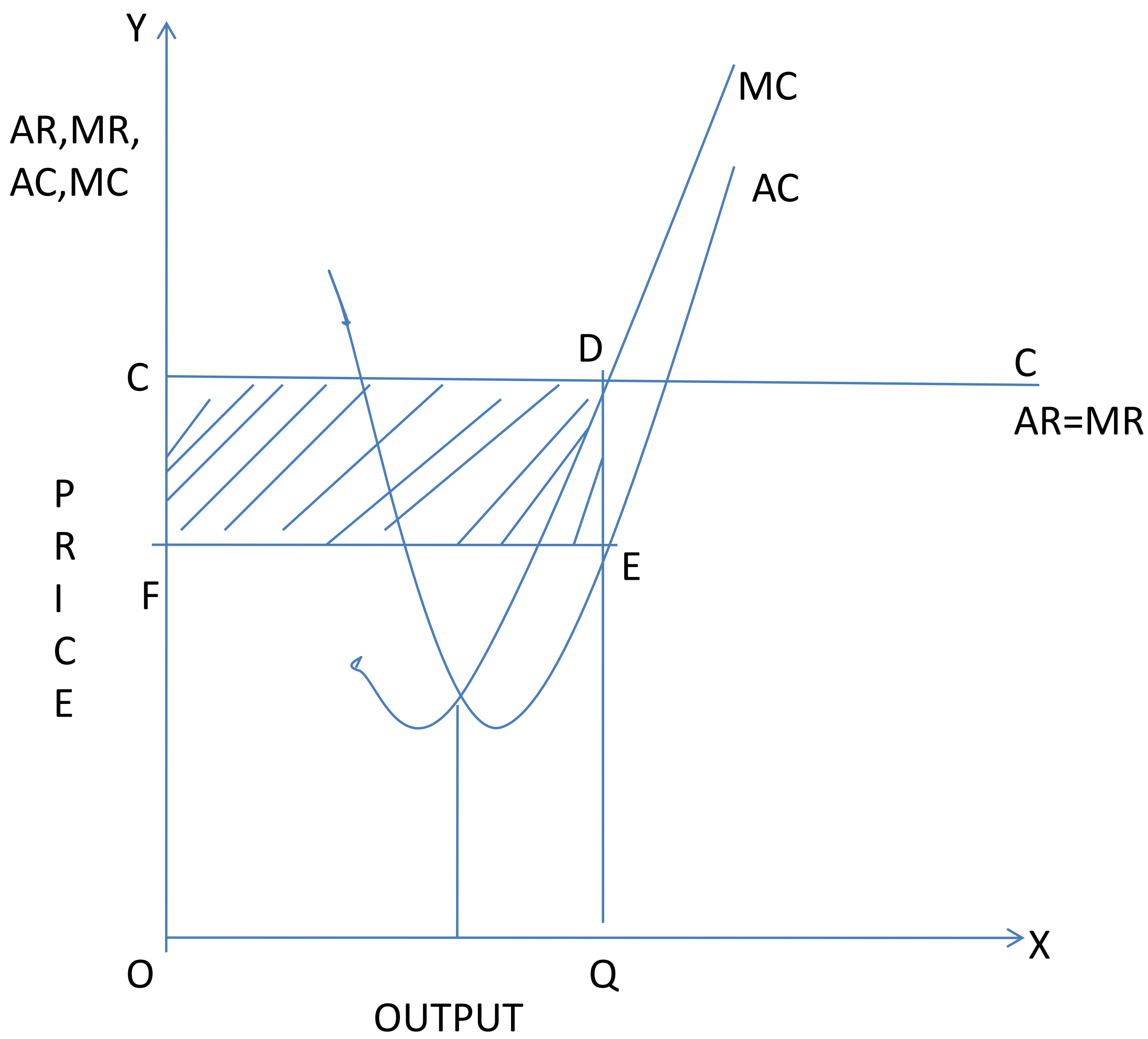
PRICE-OUTPUT DETERMINATION IN CASE OF PERFECT COMPETITION

Short-run

- The price and output of the firm are determined, under perfect competition, based on the industry price and its own costs.
- The industry price has greater say in this process because the firm's own sales are very small and insignificant.
- the process of price output determination in case of perfect competition is illustrated as follows:

- The firm’s demand curve is horizontal at the price determined in the industry(MR=AR=PRICE).
- This demand curve is also known as Average Revenue Curve(ARC).
- This is because if all the units are sold at the same price, on or average, the revenue to the firm equals its price.
- When the average revenue is constant (neither falling nor rising), it will coincide with the marginal revenue curve.
- Thus, CC is the demand curve representing the price, average revenue curve, and also marginal revenue curve(Price=AR=MR).

- **Average cost (AC) and marginal cost(MC) are the firms average and marginal cost curves.**
- **The firm satisfies both conditions: i) MR=MC and ii) MC curve must cut the MR curve from below. The firm attains equilibrium at point D where MR=MC. The MC curve passes through the minimum point of AC curve.**


Y
AR,MR,
AC,MC
MC
AC
D
C
C
AR=MR
P
R
I
C
E
F
E
X
O
Q
OUTPUT

Equilibrium Output Determination of a Firm Under Perfect Competition

- The firm gets higher profits as long as the price (in this case MR or AR) it receives for each unit exceeds the average cost (AC)of production.

  OC = QD, which is the price.

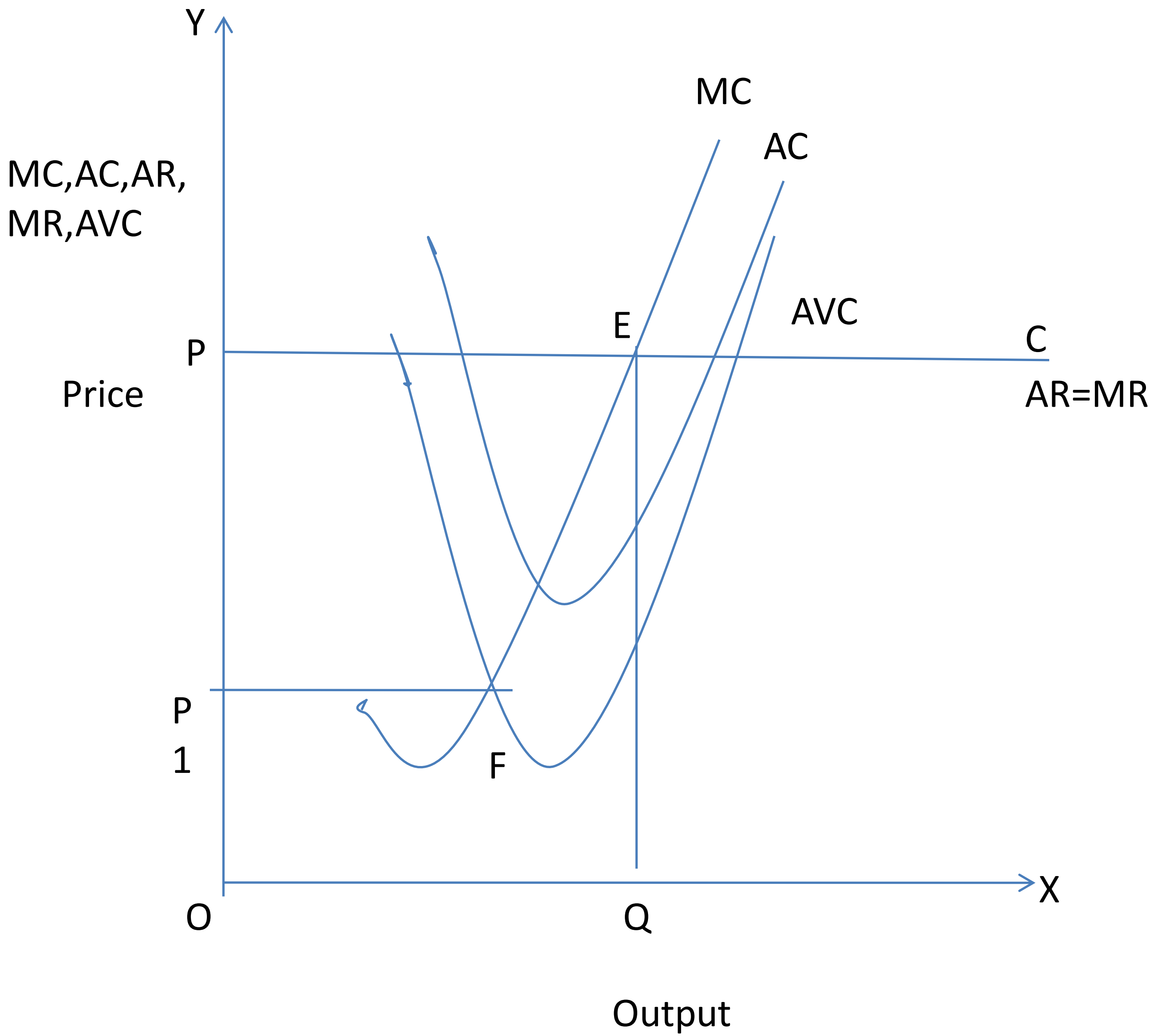
  OF= QE, which is the average cost.

  OQ= FE which is the equilibrium output.

  Average profit= price minus Average cost.

- Here, DE is the average profit and the area CDEF is the total profit which constitutes the supernormal or abnormal profits.
- Based on its cost function and market condition, the firm may make profits, losses or just break even in the short-run.

FIRM'S SHORT-RUN SUPPLY CURVE



- In short run, if the market price is below the average cost, the firm may still supply goods provided the market price is above the average variable cost.
- If the market price is below the average variable cost, the firm refuses to sell the goods even in the short-run for the simple reason that, by not selling the goods, the firm suffers a loss equal to average fixed cost only.
- If it sells the goods, the loss will be more than the average fixed costs.
- Thus, the firm's short run supply curve will be that portion of the marginal cost curve which is above the average variable cost curve.

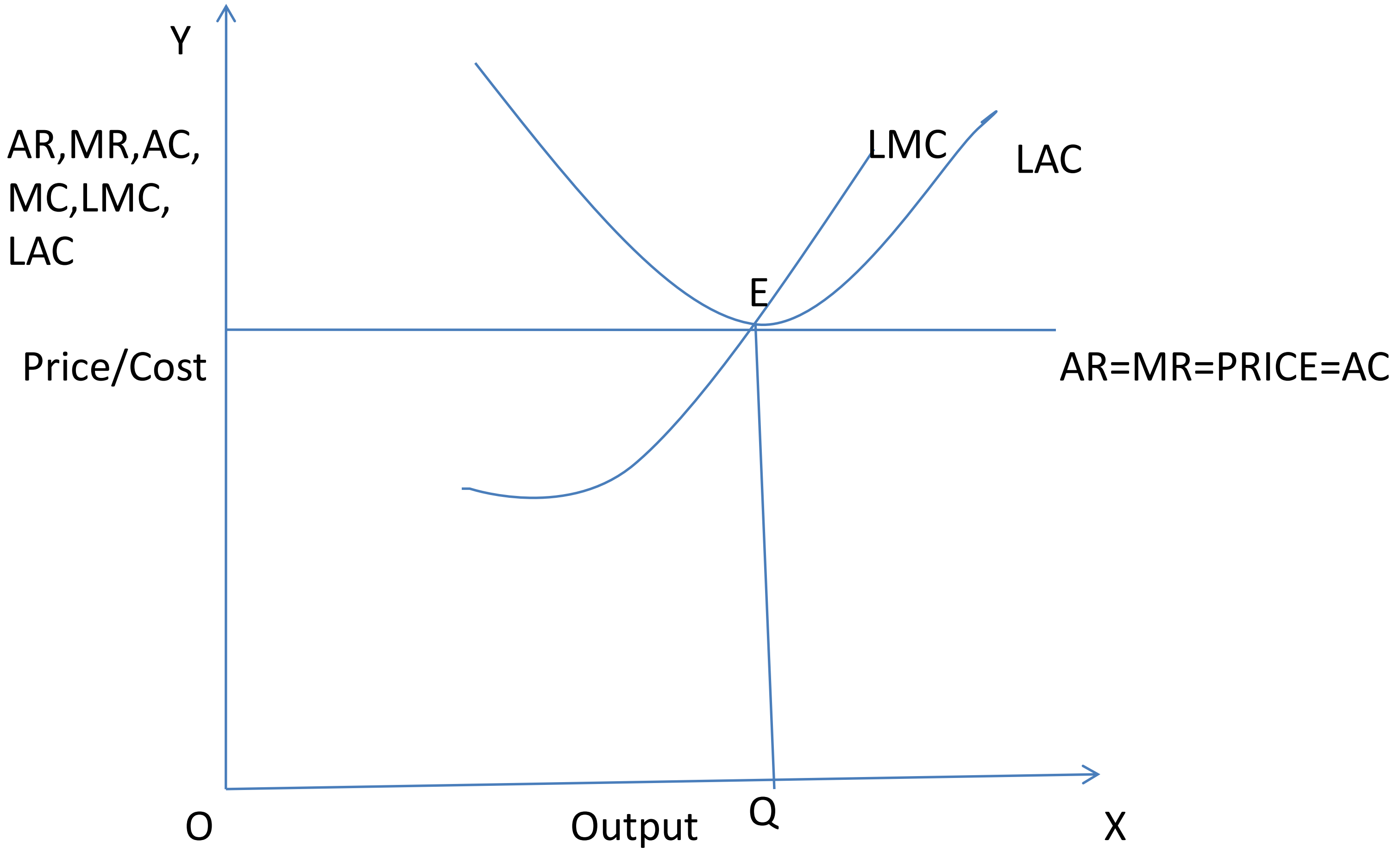
- From the above Figure it can be seen that if the market price is less than p1, the firm refuses to sell, as the price is less than the average variable cost.
- The firm's supply curve is that portion of the marginal cost curve which begins from point F.
- Point E refers to the equilibrium point where MR=MC.

Long-run:

- Having been attracted by supernormal profits, more and more firms enter the industry.
- With a result, there will be a scramble for scarce inputs among the competing firms pushing the input prices.
- The entry of more firms will expand the supply pulling down the market price.

- In the long run, the firms will be in a position to enjoy only normal profits but not supernormal profits.
- Normal profits are the profits that are just sufficient for the firms to stay in the business.
- It is to be noted that normal profits are included in the average cost curve.
- All those firms that are not able to earn at least normal profits will leave the industry.

Price-Output Determination in case of Long-run Under Perfect Competition



- The Figure shows the long-run equilibrium position of the firm under perfect competition.
- Two conditions are to be fulfilled in the long-run. (i) MR=MC (ii) AR=AC and AC must be tangential to AR at its lowest price.
- QE is the price and also the long-run average cost curve(LAC).
- Long-run Marginal Cost (LMC) curve passes through the marginal revenue curve.

- E is the equilibrium point and the firm produces OQ units of output.
- It can be noted that normal profits are not visible to the naked eye since normal profits are included in the average cost.
- Long–run average cost includes the opportunity cost of staying in business. In the market price is below long-run average cost of the firm, the firm will have to Leave/quit the industry since in the long-run, the firms have to recover average costs.

MONOPOLY MARKET

- The word monopoly is a Latin term 'Mono' means single and 'poly' means seller.
- Thus monopoly is a form of market organization in which there is only one seller of the commodity.
- There are no close substitutes for the commodity sold by the seller.

- Monopoly is that market form in which a single producer controls the entire supply of a single commodity, which has no close substitutes.
- There will be only one seller or producer.
- The commodity produced by the producer will have no close substitutes.
- Monopoly can exist only when there are strong barriers to entry.
- The barriers, which prevent the entry, may be economic, institutional or artificial in nature.

DEFINITIONS OF MONOPOLY MARKET

According to A. J. Braff, " under pure monopoly there is a single seller in the market. The monopolist's supply is market supply. The monopolist is a price maker. Pure monopoly suggests no substitute situation".

According to P. C. Dooley, " A monopoly is a market with one seller".

According to Left, " Pure monopoly is a market situation in which a single firm sells a product for which there is no good substitute".

FEATURES OF MONOPOLY MARKET

1. SINGLE PERSON(seller) OR A FIRM (producer):

- The total supply of the commodity is controlled by a single person or a firm.
- There will be no competition for monopoly firm.
- The monopolist firm is the only firm.
- It is the whole industry.
- There is a single firm dealing in a particular product or service.

2. NO CLOSE SUBSTITUTES:

- There are no close substitutes for the product. There are no competitors. If there is a substitute, then the monopoly power is lost.
- For example Railways had monopoly over distribution system developed in terms of fuel efficient heavy trucks.
- The product sold by the monopolist shall not have closely competing substitutes.
- Even if price of monopoly product increases people will not go in for substitute.
- For example: If the price of electric bulb increases slightly, consumer will not go in for kerosene lamp.

3. LARGE NUMBER OF BUYERS:

- Under monopoly, there may be a large number of buyers in the market who compete among themselves.

4.PRICE MAKER:

- Since the monopolist controls the whole supply of a commodity, he is a price-maker.
- He can alter the price.

5. SUPPLY AND PRICE:

- The monopolist can fix either the supply(Quantity) or the price.
- He cannot fix both.
- If he charges a very high price, he can sell a small amount.
- If he wants to sell more he has to charge a low price,
- He cannot sell as much as he wishes for any price he pleases.

6. DOWNWARD SLOPING DEMAND CURVE:

- The demand curve (average revenue curve) of monopolist slopes downward from left to right.
- It means that he can sell more only by lowering price.

7. There is no freedom to enter as there exists strong barriers to entry.

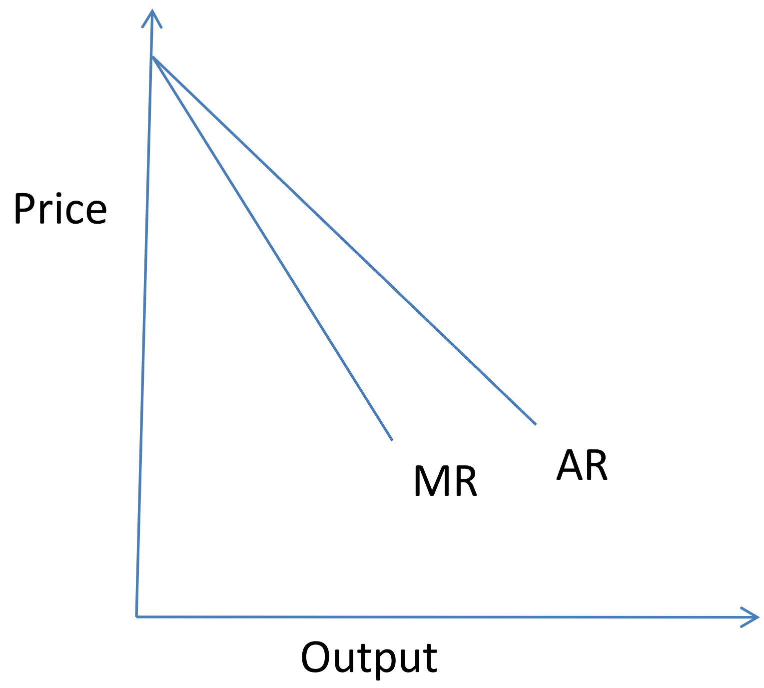
8. The monopolistic may use his monopolistic power in any manner to get maximum revenue. He may also adopt price discrimination.

9. The products and services provided by the monopolist bear inelastic demand.

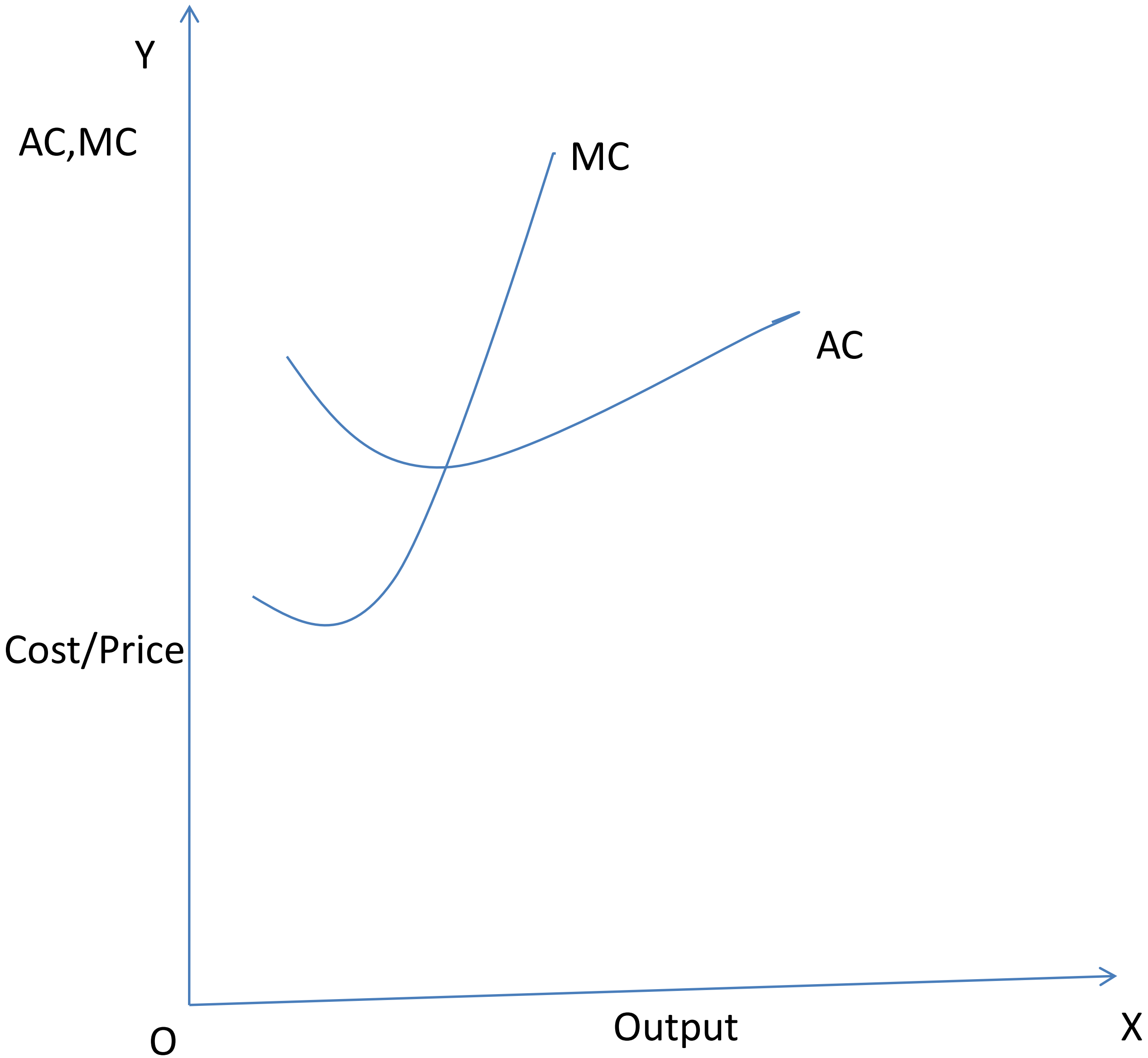
10. Monopoly may be created through statutory grant of special privileges such as licenses, permits, patent rights and so on.

REVENUE CURVES UNDER MONOPOLY

- **In case of monopoly, the Marginal Revenue(MR) is always less than the Average Revenue(AR) because of quantitative discounts or concessions.**



COST CURVES UNDER MONOPOLY

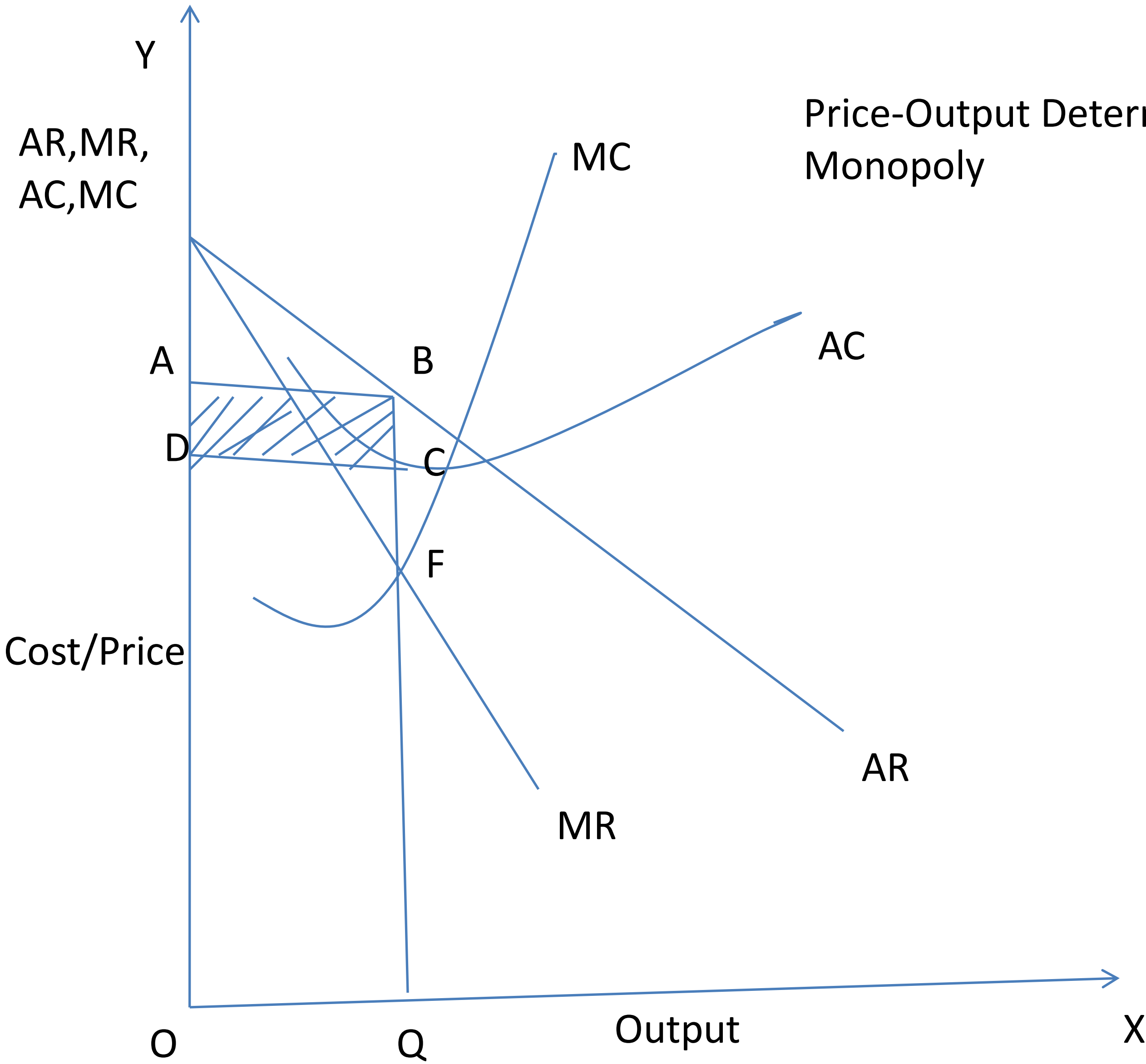


PRICE-OUTPUT DETERMINATION UNDER MONOPOLY

- Under monopoly the average revenue curve for a firm is a downward sloping one.
- It is because, if the monopolist reduces the price of his product, the quantity demanded increases and vice versa.
- In monopoly, marginal revenue is less than the average revenue.
- In other words, the marginal revenue curve lies below the average revenue curve.

- The monopolist always wants to maximize his profits.
- To achieve maximum profits, it is necessary that the marginal revenue should be more than the marginal cost.
- He can contribute to sell as long as the marginal revenue exceeds marginal cost.
- At this point F, where MR=MC, profits will be maximized.
- Profits will diminish if the production is continued beyond this point.

Price-Output Determination Under Monopoly



- From the above figure, it can be seen that the demand curve or average revenue curve is represented by AR, marginal revenue curve by MR, average cost by AC, and marginal cost by MC.
- OQ is the equilibrium output, OA is the equilibrium price, QC is the average cost, and BC is the average profit(AR minus AC is the average profit).

- Upto OQ Output, MR is greater than MC and beyond OQ, MR is less than MC.
- Therefore, the monopolist will be in equilibrium at output OQ where MR=MC and profits are maximum.
- OA is the corresponding price to the output level of OQ. The rectangle ABCD represents the profits earned by the monopolist in the equilibrium position in the short-run.

- The monopolistic firm attains equilibrium when its marginal cost is equal to marginal revenue (MC=MR).
- Under monopoly, the MC curve may cut the MR curve from below or from a side.
- In the diagram, the above condition is satisfied at the point ‘E’.

- At point E, MC=MR. The firm is in equilibrium. The equilibrium output is OQ.
- In the above diagram Average Revenue = QB or OA. Average Cost = QC.
- Profit per unit= Average Revenue- Average Cost

= QB-QC = BC

- Total Profit = Total Revenue – Total Cost

= OABQ-ODCQ = ABCD

The area ABCD represents the maximum profit earned by the monopoly firm.

MONOPOLISTIC COMPETITION

- Perfect competition and monopoly are rarely found in the real world.
- Therefore, Professor Edward. H. Chamberlin of Harvard University brought about a synthesis of the two theories and put forth, “Theory of monopolistic competition in 1933”.
- Monopolistic competition is more realistic than either pure competition or monopoly.
- Monopolistic competition refers to competition among a large number of sellers producing close but not perfect substitutes.

- Monopolistic competition is said to exist when there are many firms and each one produces such goods and services that are close substitutes to each other.
- They are similar but not identical.
- There are no restrictions on the entry and with the result, many firms who feel they can offer a relatively better product or service.

FEATURES OF MONOPOLISTIC COMPETITION

1. LARGE NUMBER OF SELLERS:

- In monopolistic competition the number of sellers is large.
- No one controls a major portion of the total out put.
- Hence each firm has a very limited control over the price of the product.
- Each firm decides its own price-output policy without considering the reactions of rival firms.
- Thus there is no interdependence between firms and each seller pursues an independent course of action.
- Independent price policy followed in this type of firm.

2. LARGE NUMBER OF BUYERS

- There are large number of buyers in this market.
- But the buyers have their own brand preferences.
- So the sellers are able to exercise a certain degree of monopoly over them.
- Each seller has to plan various incentive schemes to retain the customers who patronize his product.

3. PRODUCT DIFFERENTIATION:

- Product differentiation implies that products are different in some ways from each other.
- They are heterogeneous/ varied rather than homogeneous.
- There is slight difference between one product and others in the same category.
- Products are close substitutes but not perfect substitutes.
- Product differentiation may be due to differences in the quality of the product.

- An example of monopolistic competition and product differentiation is the toothpaste produced by various firms.
- The product of each firm is different from that of its rivals in one or more respects.
- Different toothpastes like Colgate, Close-up, Cibaca, Dabur Red tooth paste etc., provide an example of Monopolistic competition.
- These products are relatively close substitute for each other but not perfect substitutes.

- Product may be differentiated in order to suit the tastes and preferences of the consumers.
- The products are differentiated on the basis of materials used, workmanship, durability, size, shape, design, colour, fragrance, packing etc.
- Products are differentiated in order to promote sales by influencing the demand for the products.
- This can be achieved through propaganda and advertisement.
- Patent rights and trade marks also promote the product differentiation.

4. FREE ENTRY AND EXIT OF FIRMS

- Another feature of the monopolistic competition is the freedom of entry and exit of firms.
- Firms under this market are small in size and they are capable of producing close substitutes.
- Hence they are free to enter or leave the industry in the long run.
- Product differentiation increases entry of new firms in the group because each firm produces different products from others.
- There is freedom of entry and exist of firms. That is, there is no barrier as found under monopoly.

5. SELLING COST

- It is important feature of monopolistic competition.
- As there is a keen competition among the firms, they advertise their products in order to attract the customers and sell more.
- Thus selling cost has a bearing on price determination under monopolistic competition.
- Since the products are close substitute, much effort is needed to retain the existing consumers and to create new demand.
- So each firm has to spend a lot on selling cost, which includes cost on advertising and other sale promotion activities.

6. GROUP EQUILIBRIUM

- Chamberlin introduced the concept of group in the place of industry.
- Industry refers to a number of firms producing homogeneous / similar products/close substitutes.
- But, firms under monopolistic competition produce similar products but not identical products.
- Therefore, Chamberlin uses the concept of group to include firms producing goods, which are close substitutes.
- Prof. Chamberlin called the collection of firms producing close substitute products as a group.

7. NATURE OF DEMAND CURVE

- **Under Monopolistic competition, a single firm can control only a small portion of the total output.**
- **Though there is product differentiation, as products are close substitutes, a reduction in price leads to increase in sales and vice-versa.**
- **But it will have little effect on the price-output conditions of the firms.**
- **Hence each will loose only few customers, due to an increase in price.**

- **Similarly a reduction in price will increase sales.**
- **Therefore, the demand curve of a firm under monopolistic competition slopes downwards to the right.**
- **It is highly elastic but not perfectly elastic.**
- **It means, under monopolistic competition, the demand curve faced by the firm is highly elastic.**
- **It has some control over price due to product differentiation and there are price differentials between the firms.**

8. IMPERFECT KNOWLEDGE

- Imperfect knowledge about the product leads to monopolistic competition.
- If the buyers are fully aware of the quality of the product , they cannot be influenced much by advertisement or other sales promotion techniques.
- But in the business world we can see that though the quality of certain products is same, effective advertisement and sales promotion techniques make certain brands monopolistic.
- For example, effective dealer service backed by advertisement-helped popularization of some brands through the quality of almost all the cement available in the market remains the same.

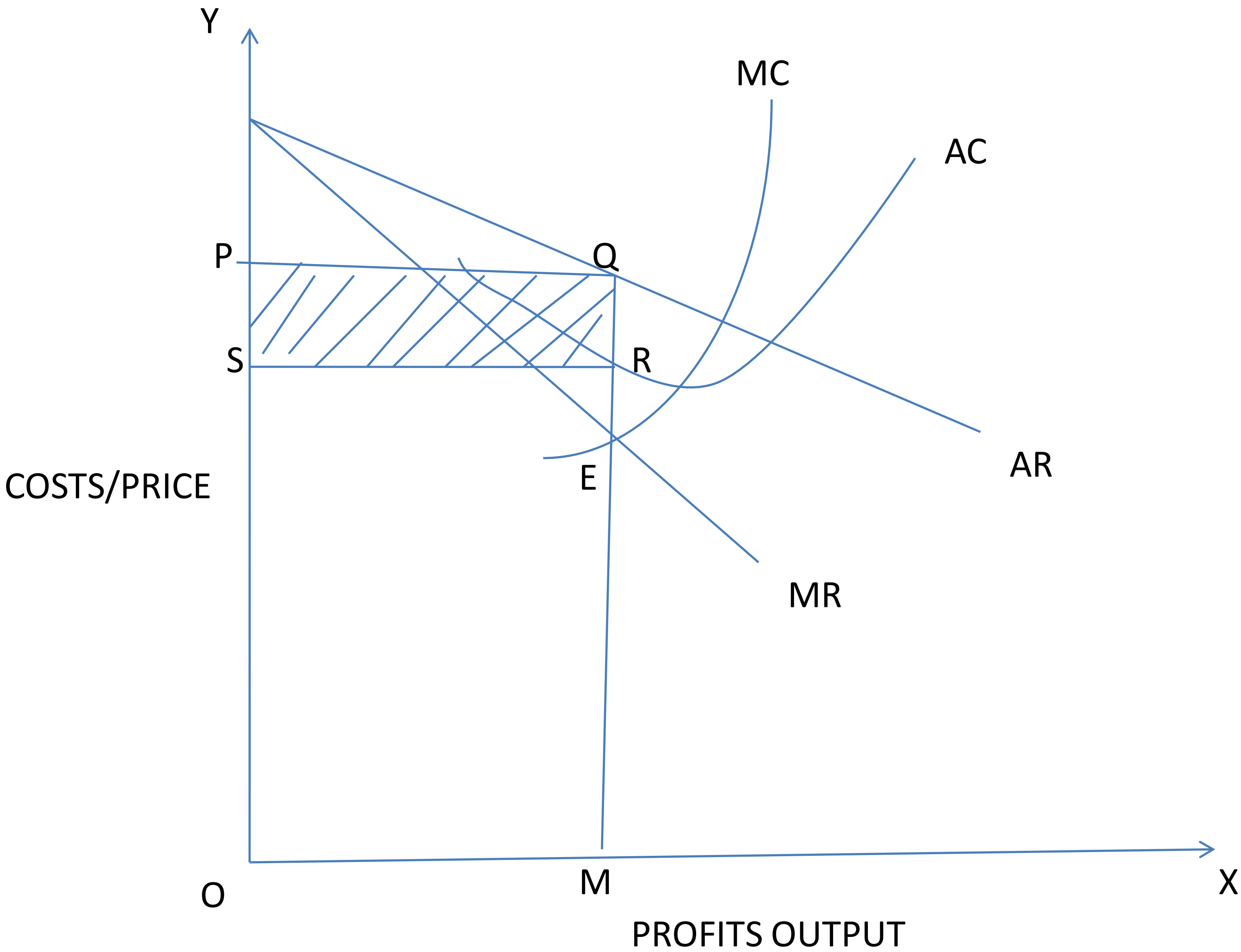
PRICE-OUTPUT DETERMINATION UNDER MONOPOLISTIC

- Since under monopolistic competition different firms produce different varieties of products, different prices for them will be determined in the market depending upon the demand and cost conditions.
- Each firm will set the price and output of its own product.
- Here also the profit will be maximized when marginal revenue(MR) is equal to marginal cost(MC).

Short-run equilibrium of the firm

- In the short run the firm is in equilibrium when Marginal Revenue equals to Marginal cost (MR=MC).
- In this diagram AR is the Average Revenue curve.
- MR is the Marginal Revenue curve, SMC is the Short-run Marginal Cost Curve.
- SAC is the Short-run Average Cost Curve.
- MR and SMC intersect at point E where output in OM and price OP.
- Thus the equilibrium output or maximum profit output is OM and the price OP or MQ.
- When the price (AR) is above average cost (AC) a firm will be making supernormal profit.

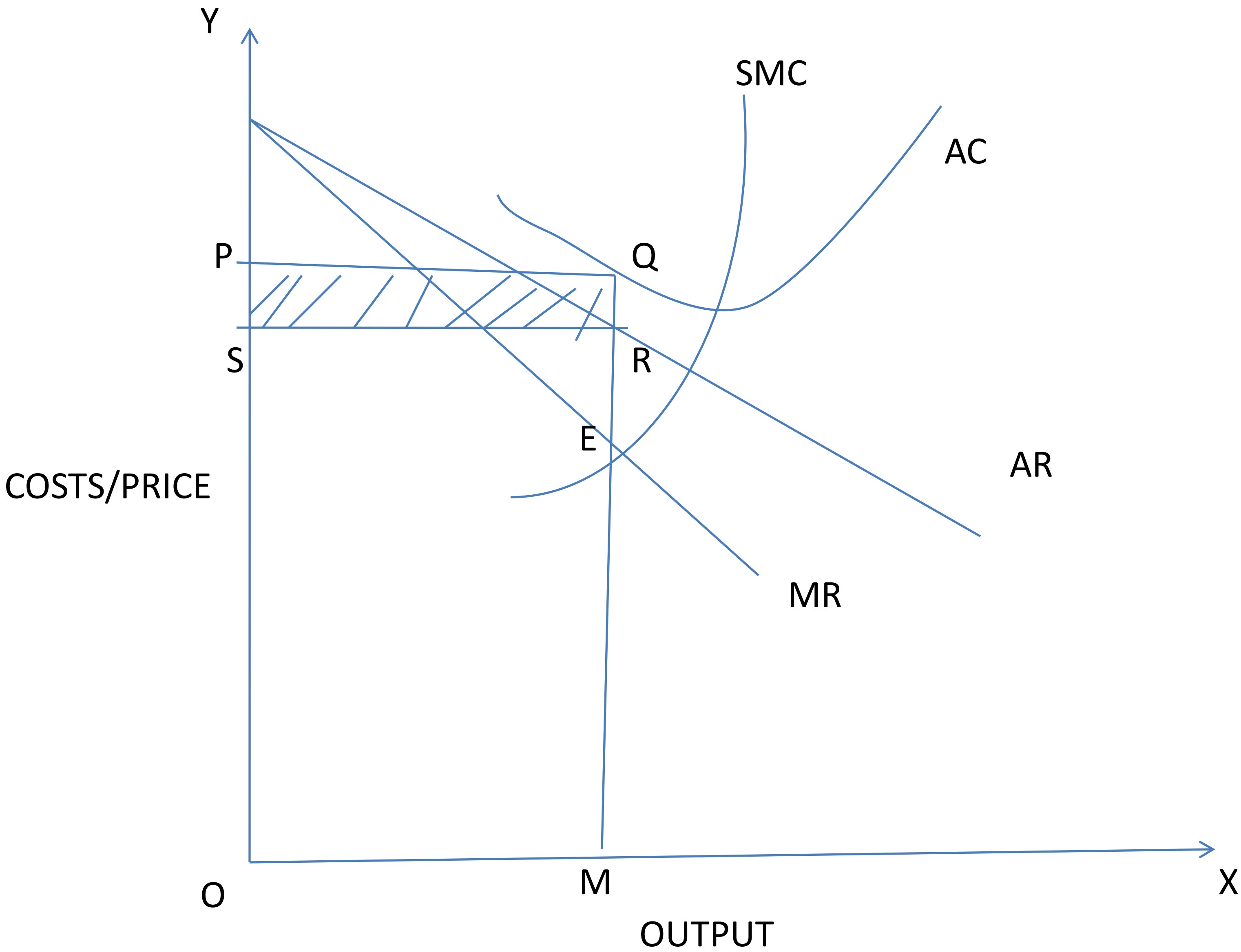
Short-run equilibrium of the firm



- **From this diagram it can be seen that AR is above AC in the equilibrium point.**
- **As AR is above AC , this firm is making abnormal profits in the short-run.**
- **The Abnormal profit per unit is QR, i.e., the difference between AR and AC at equilibrium point and the super normal profit is OR X OM.**
- **This total abnormal profits is represented by the rectangle PQRS.**
- **As the demand curve here is highly elastic, the excess price over marginal cost is rather low. But in monopoly the demand curve is inelastic. So the gap between price and MC will be rather large.**

- **If the demand and cost conditions are less favourable monopolistically competitive firm may incur loss in the short-run. The following diagram illustrate this condition.**

Short-run equilibrium of the firm



- A firm incurs loss when the price is less than the average cost of production.
- MQ is the Average Cost.
- OS (i.e.MR) is the price per unit at equilibrium output.
- QR is the loss per unit.
- The total loss at an output OM is QR X OM.
- The rectangle PQRS represents the total losses in the short-run.

Long-run equilibrium of the firm

- According to Pappas and Hirschey the very existence of the downward slopping demand curve implies that consumers value the firm's products than the products of the other producers.
- Monopolistic competition industry provides a variety of products and more varieties result in greater consumer satisfaction.
- Consumers will be happy only when they have more choice as variety is the spice of life.

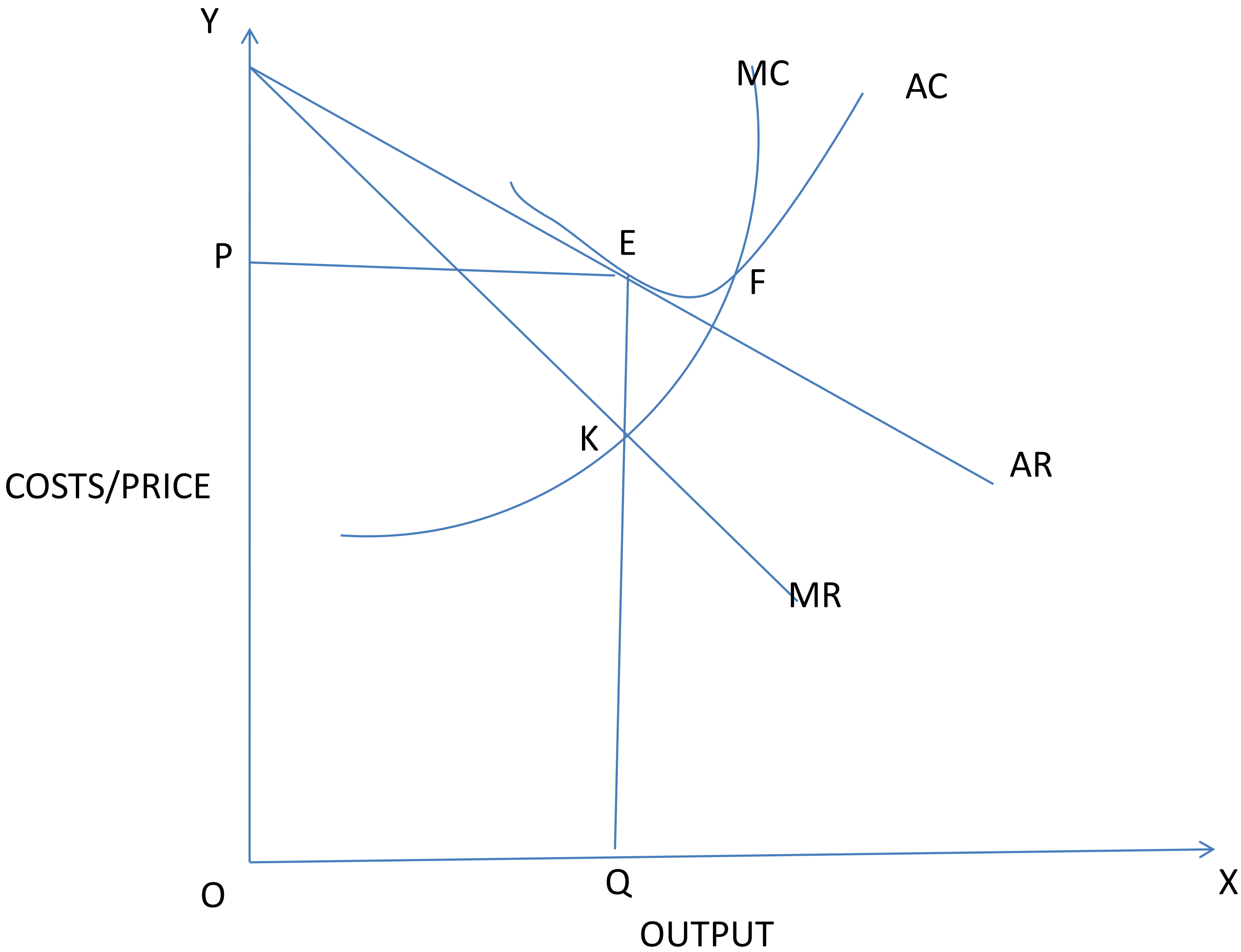
Long-run equilibrium of the firm

- In the long run, in order to achieve equilibrium position, the firm has to fulfil the following two conditions.

1. MR = MC
2. AR = AC at the equilibrium level of output.

- AC will not be at its minimum point at equilibrium level of output.
- And also MR is not equal to either AR or AC, MR is well below AR in the case of monopolist competition.

Long-run equilibrium of the firm



- **From the above diagram/ figure It can be observed that in the long run, the average cost (AC) curve will be tangential to the downward slopping average revenue curve (AR) at point E.**
- **It can be noted that the average cost curve is tangential to the average revenue curve at higher than its minimum point F.**
- **MR = MC at point K.**
- **OQ is the equilibrium output and OP is the equilibrium price.**
- **Thus in long-run , a firm under monopolistic competition achieves equilibrium price and output level when both conditions of equilibrium are satisfied.**

UNIT-IV

CAPITAL AND CAPITAL BUDGETING

CAPITAL BUDGETING(Unit-VI)

MEANING OF CAPITAL BUDGETING:

- **Capital budgeting is the process of making investment decisions in capital expenditures.**
- **A capital expenditure may be defined as an expenditure the benefits of which are expected to be received over a period of time exceeding one year.**

DEFINITIONS OF CAPITAL BUDGETING

1.According to Charles T. Horngreen, " capital budgeting is long term planning for making and financing proposed capital outlays."

2. According to Richard and Greenlaw, " capital budgeting as acquiring inputs with long run return."

3. In the words of Lynch, " capital budgeting consists in planning development of available capital for the purpose of maximising the long term profitability of the concern."

Significance / Importance of Capital Budgeting

Capital budgeting decisions assume special significance for the following reasons:

1. **Substantial capital outlays:** Capital budgeting decisions involve substantial capital out lays.
2. **Long-term implications:** Capital budgeting proposals are of longer duration and hence have long-term implications. For instance, the cash flows for the next 5 years to 15 years have to be forecast.
3. **Strategic in Nature:** Capital budgeting decision can affect the future of the company significantly as it constitutes the strategic determinant for the success of a company. A right investment decision is the secret for the success of many business enterprises.

4. **Irreversible:** Once the funds are committed to a particular project, we cannot take back the decision. If the decision is to be reversed, we may have to lose a significant portion of the funds already committed. It may involve loss of time and efforts. In other words, the capital budgeting decisions are irreversible or may not be easily reversible.

LIMITATIONS OF CAPITAL BUDGETING:

1. **Uncertainty in future:** The Capital budgeting proposals are infested with the uncertainty in future. All data used in the evaluation of proposals is the estimates. The data is error-prone more with the human judgement, bias or discretion in the identification of cash inflows and cash out flows. Even advanced capital budgeting techniques such as sensitivity analysis cannot be useful if the data is erroneous.

2. **Qualitative factors ignored:** In capital budgeting, we consider only such factors which can be quantified in terms of money. Factors such as improved morale of employees as a result of implementation of proposals are not focused. The other factors in the business environment such as social, political and economic conditions and so on, are not reflected here.
3. **Volatile business conditions:** The factors influencing investment decisions include technological advancement, government policies, sales forecast, attitudes of management, estimated cash flows discount factor and rate of return. Any change in one or more of these factors is going to affect the capital budgeting decisions. .

4. **Unrealistic Assumptions:** There are certain unrealistic assumptions underlying capital budgeting process. They are i) There is no risk and uncertainty in the business environment. This is not correct. The future of the business is full of uncertainty and we apply the management techniques to minimise the risk. ii) The cash flows are received in lump sum at the end of the given period. iii) The key variables such as sales revenue, costs , price or investments and so on are taken based on past data. Particularly in times of raising prices , these seldom hold good for future. iv) The cost of capital and discount rates are one and the same.

CONCEPT OF BUSINESS

- Literally speaking, the term Business means a state of being busy.
- Hence, business included all occupations in which people are busy in earning income either by production or purchase and sale or exchange of goods and services to satisfy the needs of other people so as to earn income or profit.
- Business relates to the creation of three utilities viz., i) form utility through processing

  ii) Time utility through storage

  iii) Place utility through transportation.

Meaning of Business

- **Any activity carried mainly with the object of earning profit can be called as business activity.**
- **This object of earning profit is achieved by production and /or exchange of want satisfying goods and services.**
- **A person engaged in business is called a businessman or entrepreneur.**
- **Similarly a firm established for the purpose of carrying a business called enterprise or a business unit.**

CONCEPT OF BUSINESS

Meaning of Business

- **Business is an economic activity. It refers to all those activities which are connected with the production or purchase of goods and services with object of earning profits on their sale.**
- **Hence the primary object of every business activity is earning profit.**

DEFINITIONS OF BUSINESS

1. ACCORDING TO L.H.HANEY

“Business may be defined as human activity directed towards providing or acquiring wealth through buying and selling”.

2. ACCORDING TO WHEELER

“ Business is an institution organized and operated to provide goods and services to the society under the incentive of private gain”.

3. ACCORDING TO PETERSON AND PLOWMAN

“Business may be defined as an activity in which different persons exchange something of value whether goods or services for mutual gain or profit”.

The term ‘Business’ includes all those activities which are related to the production and distribution of goods and services. It also includes all those activities which indirectly help in production and exchange of services such as transport , insurance, banking and warehousing etc.

CHARACTERISTICS OF BUSINESS

1. ENTREPRENEUR:

- There must be someone to take initiative for establishing a business.
- The Person who recognizes the need for a product or service is known as Entrepreneur.
- He visualizes/Organizes a business, combines various factors of production and puts them into a going concern.

2. ECONOMIC ACTIVITIES:

- **Business includes only economic activities.**
- **All those activities relating to the production and distribution of goods and services are called economic activities.**
- **These activities are undertaken with a profit motive.**
- **Maximization of profit and minimization of costs or expenditure of earning it are the dual aims which guide all business enterprises.**

3. EXCHANGE OF GOODS AND SERVICES:

- A business must involve exchange of goods and services.
- The goods may be consumer goods like bread, butter, milk, tea, water.
- Capital goods like plant, machinery and equipment. The services may relate to transport, banking, insurance, warehousing, advertising and so on.
- The goods to be exchanged may be produced or procured from other sources.
- The exchange of goods and services is undertaken with profit motive.

4.CONTINUITY OF TRANSACTIONS:

- **A single transaction shall not be treated as business.**
- **An activity is treated as business only when it is undertaken continuously or at least recurrently.**
- **For example, A person builds a house for himself but later on sells it on profit. We will not call it as business.**
- **On the other hand, if a House-Building Society build houses and sells them on profit, it will be called as business.**

5. PROFIT MOTIVE:

- Business activities are performed with the primary objective of earning profit.
- Profits are essential to enable the business to survive, to grow, to expand and to get recognition.
- For example, if goods are produced or purchased for distribution among poor families or victims of floods, earthquakes or storms, it is considered as charitable activity and not a business activity.
- The responsibility of business towards society restricts a business man from earning ridiculous/very high profit.

6. ELEMENT OF RISK:

- Business involves an element of risk.
- the possibility of incurring loss is termed as risk.
- Risk arises due to uncertainties of future.
- The element of risk exists due to variety of factors, which are outside the control of the business enterprise.
- Risks can be divided into two types.

i) INSURABLE RISKS: Risks whose probability can be calculated and can be insured. Eg. Risk of loss due to fire, flood, earthquake, theft etc.,

ii) NON-INSURABLE RISKS: Risks whose probability cannot be calculated and which cannot be insured against loss.

Eg. loss due to fall in demand, changing technology, changing fashions etc.

7. CREATION OF UTILITY:

- Business creates various types of utilities in goods so that consumers may use them.
- The utility may be form utility, place utility, time utility etc., when raw materials are converted into finished goods it creates form utility.
- When goods are transported from the places of production to the places of ultimate consumers, it creates place utility.
- When goods are stored in the Warehouse until the consumption, it creates Time Utility.
- So the business creates many utilities so that the consumers may use them according to their preferences and needs.

8. ORGANISATION:

- Various business activities are divided into Departments, Sections and Jobs.
- An organisation is needed to coordinate these various business activities.

9. FINANCING:

- Every business enterprise requires fixed and working capital.
- The availability of all other factor of production depends upon the availability of finances.
- Financial requirements are to be accurately estimated.
- Then the business man should to find out the sources from which these requirements will be met.

10. CONSUMER SATISFACTION:

- **The ultimate aim of business is to supply goods to the consumers.**
- **The goods are produced for consumers.**
- **If the consumer is satisfied, then he purchase the same thing again.**
- **Otherwise he will go for an alternative commodity.**
- **Therefore, the business man should try to satisfy the consumers so that the demand for his product is maintained.**

11. SATISFY SOCIAL NEEDS:

- **The business is a socio-economic institution.**
- **It must look to the public good.**
- **Now-a-days, a great emphasis is laid on social obligations of the business.**
- **So business enterprise must serve public purpose.**

SOLE TRADER

- The sole trading concern is the simplest, oldest and natural form of business organization.
- It is also called Sole Proprietorship, Individual Proprietorship or Single Entrepreneurship.
- Sole Means One.
- Sole trader implies that there is only one trader who is the owner of the business.
- It is one man form of organization wherein the trader assumes all the risk of ownership carrying out the business with his own capital, skill and intelligence.
- He is the boss for himself. He has total operational freedom. He is the owner, sole organiser, manager and controller and master of his business.

DEFINITIONS OF SOLE TRADER

1. ACCORDING TO L.H.HANEY

"The individual entrepreneurship is the form of business organization on the head of which stands an individual as the one who is responsible, who directs its operations, who alone runs the risk of failure".

2. ACCORDING TO JAMES STEPHENSON

"A sole trader is a person who carries on business exclusively by and for himself. He is not only the owner of the capital of the undertaking, but also usually the organiser and manager and takes all the profits or responsibility for losses ".

DEFINITIONS OF SOLE TRADER

3. ACCORDING TO PETERSON AND PLOWMAN

"A sole proprietorship is a business unit whose ownership and management are vested in one person. This individual assumes all risks of loss or failure of the enterprise and receives all profits from its successful operation ".

FEATURES OF SOLE TRADING ORGANIZATION

1. **EASY TO START AND CLOSE:**

   It is easy to start a business under this form and also easy to close because of no legal formalities are required to start sole proprietorship

2. **SMALL AND OLD TYPE OF BUSINESS:**

   The sole trading concern is the old type of business unit. The size of the business unit is small.

FEATURES OF SOLE TRADING ORGANIZATION

3. NO SEPARATION OF OWNERSHIP AND MANAGEMENT:

The owner himself manages the business. The separation of ownership from management is not possible in this form of organization. The proprietor exercises a high degree of supervision and control in the working of his business.

4. ONE MAN OWNERSHIP:

The ownership lies with one person only. He invests his own money or borrows from friends, relatives and banks.

FEATURES OF SOLE TRADING ORGANIZATION

5. NO LEGAL FORMALITIES:

- No legal formalities are required to start sole proprietorship.
- Of course, there are some legal restrictions for 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 license may be required. For example, to start a hotel, one needs to get license from municipal corporation.

FEATURES OF SOLE TRADING ORGANIZATION

6. SHARING PROFITS:

- One person is the sole owner of the business.
- He enjoys all profits and bears losses, If any.
- There is a direct relationship between efforts and rewards.

7. UNLIMITED LIABILITY:

- The law does not recognize any distinction between his private and business property.
- All the outstanding trading debts will be first satisfied from his business property.
- If the business property is not sufficient, the balance of debts shall be paid from his private property.
- Therefore, the liability of the sole trader is unlimited.

FEATURES OF SOLE TRADING ORGANIZATION

8. PURELY LOCAL:

- The activities of the sole trader are limited to a certain locality.
- This is so because of (i) limited capital and (ii) limited managerial skill and ability.

9. 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.

FEATURES OF SOLE TRADING ORGANIZATION

10. SECRECY:

- All important decisions are taken by the owner himself.
- He keeps all the business secrets only to himself.
- Business secrets are very important for the success of small business.

11. 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.

FEATURES OF SOLE TRADING ORGANIZATION

12. FLEXIBILITY:

He has a high degree of flexibility to shift from one business to other business.

13.TRAINING TO FAMILY MEMBERS:

As he alone, he has to look after by him/ herself all the activities related to purchase, sale, cash, accounts and taking care of the customers. He may take the help of his family members or paid employees in carrying out of the business.

FEATURES OF SOLE TRADING ORGANIZATION

14. LACK OF CONTINUITY / INSTABILITY:

There is no continuity. The business comes to close with the death, illness or insanity of the sole trader. Unless the legal heirs show interest to continue the business. The business cannot be restored.

15. FREEDOM: He has total operational freedom. He is the owner, manager and controller of the business.

16. CONTACTS WITH CUSTOMERS: He can be directly in touch with the customers. He maintains personal rapport with the customers. He can take decision very fast and implement them promptly. He can easily know their tastes, likes and dislikes and adjust his operations accordingly. This results into increase in sale of goods.

17. LOW RATE OF TAX: Rates of tax , for example, income tax and so on are comparatively very low.

ADVANTAGES OF SOLE TRADING ORGANIZATION

1. Easy to start and easy to close:

- Formation of a sole trader form of organization is relatively easy.
- Even closing the business is also very easy.

2. Personal Contacts with customers directly:

Based on the tastes and preferences of customers, the stocks can be maintained.

ADVANTAGES OF SOLE TRADING ORGANIZATION

3. Prompt Decision making:

- To improve the quality of service to the customers, he can take any decision and implement the same promptly. He is the boss and he is responsible for his business. Decisions relating to growth or expansion can be made promptly.

4. High Degree of Flexibility:

Based on the profitability, the tader can decide to continue or change the business, if need be.

ADVANTAGES OF SOLE TRADING ORGANIZATION

5. Secrecy:

- Business secrets can well be maintained because there is only one trader.

6. Low Rate of Taxation:

The rate of income tax for sole traders is relatively very low.

ADVANTAGES OF SOLE TRADING ORGANIZATION

7. Direct Motivation:

- If there are profits, all the profits belong to the trader himself.
- In other words, if he works more hard, he will get more profits.
- This is the direct motivating factor. At the same time, he does not take active interest, he may stand to lose badly also.

8. Total Control:

The ownership, management and control are in the hands of the sole trader and hence it is easy to maintain the hold on business.

ADVANTAGES OF SOLE TRADING ORGANIZATION

9. Minimum Interference from Government:

- Except in matters relating to public interest, government does not interference in the business matters of the sole trader.
- The sole trader is free to fix price for his products/ services if he enjoys monopoly market.

10. Transferability :

The legal heirs of the sole trader may take the possession of the business.

DISADVANTAGES OF SOLE TRADING ORGANIZATION

1. Unlimited Liability:

- The liability of the sole trader is limited .
- It means that the sole trader has to bring his personal property to clear off the loans of his business.
- From the legal point of view, he is not different from his business.

2. Limited capital:

The resources of the sole trader can mobilize cannot be very large and hence this naturally sets a limit for the scale of operations.

DISADVANTAGES OF SOLE TRADING ORGANIZATION

3. No Division of Labour:

- All the work related to different functions such as marketing, production, finance, labour and so on has to be taken care of by sole trader himself.
- There is nobody else to take his burden.
- Family members and relatives can not show as much interest as the trader takes.

4. Uncertainty:

- There is no continuity in the duration of the business.
- On the death, insanity or insolvency the business may come to end.

DISADVANTAGES OF SOLE TRADING ORGANIZATION

5. Inadequate for Growth and Expansion:

- This form is suitable for only small size, one-man-show type of organization.
- This may not really work out for growing and expanding for organizations.

6. Lack of Specialization:

- The services of specialists such as accountants, market researchers, consultants and so on are not within the reach of most of the sole traders.

DISADVANTAGES OF SOLE TRADING ORGANIZATION

7. More Competition:

- Because it is very easy to set up a small business, there is a high degree of competition among the small business men and a few who are good in taking care of customer requirements alone can survive.

8. Low Bargaining Power:

- The sole trader is in the receiving end in terms of loans or supply of raw materials.
- He may have to compromise many times regarding the terms and conditions of purchase of materials or borrowing loans from the finance houses or banks.

DEFINITIONS OF PARTNERSHIP

1. ACCORDING TO JOHN A. SHUBIN

"Two or more individuals may form partnership by making a written or oral agreement that they will jointly assume full responsibility for the conduct of business".

2. ACCORDING TO J.L. HANSON

"A partnership is a form of business organization in which two or more persons upto a maximum of twenty join together to undertake some form of business activity".

3. IN THE WORDS OF L.H.HANEY

- "The relationship between persons who agree to carry on a business in common with a view to private gain".

4. IN THE WORDS OF KIMBALL AND KIMBALL

"A partnership firm as it often called, is then a group of men who have joined capital or services for the prosecution of some enterprise".

5. ACCORDING TO SECTION 4 OF INDIAN PARTNERSHIP ACT, 1932

"The relationship between persons who have agreed to share profits of business for profit".

6. ACCORDING TO UNIFORM PARTNERSHIP ACT, USA

"An association of two or more persons to carry on as co-owners of a business for profit".

7. ACCORDING TO ENGLISH PARTNERSHIP ACT, 1890

"Partnership is the relation which subsist between persons carrying on a business in common with a view of profits".

MEANING OF PARTNERSHIP FIRM

A partnership firm is an association of two or more persons formed with the object of sharing profits arising out of business or an undertaking or a venture.

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 .

FEATURES OF PARTNERSHIP

1. NUMBER OF PERSONS:

- There must be atleast two persons to form a partnership firm.
- The maximum number is fixed at ten for a partnership carrying on banking business and at twenty for a partnership carrying on any other business or non-banking business.

2. AGREEMENT

- Partnership is the result of an agreement.
- It is created by mutual consent and voluntary agreement among the partners.
- Persons who are not competent to contract cannot be partners.
- Minors cannot form a partnership firm as they are incompetent to enter into a contract.
- The contract/ agreement may be oral or written but in practice written agreement is made.

3. PROFIT MOTIVE

- The purpose of the business should be to make profits and distribute them among the partners.
- This is one of the basic elements of partnership.
- If a work is done for charity purpose, it will not be called partnership.
- Similarly, if two or more persons jointly own some property and share its income, it is not regarded as partnership.
- So the motive of the business should be to earn profits.

4. PRINCIPAL- AGENT RELATIONSHIP

- The business may be carried on by all or any one acting on behalf of all the partners.
- Each partner is both an agent and a principal for himself and others.
- Each partner is an agent of the firm and his services bind the firm.
- He also acts as a principal because he is bound by the activities of the other partners.
- In fact, partnership is an extension of agency.

5. UNLIMITED LIABILITY

- In respect of business debts, each partner has unlimited liability.
- This means that if assets of the firm are not sufficient to meet the obligations of the firm, the partners have to pay from their private assets.
- The creditors can claim their dues from any one of the partners or from all the partners.
- The partners are liable individually and collectively.
- Thus every partner has unlimited liability and it is joint as well as several.

6. UTMOST GOOD FAITH

- A partnership agreement rests on utmost good faith.
- Therefore, every partner must be honest to one another.
- Every partner should act honestly.
- He should give proper accounts to other partners.
- Hence it is necessary to be very careful when selecting a partner.

7. RESTRICTION ON TRANSFER OF SHARES

- No partner can sell or transfer his share to an outsider without the consent of other partners.

8. NO PERPETUITY:

- The partnership firm and the partners are one and the same.
- The partnership firm is not different from the partners.
- So a partnership is deemed to be dissolved on the death, insolvency, insanity or retirement of any partner.

9. REGISTRATION:

The partnership may or may not be registered. If it is registered , it gets some privileges and facilities from the government.

ADVANTAGES OF PARTNERSHIP FIRM

1. EASY TO FORM:

Once there is a group of like minded persons and good business proposal, it is very easy to start and register a partnership.

2. AVAILABILITY OF LARGE AMOUNT OF CAPITAL:

More amount of capital can be raised from more number of partners.

3. DIVISION OF LABOUR:

The different partners come with varied background and skills. This facilitates division of labour.

ADVANATAGES OF PARTNERSHIP FIRM

4. FLEXIBILITY:

The partners are free to change their decisions, add or drop a particular product or start a new business or close the present one and so on.

5. PERSONAL CONTACT WITH CUSTOMERS:

There is a scope to keep close monitoring with customers requirements by keeping one of the partners in charge of sales and marketing. Necessary changes can be initiated based on the merits of proposals from the customers.

6. QUICK DECISIONS AND PROMT ACTIONS:

If there is consensus among partners, it is enough to implement any decision and initiate prompt actions. Some times, it may take more time for the partners on strategic issues to reach consensus/agreement.

ADVANATAGES OF PARTNERSHIP FIRM

7. THE POSITIVE IMPACT OF UNLIMITED LIABILITY:

Every partner is always alert about his impending danger of unlimited liability. Hence he tries to do his best to bring profits for the partnership firm by making good use of all his contacts.

8. TAX RATE:

when compared to company form , the rate of tax is low.

DISADVANATAGES OF PARTNERSHIP FIRM

1. FORMATION OF PARTNERSHIP IS DIFFICULT:

- Only like minded persons can start a partnership .
- It is sarcastically said, "it is easy to find a life partner, but not a business partner".

2. UNLIMITED LIABILITY:

- The persons have joint and several liabilities beside unlimited liability.
- Joint and several liability puts additional burden on the partners, which means that even the personal properties of the partner or partners can be attached.
- Even when all but one partner become insolvent, the solvent partner has to bear the entire burden of business loss.

DISADVANATAGES OF PARTNERSHIP

3. LACK OF HARMONY OR COHESIVENESS:

- It is likely that partners may not, most often work as a group with cohesiveness.
- This results in mutual conflicts, an attitude of suspicion and crisis of confidence.
- Lack of harmony results in delay in decisions and paralyses the entire operations.

4. LIMITED GROWTH:

- The recourses when compared to sole trader, a partnership may raise little more.
- But when compared to other forms such as company , resources raised in this form of organization are limited.
- Added to this, there is a restriction on the maximum number of partners.

DISADVANATAGES OF PARTNERSHIP

5. INSTABILITY:

- The partnership form is known for its instability.
- The firm may be closed on death, insolvency or insanity of any of the partners.

6. LACK OF PUBLIC CONFIDENCE:

- Public and even the financial institutions look at the unregistered firms with a suspicious eyes.
- Though registration of the firm under the Indian partnership Act is a solution for such problem, this cannot revive public confidence into this form of organization overnight.
- The partnership can create confidence in others only with their performance.

DISADVANATAGES OF PARTNERSHIP

7. IMPLIED AUTHORITY MISUSED:

- Where there is no periodic monitoring, there is a possibility that the active partner may misuse his implied authority.
- One of the solutions for this problem is that the partners should meet once every month and review the progress from time-to- time .

8. HIGH RATE OF TAX:

- When compared to the sole trader the tax rate is higher..

PARTNERSHIP DEED

- The written agreement among the partners is called the partnership deed. It contains the terms and conditions governing the working of partnership. The following are the contents of the partnership deed.

1. Names and addresses of the firm and partners.
2. Nature of the business proposed.
3. Duration.
4. Amount of the capital of the partnership and the ratio for contribution by each of the partners.
5. Their profit sharing ratio.(this is used for sharing losses also)
6. Rate of interest charged on capital contributed, loans taken from the partnership and amounts drawn, if any by the partners from their respective capital balances.

PARTNERSHIP DEED

7. The amount of salary or commission payable to any partner.
8. Procedure to value goodwill of the firm at the time of admission of a new partner, retirement, or death of a partner.
9. Allocation of responsibilities of the partners in the firm.
10. Procedure for dissolution of the firm.
11. Name of the arbitrator to whom the disputes, if any, can be referred to for settlement.
12. Special rights, obligations and liabilities of partner(s), if any.

KINDS OF PARTNERS

1. **ACTIVE PARTNER:**

   Active partner takes active part in the affairs of the partnership. He is also called working partner.

2. **SLEEPING PARTNER:**

   Sleeping partner contributes to capital but does not take active part in the affairs of the partnership.

3. **NOMINAL PARTNER:**

   Nominal partner is partner just for namesake. He either contributes to capital nor takes active part in the affairs of the business. Normally, the nominal partners are those who have good business connections, and are well placed in the society. The partnership derives benefit from such contacts in terms of business growth and increase in profits.

KINDS OF PARTNERS

4. PARTNER BY ESTOPPEL

Estoppel means behavior or conduct. Partner by estoppel gives an impression to outsiders that he is the partner in the firm. In fact he neither contributes to capital nor takes any role in the affairs of the partnership. Because he has mislead the outsiders , partner by estoppel is held liable for the claims, if any, of the outsiders .

5. PARTNER BY HOLDING OUT

If partners declare a particular person(having social status) as partner and this person does not contradict even after he comes to know such declaration, he is called a partner by holding out and he is liable for the claims of third parties. However, the third parties should prove they entered into contract with the firm in the belief that he is the partner of the firm. Such a person is called partner by holding out.

6. MINOR PARTNER:

Minor has a special status in the partnership. A minor can be admitted for the benefits of the firm. A minor is entitled to his share of profits of the firm. The liability of a minor partner is limited to the extent of his contribution of the capital of the firm. After attaining majority, the minor is free to continue as partner to severe his relations with the firm. In case he chooses to severe, he has to give a public notice of such a decision within six months from the date of attaining majority. If he does not give such a notice, it means that he opts to continue as partner, he becomes a full-fledged partner with unlimited liability.

JOINT STOCK COMPANY

- The joint stock company emerges from the limitations of partnership such as joint and several responsibility, unlimited liability, limited resources, and uncertain duration and so on.
- The word company has a Latin origin, com means ‘come together’ pany means ‘bread’. Joint stock company means people come together to earn their livelihood by investing in the stock of the company jointly.

DEFINITIONS OF JOINT STOCK COMPANY

1. ACCORDING TO L.H.HANEY

"joint stock company is a voluntary association of individuals for profit, having a capital divided into transferable shares, the ownership of which is the condition of the membership".

2. ACCORDING TO LORD LINDLEY

"An association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose".

3. ACCORDING TO INDIAN COMPANIES ACT 1956

A joint stock company limited by shares is "a company having permanent paid up 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".

4. ACCORDING TO CHIEF JUSTICE MARSHALL OF U.S.A.

"A corporation is an artificial being invisible, intangible and existing only in contemplation of law. Being a mere creation of law, it possesses only the properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence".

- **A joint stock company is described as a voluntary association of persons recognized by law, having a distinct name, a common seal, formed to carry on business for profit, with capital divisible into transferable shares, limited liability, corporate body and perpetual succession.**
- **Joint stock company is also defined as an artificial person recognized by law with a distinctive name, a common seal, a common capital comprised of transferable shares of fixed value carrying limited liability and having perpetual succession.**
- **In brief, it is like an artificial person created by law with perpetual succession and common seal.**

FEATURES OF JOINT STOCK COMPANY

1. **ARTFICIAL PERSON:**

The company has no form or shape . It is an artificial person created by law. It is intangible , invisible and existing only in the eyes of law.

2. SEPARATE LEGAL EXISTANCE:

- It has an independent existence.
- It is separate from its members. It can acquire the assets.
- It can borrow for the company. It can sue others it they are in default in payment of dues , breach of contract with it, If any.
- Similarly it can be sued by outsiders for any claim.
- A shareholder is not liable for the acts of the company. Similarly , the shareholders cannot bind the company by their acts.

FEATURES OF JOINT STOCK COMPANY

3. VOLUNTARY ASSOCIATION:

The company is an association of voluntary association of persons who want to carry on business for profit. To carry on business, they need capital. So they invest in the share capital of the company.

4. LIMITED LIABILITY:

- The shareholders have limited liability. i.e., liability limited to the face value of the shares held by him.
- In other words, the liability of a shareholder is restricted to the extent of his contribution to the share capital of the company.
- The shareholder need not pay any thing, even in times of loss for the company, other than his contribution to the share capital.

FEATURES OF JOINT STOCK COMPANY

5. CAPITAL IS DIVIDED INTO SHARES:

- The total capital is divided into a certain number of units. Each unit is called as a share.
- The price of each share is priced so low that even investor would like to invest in the company.
- The companies promoted by promoters of good standing (i.e., known for their reputation in terms of reliability character and dynamism) are likely to attract huge resources.

FEATURES OF JOINT STOCK COMPANY

6. TRANSFERABILITY OF SHARES:

- In the company form of organization, the shares can be transferred from one person to other.
- A shareholder of a public company can sell his holding of shares at his will.
- However, the shares of a private company cannot be transferred without the consent of other shareholders.
- A private company restricts the transferability of the shares.

FEATURES OF JOINT STOCK COMPANY

7.COMMON SEAL:

- As the company is an artificial person created by law has no physical form, it cannot sign its name on a paper.
- So, it has a common seal on which its name is engraved.
- Every document or contract should be affixed by the common seal , otherwise the company is not bound by such a document or contract.

FEATURES OF JOINT STOCK COMPANY

8. PERPECTUAL SUCCESSION:

- Members may come and members may go , but the company continues for ever and ever.
- A company has uninterrupted existence because of the right given to the shareholders to transfer the shares.

9. OWNERSHIP AND MANAGEMENT SEPERATED:

- The shares are spread over the length and breadth of the country, and sometimes, they are from different parts of the world.
- To facilitate administration, the shareholders elect some among themselves or the promoters of the company as directors to a board., which looks after the management of the business.
- The board recruits the managers and employees at different levels in the management.
- Thus the management is separated from the owners.

FEATURES OF JOINT STOCK COMPANY

10. **WINDING UP:** Winding up refers to the putting an end to the company. Because law creates it. Only law can put an end to it in special circumstances such as representation from creditors or financial institutions or shareholders against the company that their interest s are not safeguarded. The company is not affected by the death or insolvency of any of its members.

11. **THE NAME OF THE COMPANY EDS WITH LIMITED:**

- It is necessary that the name of the company ends with limited(Ltd.) to give an indication to the outsiders that they are dealing with the company with limited liability and they should be careful about the liability aspect of their transactions with the company.
- The word Limited will be added at the end of the name of public limited company and the word Private Limited will be added at the end of the name of private company.

ADVANTAGES OF JOINT STOCK COMPANY

1. MOBALIZATION OF LARGER RESOURCES:

- A joint stock company provides opportunity for the investors to invest, even small sums, in the capital of large companies.
- This facilitates raising of larger resources.

2. SEPARATE LEGAL ENTITY:

- The company has separate legal entity.
- It is registered under Indian Companies Act, 1956.

ADVANTAGES OF JOINT STOCK COMPANY

3. LIMITED LIABILITY:

- The shareholder has limited liability in respect of shares held by him.
- In no case, does his liability exceed more than the face value of the shares allotted to him.

4. TRANSFERABILITY OF SHARES:

- The shares can be transferred to others. However, the private company shares cannot be transferred.

ADVANTAGES OF JOINT STOCK COMPANY

5. LIQUIDITY OF INVESTMENT:

- By providing the transferability of shares, shares can be converted into cash.

6. INCULCATES THE HABIT OF SAVINGS AND INVESTMENTS :

- Because the share face value is very low, this promotes the habit of savings among the common man and mobilize the same towards investments in the company.

ADVANTAGES OF JOINT STOCK COMPANY

7. DEMOCRACY IN MANAGEMENT:

- The directors are elected by the shareholders in a democratic way in the general body meetings.
- The shareholders are free to make any proposals, question the practices of the management, suggest the possible remedial measures as they perceive.
- The directors respond to the issues raised by shareholders and have to justify their actions.

8. ECONOMIES OF LARGE SCALE PRODUCTION:

- Since the production is in large scale with large funds at its disposal, the company can enjoy the internal economies of large scale production.

ADVANTAGES OF JOINT STOCK COMPANY

9. CONTINUED EXISTENCE:

- The company has perpetual succession. It has no natural end. It continues forever and ever unless law puts an end to it.

10. INSTITUTIONAL CONFIDENCE:

- Financial institutions prefer to deal with companies in view of their professionalism and financial strengths.

ADVANTAGES OF JOINT STOCK COMPANY

11. PROFESSIONAL MANAGEMENT:

- With the larger funds at its disposal, the board of directors recruits competent and professional managers to handle the affairs of the company in a professional manner.

12. GROWTH AND EXPANSION:

- With a large resources and professional management, the company can earn good returns on its operations, build good amount of reserves and further consider the proposals for growth and expansion.

DISADVANTAGES OF JOINT STOCK COMPANY

1. FORMATION OF COMPANY IS A LONG DRAWN PROCEDURE:

- Promoting a joint stock company involves a long drawn procedure.
- It is expensive and involves large number of legal formalities.

2. HIGH DEGREE OF GOVERNMENT INTERFERENCE:

- The government brings out a number of rules and regulations governing the internal conduct of the operations of a company such as meetings, voting, audit and any violation of these rules results into statutory lapses, punishable under the companies Act.

DISADVANTAGES OF JOINT STOCK COMPANY

3. INORDINATE DELAY IN DECISION MAKING:

- As the size of the organization grows , the number of levels in the organization also increases in the name of specialization.
- The more number of levels, the more is the delay in decision making. Some times, so called professionals do not respond to the urgencies as required.
- It promotes delay in administration which is referred to ‘red tape and bureaucracy’.
- With all these, the company form of organization tends to be an inflexible organization.

4. LACK OF INITIATIVE:

- In most of the cases, the employees of the company at different levels show slack in their personal initiative with the result, the opportunities once missed do not recur and the company loses the revenue.

DISADVANTAGES OF JOINT STOCK COMPANY

5. LACK OF RESPONSIBILITY AND COMMITMENT:

- In some cases, the managers at all levels are afraid to take risk and more worried about their jobs rather than the huge funds invested in the capital of the company.
- Where managers do not show up willingness to take responsibility, they cannot be considered as committed.
- They will not be able to handle the business risks.

6. CONFLICTING INTERESTS:

- The company has divergent groups of people associated with it.
- The shareholders want more dividends.

DISADVANTAGES OF JOINT STOCK COMPANY

- The company wants to maintain good amount of reserves. It is not possible to pay larger dividends, and yet , to maintain good amount of reserves.
- It is necessary to reconcile such conflicting interests.
- The board of directors usually justify their actions of declaring low or high rate of dividend.

7. PROMOTES SPECULATION:

- Speculation is the process of expecting a higher price for a particular share and buying it at a lower rate.
- In the stock markets where shares are bought and sold, speculation is the undercurrent of all transactions.
- In this process, there is a danger that some shares are manipulated and common investors are trapped in such manipulation.
- At times, prices are manipulated.

DISADVANTAGES OF JOINT STOCK COMPANY

- The common investors buy certain shares with the expectation that the prices of these shares will go up further.
- They seldom realize that they are manipulated prices.

8. LOBBYING WITH GOVERNMENT DEPARTMENTS:

- The corporate giants have the capacity to lobby with government departments to influence the government policies to suit their business conditions.
- The corporate giants gain this strength only from their large base of funds.

DISADVANTAGES OF JOINT STOCK COMPANY

9. TENDS TO MONOPOLY:

Where the company has growth to larger size, it may fix the price on its own for its products and services as a monopolist.

10. HIGHER TAXES:

- The rate of income tax is very high when compared to the other forms of organizations.

KINDS/TYPES OF COMPANIES

I. KINDS OF COMPANIES BASED ON INCORPORATION:

1. Charted Companies:

- A chartered company is created by the royal charter of the state.
- The charter contains the rights, privileges and powers to be used by the chartered company for example, British East India Company formed in England in 1600 to trade with India and the East.

KINDS/TYPES OF COMPANIES

2. Statutory corporation:

- A statutory corporation is created by an Act of the state legislature or Parliament.
- The objective, scope, powers, responsibilities are clearly defined in this Act.
- The examples of statutory corporation are Reserve Bank of India, Industrial Development Bank of India, Food Corporation of India, APSRTC.

KINDS/TYPES OF COMPANIES

3. Registered company:

- A registered company is one that is registered under Indian Companies Act, 1956(earlier it was Indian companies Act 1913).
- The provision of the Act govern the formation and working of these companies.
- A registered company may be a public limited company , private limited company, government company, company limited by guarantee or an unlimited company.

KINDS/TYPES OF COMPANIES

II. KINDS OF COMPANIES BASED ON PUBLIC INTEREST:

1. **Private limited company:** According to section 3 of Indian Companies Act, a private company means a company that has a minimum paid up capital of one lakh rupees or such higher paid up capital as may be prescribed, and by its articles

a. restricts the right of transfer its shares, if any

b. limits the number of its members to fifty excluding present and past employees

KINDS/TYPES OF COMPANIES

c. Prohibits any invitation to the public to subscribe any shares in or debentures of the company

d. Prohibits any invitation or acceptance of deposits from persons ther than its members, directors or their relatives.

e. The name of the private company should ends with the words private limited (Pvt.Ltd.)

KINDS/TYPES OF COMPANIES

2. Public company:

This means a company that

a. is not a private company
b. has a minimum paid up capital of five lakh rupees or such higher paid up capital, as may be prescribed.
c. is a private company , which is a subsidiary of a company that is not a private company.
d. allows transfer of its shares
e. can have any number of members but minimum, there should be seven.
f. can issue the prospectus to raise the capital.
g. The name of the public company ends with the word limited(Ltd.)

KINDS/TYPES OF COMPANIES

3. Government Company:

- Section 617 of the Indian Companies Act, 1956 defines a government company as any company in which not less than 51 per cent of the paid up capital is held by central government, or by any state governments or partly by central government and partly by one or more state governments and include a company which is a subsidiary of government company.
- Examples of National Thermal Power Corporation (NTPC), Bharat Heavy Electricals Ltd. (BHEL) , Hindustan Machine Tools (HMT) , Hindustan Port Trust, Steel Authority of India (SAIL).

KINDS/TYPES OF COMPANIES

III. ON THE BASIS OF CONTROLLING INTEREST:

Holding and Subsidiary Companies:

- A holding company is a company that controls the composition of the board of directors of another company or holds more than half of the nominal value of the equity share capital of another company.
- The other company that is controlled by the holding company is called subsidiary company. A company (say X), which is a holding company of another company (say Y),but subsidiary of a third company (say Z) , then that another company (Y) will also be subsidiary of the third company(Z).

KINDS/TYPES OF COMPANIES

IV. KINDS OF COMPANIES BASED ON LIABILITY

1. Unlimited company:

- An unlimited company is a company in which the liability of every member is unlimited.
- This implies that the personal property of every member is also liable for the debts of the company.
- The liability of a member is enforceable only at the time of winding up of the company.
- Unlimited companies are rarely found in practice even though as per Indian Companies Act, Unlimited companies can be incorporated.

KINDS/TYPES OF COMPANIES

2. Limited company:

- A company is said to be limited liability company where the liability of its members is limited by the unpaid amount on the shares respectively held by them.
- Generally, the companies incorporated under Indian Companies Act are limited liability companies only.

3. Companies limited by guarantee:

company is said to be limited by guarantee where the liability of the members is limited to such an amount as they agreed upon to contribute to the assets of the company in the event of being wound up.

KINDS/TYPES OF COMPANIES

V. KINDS OF COMPANIES BASED ON NATIONALITY

Based on the nationality the companies can be classified into two categories.

1. **Foreign Companies:** Foreign company is a company incorporated outside India but established a place of business within India. Foreign companies come under the purview of the Indian Companies Act, 1956.

2. **Indian Company:** A company incorporated in India under the Indian Companies Act, 1956.

PUBLIC ENTERPRISES

- Public enterprises occupy an important position in the Indian economy.
- Public enterprises provide the substance and heart of the economy.
- Its investment of over Rs. 10,000 crore is in heavy and basic industry, and infrastructure like power, transport and communications.
- The concept of public enterprise in India dates back to the era of pre-independence.

GENESIS OF PUBLIC ENTERPRISES

- In consequence to declaration of its goal as socialistic pattern of society in 1954, the Government of India realized that it is through progressive extension of public enterprises only, the following aims of our five year plans can be fulfilled.
- Higher Production.
- Greater Employment.
- Economic Equality.
- Dispersal of Economic Power.

NEED FOR PUBLIC ENTERPRISES

The Industrial Policy Resolution 1956 sates the need for promoting public enterprises as follows:

- **To accelerate the rate of economic growth by planned development.**
- **To speed up industrialization, particularly development of heavy industries and to expand public sector and to build up a large and growing cooperative sector.**
- **To increase infrastructural facilities.**
- **To disperse the industries over different geographical areas for Balanced regional development.**
- **To increase the opportunities of gainful employment.**
- **To help in raising the standards of living. To reducing disparities in income and wealth (by preventing private monopolies and curbing concentration of economic power and vast industries in the hands of a small number of individuals).**

NEED FOR PUBLIC ENTERPRISES

- The rationale of public enterprises in India was to take independent in India was to take independent in India, in the words of Pandit Jawaharlal Nehru, to the ‘commanding heights’.
- The strategy was to quicken the pace of economic development and strengthen the Independent in India in basic industries, defense requirements, public utilities and infrastructure.
- All these were the areas where it was not possible to mobilize private investment.
- Private institutions cannot invest large funds and wait for an indefinitely long period for returns on their investment.

ACHIEVEMENTS OF PUBLIC ENTERPRISES

The achievements of public enterprise are vast and varied. They are

1. Setting up a number of public enterprises in basic and key industries.

2. Generating considerably large employment opportunities in skilled, unskilled, supervisory and managerial cadres.

3. Creating internal resources and contributing towards national exchequer for funds for development and welfare.

ACHIEVEMENTS OF PUBLIC ENTERPRISES

4. Bringing about development activities in backward regions through locations in different areas of the country.

5. Assisting in the field of export promotion and conservation of foreign exchange.

6. Creating viable infrastructure and bringing about rapid industrialization (ancillary industries developed around the public sector as its nucleus).

7. Restricting the growth of monopolies.

8. Stimulating diversified growth in private sector.

ACHIEVEMENTS OF PUBLIC ENTERPRISES

9. Taking over sick industrial units and putting them, in most of the cases, in order.

10. Creating a financial system through a powerful networking of financial institutions, development and promotional institutions, which has resulted in social control and social orientation of investment, credit and capital management system.

11. Benefiting the rural areas, priority sectors, small businesses in the fields of industry, finance, credit, services, trade, transport, consultancy and so on.

FORMS OF PUBLIC ENTERPRISES

Public enterprises can be classified into three forms:

They are

I. DEPARTMENTAL UNDERTAKINGS

II. PUBLIC CORPORATION

III. GOVERNMENT COMPANY

I. DEPARTMENTAL UNDERTAKING

- This is the earliest form of public enterprise.
- Under this form, the affairs of public enterprise are carried out under the overall control of one of the departments of the government.
- The government department appoints a managing director (normally a civil servant) for the departmental undertakings.
- He will be given the executive authority to take decisions.
- The departmental under taking does not have a budget of its own.
- As and when it wants, it draws money from the government exchequer and when it has surplus money, it deposits it in the government exchequer.

I. DEPARTMENTAL UNDERTAKING

- However, it is subject to budget, accounting and audit controls.
- Examples for departmental undertakings are Railways, Department of Posts, All India Radio, Doordarshan, Defense undertakings like DRDI, DLRI, Ordinance factories and such.

FEATURES OF DEPARTMENTAL UNDERTAKING

1. **UNDER THE CONTROL OF GOVERNMENT DEPARTMENT:**

- The departmental undertaking is not an independent organization.
- It is designed to work under close control of a government department.
- It is subject to direct ministerial control.

FEATURES OF DEPARTMENTAL UNDERTAKING

2. MORE FINANCIAL FREEDOM:

- The departmental undertaking can draw funds from government account as per the needs and deposit back when convenient.

FEATURES OF DEPARTMENTAL UNDERTAKING

3. LIKE ANY OTHER GOVERNMENT DEPARTMENT:

- **The departmental undertaking is almost similar to any other government department.**

FEATURES OF DEPARTMENTAL UNDERTAKING

4. BUDGET, ACCOUNTING AND CONTROLS:

- The departmental undertaking has to follow the guidelines (as applicable to the other government departments) underlying budget preparation, maintenance of accounts and getting the accounts audited internally and by external auditors.

FEATURES OF DEPARTMENTAL UNDERTAKING

5. MORE A GOVERNMENT ORGANIZATION LESS A BUSINESS ORGANIZATION:

- The set up of a departmental undertaking is more rigid, less flexible, slow in responding to market needs.

ADVANTAGES OF DEPARTMENTAL UNDERTAKING

1. EFFECTIVE CONTROL:

- Control is likely to be effective because it is directly under the ministry.

2. RESPONSIBLE EXECUTIVES:

- Normally the administration is entrusted to a senior civil servant. The administration will be organised and effective.

ADVANTAGES OF DEPARTMENTAL UNDERTAKING

3. LESS SCOPE FOR MISUTILIZATION OF FUNDS:

- Departmental undertaking does not draw any money more than is needed, that too subject to ministerial sanction and other controls. So chances for misutilisation are low.

4. ADD TO GOVERNMENT REVENUE:

- The revenue of the government is on the rise when the revenue of the departmental undertaking is deposited in the government account.

DISADVANTAGES OF DEPARTMENTAL UNDERTAKING

1. DECISIONS DELAYED CONTROL IS CENTRALISED:

- This results in lower degree of flexibility.
- Officials in the lower levels cannot take initiative.
- Decisions cannot be fast and actions cannot be prompt.

2. : NO INCENTIVE TO MAXIMISE EARNINGS:

- The departmental undertakings does not retain any surplus with it. So there is no incentive for maximizing the efficiency or earnings.

DISADVANTAGES OF DEPARTMENTAL UNDERTAKING

3. SLOW RESPONSE TO MARKET CONDITIONS:

- Since there is no competition, there is no profit motive, there is no incentive to more swiftly to market needs.

4. REDTAPISM AND BUREAUCRACY:

- The departmental undertakings are in the control of civil servant and under the immediate supervision of a government department.
- Administration gets delayed substantially.

DISADVANTAGES OF DEPARTMENTAL UNDERTAKING

5. INCIDENCE OF MORE TAXES:

- At times, in case of losses, there are made up government funds only.
- To make up these, there maybe a need for fresh taxes which is undesirable.

II. PUBLIC CORPORATION

MEANING:

- ‘Public corporation is a right mix of public ownership, public accountability and business management for public ends’.
- The public corporation provides a machinery which is flexible, while at the same time retaining public control.
- A public corporation has total freedom in planning, management and control of its operations. It can formulate its own budget.
- It can recruit staff at different levels based on the necessary specialization.
- Public Corporation is also called Statutory Corporation.

II. PUBLIC CORPORATION

DEFINITION OF PUBLIC CORPORATION:

- A public corporation is defined as a "body corporate created by an Act of Parliament or Legislature and notified by the name in the official Gazette of the Central or State Government. It is a corporate entity having perpetual succession and common seal with powers to acquire, hold, dispose off property , sue and be sued by its name."
- Examples of a public corporations are Life Insurance Corporation of India, Unit Trust of India, Industrial Finance Corporation of India, Damodhar valley Corporation and others.

FEATURES OF PUBLIC CORPORATION

1. A BODY CORPORATE:

- It has a separate legal existence. It is a separate company by itself.
- It can raise resources, buy and sell properties, by name sue and be sued.

FEATURES OF PUBLIC CORPORATION

2. MORE FREEDOM IN DAY-TO-DAY OPERATIONS:

- A public corporation has a high degree of operational freedom in its day-to-day affairs.
- It is relatively free from any type of political interference.
- It enjoys administrative autonomy.

FEATURES OF PUBLIC CORPORATION

3. FREEDOM REGARDING PERSONNEL:

- The employees of public corporation are not government civil servants.
- The corporation has absolute freedom to formulate its own personnel policies and procedures and these are applicable to all the employees including directors.

FEATURES OF PUBLIC CORPORATION

4. PERPECTUAL SUCCESSION:

- A Statute in Parliament or State Legislature creates it.
- It continues forever and till a statute is passed to wind it up.

FEATURES OF PUBLIC CORPORATION

5. FINANCIAL AUTHORITY:

- Though the public corporation is a fully owned government oganisation, and the initial finances the provided by the government, it enjoys total financial autonomy.
- Its income and expenditure are not shown in the annual budget of the government.
- However, for its freedom it is restricted regarding capital expenditure beyond the laid down limits and raising the capital through capital market.

FEATURES OF PUBLIC CORPORATION

6. COMMERCIAL AUDIT:

- Except in the case of banks and other financial institutions where charted accounts are auditors, in all corporations, the audit is entrusted to the Controller and Auditor General of India.

7.RUN ON COMMERCIAL PRINCIPLES:

As far the discharge of functions, the corporations shall act as far as possible on sound business principles.

ADVANTAGES OF PUBLIC CORPORATION

1. INDEPENDENCE, INITIATIVE AND FLEXIBILITY:

- The corporation has an autonomous set up.
- so it is independent, take necessary initiative to realize its goals and it can be flexible in its decisions as required.

ADVANTAGES OF PUBLIC CORPORATION

2.SCOPE FOR REDTAPISM AND BUREAUCRACY MINIMISED:

- The corporation has its own policies and procedures.
- If necessary they can simplified to eliminated redtapism and bureaucracy, if any.

ADVANTAGES OF PUBLIC CORPORATION

3. PUBLIC INTERESTS PROTECTED:

- The corporation can protect the public interests by making its policies more public friendly.
- Public interests are protected because every policy of the corporation is subject to ministerial directives and broad parliamentary control.

ADVANTAGES OF PUBLIC CORPORATION

4. EMPLOYEES FRIENDLY WORK ENVIRONMENT:

- Corporation can design its own work culture and train its employees accordingly.
- It can provide better amenities and better terms of service to the employees and thereby secure greater productivity.

ADVANTAGES OF PUBLIC CORPORATION

5. COMPETITIVE PRICES:

- The Corporation is a government organization and hence can afford with minimum margins of profit.
- It can offer its products and services at competitive prices.

ADVANTAGES OF PUBLIC CORPORATION

6. ECONOMIES OF SCALE:

- By increasing the size of its operations, it can achieve economies of large scale production.

7. PUBLIC ACCOUNTABILITY:

It is accountable to the parliament or legislature. It has to submit its annual report on its working results.

DISADVANTAGES OF PUBLIC CORPORATION

1. CONTINUED POLITICAL INTERFERENCE:

- The autonomy is on paper only and in reality, the continued political interference disturbs the work environment of the corporations.
- Pressures for employment, providing facilities, operating at low margins restrict the freedom of public corporation.

2. MISUSE OF POWER:

In some cases, the grater autonomy leads to misuse of power. It takes time to unearth the impact of such misuse on the resources of the corporation. Cases of misuse of power defeat the very purpose of the public corporation.

DISADVANTAGES OF PUBLIC CORPORATION

3. BURDEN FOR THE GOVERNMENT:

- Where the public corporation ignore the principles and suffers losses, it is burdensome for the government to provide subsidies to make up the losses.

III. GOVERNMENT COMPANY

DEFINITION OF GOVERNMENT COMPANY:

- **Section 617 of the Indian companies Act defines a government company as "any company in which not less than 51 percent of the paid up share capital" is held by the central government or by any state government or governments or partly by**

FEATURES OF GOVERNMENT COMPANY

1.LIKE ANY OTHER REGISTERED COMPANY:

- It is incorporated as a registered company under the Indian companies Act, 1956.
- Like any other company the government company has separate legal existence, common seal, limited liability and so on.
- The provision of the Indian companies Act apply for all matters relating to formation, administration and winding up.
- However, the government has a right to exempt the application of any provisions of the government companies.

2. SHAREHOLDING

- The majority of the shares are held by the government, central, state, partly by the central and state government(s) in the name of the president of India.
- It is also common that the collaborators are alloted some shares for providing the transfer of technology.

3. DIRECTORS ARE NOMINATED:

- As the government is the owner of the entire or majority of the share capital of the company, it has a freedom to nominate the directors to the board.
- Government may consider the requirements of the company in terms of necessary specialization and appoints the directors accordingly.

4. ADMINISTRATIVE AUTONOMY AND FINANCIAL FREEDOM:

- A government company functions independently with full discretion and in the normal administration of the affairs of the undertakings.

5. SUBJECT TO MINISTERIAL CONTROL:

- Concerned minister may act as the immediate boss.
- It is because, it is the government that nominates the directors, the minister issues directions for a company and he can call for information related to the progress and affairs of the company any time.

ADVANTAGES OF GOVERNMENT COMPANY

1. FORMATION IS EASY:

- There is no need for the Act in legislature or parliament to promote a government company.
- The government company canbe promoted as per the provisions of the companies Act, which is relatively easier.

2. SEPARATE LEGAL ENTITY:

- It retains the advantages of public corporation such as autonomy, legal entity.

3. ABILITY TO COMPETE:

- It is free from the rigid rules and regulations.
- It can smoothly function with all the necessary initiative and drive necessary to compete with any other private organizations.

4. FLEXIBILITY:

- A government company is more flexible than a departmental undertaking or public corporation.
- Necessary changes can be initiated within the frame work of the company law.
- Government can, if necessary, change the provisions of the company Act, if found restricting the freedom of the government company.
- The form of government company is so flexible that it can be used for taking over sick units promoting strategic industries in the context of national security and interest.

5. QUICK DECISIONS AND PROMT ACTIONS:

- In view of the autonomy, the government company can take decisions quickly and ensure that the actions are initiated promptly.

6. PRIVATE PARTICIPATION FACILITATED:

- Government company is the only form providing scope for private participation in the ownership.
- This facilitates to take the best, necessary to conduct the affairs of the business from the private sector and also from the public sector.

DISADVANTAGES OF GOVERNMENT COMPANY:

1. CONTINUED POLITICAL AND GOVERNMENT INTERFERENCE:

- Government seldom leaves the government company function on its own.
- Government is the major shareholder and it dictates its decisions to the board.
- The board of directors gets these approved in the general body.
- there were a number of cases where the operational policies were influenced by the whims and fancies of the civil servants and the ministers.

2. HIGHER DEGREE OF GOVERNMENT CONTROL:

- **The degree of government control is so high that the government company is reduced to mere adjuncts to the ministry and in majority of cases, not treated better than the subordinate organization or offices of the government.**

3. EVADES CONSTITUTIONAL RESPONSIBILITY:

- A government company is created by executive action of the government without the specific approval of the parliament or Legislature.

4. POOR SENSE OF ATTACHMENT OR COMMITMENT:

- The members of the board of man agent of government companies are from the ministerial departments in their ex-officio capacity. They lack the sense of attachment and do not reflect any degree of commitment lead the company in a competitive environment.

5. DIVIDEND LOYALITIES:

- The employees are mostly drawn from the regular government departments for a defined period.
- After this period, they go back to their government departments and hence their dividend loyalty dilutes their interest towards their job in the government company.

6. FLEXIBILITY ONLY ON PAPER:

- The powers of the directors are to be approved by the concerned Ministry, particularly the powers relating to borrowing, increase in capital expenditure.
- The government companies are rarely allowed to exercise their flexibility and independence

Differences between Public and Private companies

Point of Difference	Public Company	Private Company
1. NUMBER OF MEMBERS	It can be started with a minimum of seven members. There is no limit to the maximum number of members.	It can be started with a minimum of two members. The maximum number of members is fifty.
2. TRANFER OF SHARES	No restriction on transfer of shares.	Transfer of shares is generally restricted by the Articles.
3. ISSUE OF PROSPECTUS	It can issue prospectus or statement in lieu of prospectus for inviting the public for purchase of its shares.	It cannot issue prospectus for inviting the public for purchase of its shares.
4. MINIMUM PAID UP CAPITAL	Minimum capital of public company is Rs.5 lakh or higher, as may be prescribed.	Its minimum capital is Rs.1 lakh , as may be prescribed.

Differences between Public and Private companies

Point of Difference	Public Company	Private Company
5. USE OF THE WORD 'LIMITED'	The words 'Limited' must be added at the end of its name.	The words 'Private Limited' must be added at the end of its name.
6. MINIMUM SUBSCRIPTION	It must secure minimum subscription.	It need not secure minimum subscription before the allotment of shares.
7. COMMENCEMENT OF BUSINESS	It cannot commence business unless it gets 'Certificate of commencement of Business'	It can commence business as soon as it gets 'Certificate of Incorporation'
8. NUMBER OF DIRECTORS	The minimum number of directors is three.	The minimum number of directors is two.

Differences between Public and Private companies

Point of Difference	Public Company	Private Company
9. ISSUE OF SHARES	It can issue only equity and preference shares.	It can issue shares of any kind including deferred shares.
10. INSPECTION OF ACCOUNTS	Final accounts are open for public inspection.	Final accounts of this company are not open to inspection by the public.
11. WRITTEN CONSENT OF DIRECTORS	Written consent of directors is necessary to get 'Certificate of Incorporation'	Written consent of directors is not necessary to get certificate of incorporation.
12. POSSESSION OF QUALIFICATION SHARES	Directors should possesses qualification shares.	Directors need not possesses qualification shares.

Differences between Public and Private companies

Point of Difference	Public Company	Private Company
13. STATUTORY MEETING	It must hold statutory meeting and file a statutory report.	It need not hold statutory meeting nor file statutory report.
14. AGE LIMIT OF DIRECTORS	Persons who are of 65 years of age or more cannot be appointed as directors.	There is no age limit to the directors of this company.
15. RETIREMENT OF DIRECTORS	One-third of the retiring directors should retire by rotation every year.	Directors need not retire by rotation.
16. RESOLUTION 17. GRANT LOANS	A separate resolution is necessary for electing each director. It can grant loans to its directors only with the consent of the government.	A single resolution is sufficient for electing all directors. It can grant loans to its directors without the consent of government.

UNIT-IV

CAPITAL AND CAPITAL BUDGETING

CAPITAL BUDGETING(Unit-VI)

MEANING OF CAPITAL BUDGETING:

- Capital budgeting is the process of making investment decisions in capital expenditures.
- A capital expenditure may be defined as an expenditure the benefits of which are expected to be received over a period of time exceeding one year.

DEFINITIONS OF CAPITAL BUDGETING

1.According to Charles T. Horngreen, " capital budgeting is long term planning for making and financing proposed capital outlays."

2. According to Richard and Greenlaw, " capital budgeting as acquiring inputs with long run return."

3. In the words of Lynch, " capital budgeting consists in planning development of available capital for the purpose of maximising the long term profitability of the concern."

Significance / Importance of Capital Budgeting

Capital budgeting decisions assume special significance for the following reasons:

1. **Substantial capital outlays:** Capital budgeting decisions involve substantial capital out lays.
2. **Long-term implications:** Capital budgeting proposals are of longer duration and hence have long-term implications. For instance, the cash flows for the next 5 years to 15 years have to be forecast.
3. **Strategic in Nature:** Capital budgeting decision can affect the future of the company significantly as it constitutes the strategic determinant for the success of a company. A right investment decision is the secret for the success of many business enterprises.

4. **Irreversible:** Once the funds are committed to a particular project, we cannot take back the decision. If the decision is to be reversed, we may have to lose a significant portion of the funds already committed. It may involve loss of time and efforts. In other words, the capital budgeting decisions are irreversible or may not be easily reversible.

LIMITATIONS OF CAPITAL BUDGETING:

1. **Uncertainty in future:** The Capital budgeting proposals are infested with the uncertainty in future. All data used in the evaluation of proposals is the estimates. The data is error-prone more with the human judgement, bias or discretion in the identification of cash inflows and cash out flows. Even advanced capital budgeting techniques such as sensitivity analysis cannot be useful if the data is erroneous.

2. **Qualitative factors ignored:** In capital budgeting, we consider only such factors which can be quantified in terms of money. Factors such as improved morale of employees as a result of implementation of proposals are not focused. The other factors in the business environment such as social, political and economic conditions and so on, are not reflected here.
3. **Volatile business conditions:** The factors influencing investment decisions include technological advancement, government policies, sales forecast, attitudes of management, estimated cash flows discount factor and rate of return. Any change in one or more of these factors is going to affect the capital budgeting decisions. .

4. **Unrealistic Assumptions:** There are certain unrealistic assumptions underlying capital budgeting process. They are i) There is no risk and uncertainty in the business environment. This is not correct. The future of the business is full of uncertainty and we apply the management techniques to minimise the risk. ii) The cash flows are received in lump sum at the end of the given period. iii) The key variables such as sales revenue, costs , price or investments and so on are taken based on past data. Particularly in times of raising prices , these seldom hold good for future. iv) The cost of capital and discount rates are one and the same.

UNIT-V

INTRODUCTION TO FINANCIAL ACCOUNTING

AND

ACCOUNTING RATIOS

DEFINITIONS OF FINANCIAL ACCOUNTING

1. According to Smith and Ashburne,

"Accounting is the science of recording and classifying business transactions and events, primarily of financial character and art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgements".

2. **According to committee on terminology of American Institute of Certified Public Accountants (AICPA),**

"Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are in part, at least of financial character and interpreting the results thereof."

DEFINITIONS OF FINANCIAL ACCOUNTING

3. Another definition given by the same professional body, namely, AICPA stated that

"Accounting is the collection, measurement, recording, classification and communication of economic data relating to an enterprise for the purpose of reporting, decision making and control.

4.In 1966, the American Accounting Association defined accounting as follows:

"Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information."

CHARACTERISTICS/NATURE OF FINANCIAL ACCOUNTING

1. It is a Science and an Art:

Accounting is a science because it has some objects. In other words Accounting is a science because every business transaction is recorded in a systematic manner. This is done first in the Journal which is the primary book of Accounting/ Business. Accounting is an art because it prescribes the process through which the objects can be achieved.

2. It is the art of recording business transactions:

First, all transactions should be recorded in the journal or the books of original entry known as subsidiary books as and when they take place so that a complete record of financial transactions is available.

CHARACTERISTICS/NATURE OF FINANCIAL ACCOUNTING

3. It is the art of classifying business transactions

All entries in the journal or subsidiary books should be classified by posting them to the appropriate ledger accounts to find out at a glance the total effect of all such transactions in a particular account.

For example, all transactions relating to shyam Sundar's Account in the journal or various subsidiary books will be posted to shyam Sundar's Account. I t may be noted that business transactions are recorded and classified in such a way that it may be possible to determine profit or loss made by the business and its financial position on a specified date.

4. Recording of Transactions of Financial Nature:

Transactions or events which are of financial or economic nature are only recorded in accounting. Transactions or Events which cannot be measured in terms of money, are not at all recorded in financial accounting. For example, a quarrel between production manager and financial manager may be affecting the business but it cannot be measured in terms of money and thus will not be recorded in the books of accounts. Another example is efficiency or honesty of the employees cannot be recorded because it cannot be measured in terms of money though it affects the total profits of business.

5. It is the art of summarizing financial transactions:

After recording and classifying financial transactions next stage is to prepare the trial balance and final accounts with a view to ascertaining the profit or loss made during a trading period and financial position of the business on a particular date.

6. It is an art of analysis and interpretation of these financial transactions:

The accounting information must be analyzed and interpreted by calculating various ratios and percentages or other relationship in order to evaluate the past performance of the business and to make sound plans for the future. As we know that the purpose of accounting is not only recording of transactions but also of analyzing and interpreting data for taking certain important future decisions. This is also known as future forecasting. Thus we see the definition of accounting is changing rapidly because of increase in its functions. i.e., recording of transactions to interpreting of economic events.

7. The results of such analysis must be communicated to the persons who are to make decisions or form judgments:

All information must be provided in time and presented to the different categories of the persons so that appropriate decisions may be taken at the right time.

OBJECTIVES OF FINANCIAL ACCOUNTING

1. Maintaining proper/systematic record of Business Transactions: Accounting replaces the limitations of human memory. The main purpose of accounting is to identify business transactions of financial nature and enter them into appropriate books of accounts. Accounting helps to keep record of all financial transactions and events systematically in proper books of accounts.

2. To ascertain the financial results of the enterprise: One of the main objects of accounting is to ascertain or calculate the profit or loss of the business enterprise. Income statements are prepared with the help of trial balance (prepared with the balances of ledger accounts). At the end of the accounting period, we prepare trading account and ascertain gross profit or gross loss. Afterwards profit and loss account is prepared to ascertain net profit or net loss.

OBJECTIVES OF FINANCIAL ACCOUNTING

3. **To ascertain financial position or financial health of the business:** At the end of the accounting period, we prepare position statement. Blance sheet is a statement of assets and liabilities of the business on a particular date and serves as a parameter to measure the financial health of the business.

4. To help in decision making: Accounting serves as an information system for helping to arrive at rational decisions. American Accounting Association also stresses upon this point while defining the term Accounting as "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information. Accounting keeps systematic record of all transactions and events which are used to assist the management in its function of decision making and control.

OBJECTIVES OF FINANCIAL ACCOUNTING

5. **Providing Effective Control over the Business:** Accounting reveals the actual performance of the business in terms of production, sales, profit, loss, cost of production and the book value of the sundry assets. The actual performance can be compared with the planned and or desired performance of the business. I t can also be compared with the previous performance. Comparison reveals deviation in terms of weaknesses and plus points.

6. **Making Information to various groups:** Accounting makes information available to all these interested parties. Proprietors have interest in profit or dividend, debenture holders, lenders and investors are concerned with the safety of money advanced by them to the business and interest thereon. The object of the accounting is to provide meaningful information to all these interested parties.

Meaning of an Account:

An account is a classified summary of business transactions relating to a particular person or property or an income or an expense.

It is vertically divided into two halves/parts.

It is prepared in the form of alphabet T.

The left side of this account is known as Debit side and right side of the account is known as Credit side.

The word Dr should be written at the top left hand corner side of the account.

The word Cr should be written at the top right hand corner side of the account. The title or name of the account should be written at the top in the middle of the account.

The word 'To' should be written on the debit side of an account in the particulars column.

The word 'By' should be written on the credit side in the particulars column of an account. All the receiving aspects are entered on the debit side and all the giving aspects are entered on the credit side of the account in the particulars column.

All accounts are maintained in Ledger. So they are called "Ledger accounts".

PROFORMA OF ACCOUNT
Name of Account

Dr DATE	PARTICULARS	J.F	Amount Rs.	DATE	PARTICULARS	J.F	Cr Amount Rs.
	To Particulars of benefits received		xxxxx		By Particulars of Benefits given		xxxxx

- An account contains 1) Date column 2) Particulars column 3) Journal Folio column 4) Amount column on the both sides. The format or ruling of an account is given as above.
- **Classification of Accounts:**
- Broadly speaking accounts are classified into two types. They are I. Personal Accounts II. Impersonal Accounts. Impersonal accounts are again divided into Real Accounts and Nominal Accounts. Thus accounts are of Three types.

1. Personal Accounts
2. Real Accounts
3. Nominal Accounts

- Real and Nominal Accounts are collectively called "Impersonal Accounts".

- # 1. Personal Accounts:
- These are accounts of persons and institutions with whom the business deals. A separate account is kept for each person. Personal accounts can be classified into three categories:
- They are i) Natural personal accounts ii) Artificial Personal accounts iii) Representative Personal accounts.
- I) Natural Personal Accounts: The term Natural Persons means who are creations of Gods. For example Ravi Account, Rani Account, Raghu account Nagarjuna Account etc., are called as Natural Personal Accounts.
- II) Artificial Personal Accounts: These accounts include accounts of corporate bodies or institutions which are recognized as persons in business dealings. The account of a Limited Company, the accounts of co-operative society, the accounts of clubs, the account of Government, the account of insurance company, the account of Colleges, Schools, Universities and Hotels etc., are examples of Artificial Personal Accounts.

Personal Accounts:

- **III) Representative Personal Accounts:** These are accounts which represent a certain person or group of persons. For example, Outstanding expenses A/c, Prepaid expenses A/c, Income Receivable A/c and Income received in advance A/c, Drawings A/c and Capital A/c are termed as Representative Accounts.
- **Principle/ Rule of Personal Account:**
- **Debit the receiver and**
- **Credit the giver.**
- For example, if cash has been paid to Raja, the account of Raja will have to be debited. Similarly, if cash received from Meena, the account of Meena will have to be credited.

- **2. Real Account:**
- Accounts relating to properties or assets or possessions of the firm are called Real Accounts. Every business firm needs Fixed Assets such as Land and Buildings, Plant and Machinery, Furniture and Fixtures etc for running its business. A separate account is maintained for each asset. There are Four types of Assets. They are
- **Fixed Assets:** Those assets which are acquired for long term use by the business concern are known as Fixed assets. For example Land and Buildings, Plant and Machinery, Furniture and Fixtures etc are called as Fixed Assets.
- **Current Assets:** Those assets which are possible to convert into cash are known as known as Current assets. For example cash in hand, cash at Bank, Stock in trade, Debtors, Bills Receivable etc., are called as current assets.
- **Tangible Assets:** Tangible assets are those which relate to such things which can be touched, felt, measured etc., Tangible assets have physical existence. Hence these assets may be transferred from one place to another place.Fixed assets and Current assets are the examples of Tangible assets.
- **Intangible Assets:** These accounts represent such things which cannot be touched. Of course, they can be measured interms of money. Intangible assets haven't any physical existence. Goodwill, copy rights, patents and trademarks are the examples of Intangible assets.

2. Principle of Real Account:

i) Debit what comes into the business and

ii) Credit what goes out of the business.

- For example, if machinery has been purchased for cash, machinery account should be debited since it is coming into the business, while cash account should be credited since cash is going out of the business.
- If furniture is sold for cash, cash account should be debited since cash is coming into the business, while Furniture account should be credited since furniture is going out of the business.

3. Nominal Account:

- Nominal accounts include accounts of all expenses, losses, incomes and gains. The examples of such accounts are salaries, wages, rent, taxes, lighting charges, transport charges, travelling charges, coolie charges, warehouse rent, insurance, advertisement paid, Bad debts, commission paid, Discount allowed, interest paid, interest paid on capital, rent received, interest received, commission received, discount received, dividend received, interest on investment received, bad debts recovered etc.,
- These accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business when salary is paid to the manager, commission is paid to the salesmen, rent is paid to landlord, cash goes out of the business and it is something real, while salary, commission, or rent as such does not exist. The accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information, it may be difficult for the cashier to explain how the cash at his disposal was utilized. Nominal accounts are also called Fictitious Accounts.

- **Principle or Rule of Nominal Account:**

1. Debit all expenses and losses and
2. Credit all incomes and gains.

- For example when salaries paid in cash, salaries account should be debited since it is an expense to the business, while cash account should be credited since cash is going out of the business. If Rent received in cash, Cash account should be debited since cash is coming into the business, while rent account should be credited since it is an income to the business.
- The principle of Nominal account is quite opposite to the principles of personal account and real account. As per the principle of Nominal account receiving aspects (Incomes and profits) are credited and giving aspects (expenses and losses) are debited. But as per the principles of personal account and real account, receiving aspect is debited and giving aspect is credited. Hence the rule of Nominal account is different from the principles of Real account and Nominal account.

Functions / Scope of Financial Accounting

- **1. Systematic record of business transactions / Recording:**

  Recording is the basic function of accounting. Accounting records business transactions in terms of money. It is essentially concerned with ensuring that all business transactions of financial nature are properly recorded. Recording is done in Journal or subsidiary books in chronological order. To keep systematic record of transactions, post them into ledger and ultimately to prepare the final accounts is the first function of accounting.

- **2. Classifying:**
- Accounting also facilitates classification of all business transactions recorded in the journal. Items of similar nature are classified under appropriated heads. It deals with classification of recorded transactions so as to group similar transactions at one place. The work of classification is done in a book called the Ledger, where similar transactions are recorded at one place under individual account heads. Eg. In sales account all sale of goods are recorded. In purchases account all purchase of goods are recorded.

Functions / Scope of Financial Accounting

3. Summarizing: It involves presenting classified transactions in a manner useful to both its internal and external users. It involves preparation of financial statements i.e profit& loss account and Balance sheet etc., Accounting summarizes the classified information. This process leads to the preparation of Trial balance, Income statement and balance sheet.

- **4. Analyzing:** The recorded data in financial statement is analyzed to make useful interpretation. The figures given in financial statements need to be put in a simplified manner. Eg. All items relating to fixed assets are placed at one place while long term liabilities are placed at one place.
- **5. Interpretation:** It deals with explaining the meaning and significance of the data simplified. The accountants should interpret the statements in a manner useful to the users. Interpretation of data helps management, outsiders and shareholders in decision making. It aims at drawing meaningful conclusions from the information. Different parties can make meaningful judgments about the financial condition and profitability of business operations.

Functions / Scope of Financial Accounting

- **6. Communicating Results to Interested Parties:**
- Accounting also serves as an information system. It is the language of the business. It supplies the meaningful information about the financial activities of the business to varies parties i.e., owners, creditors, investors, employees, government, public, research scholars and managers at the right time. It is a service function. It is not an end itself but a means to an end. It involves preparation and distribution of reports to the users to make decisions.
- **7. Compliance with legal requirements:** The accounting system must aim at fulfilling the requirements of law. Under the provisions of law, the business man has to file various statements such as income-tax returns, sales tax returns etc.
- **8. Protecting the property of the business:** For performing this function the accountant is required to devise such a system of recording information so that assets of the business are not put to wrong use and a complete record of the assets of the concern is available without any difficulty.

ADVANTAGES/ IMPORTANCE OF FINANCIAL ACCOUNTING

- **1. Provides for systematic records:** Since all the financial transactions are recorded in the books, one need not rely on memory. Any information required is really available from these records.
- **2. Facilitates the preparation of financial statements:** Profit and Loss Account and Balance Sheet can be easily prepared with the help of the information in the records. This enables the trader to know the net result of the business operations. During the accounting period and financial position of the business at the end of the accounting period.
- **3. Provides control over assets:** Book-keeping provides information regarding cash in hand, cash at bank, stock of goods, Accounts receivables, from various parties and the amounts invested in various other assets. As the trader knows the values of the assets he will have control over them.
- **4. Assistance to various parties:** It provides information to various parties i.e., owners, money lenders, creditors, investors, government, managers, research scholars, public and employees and financial position of a business concern from their own view point.
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ADVANTAGES/ IMPORTANCE OF FINANCIAL ACCOUNTING

- **5. Assistance to the insolvent person:** If a person is maintaining proper accounts and unfortunately he becomes insolvent (i.e., when he is unable to pay to his creditors), he can explain many things about the past with help of accounts and can start a fresh life.
- **6. Comparative study:** One can compare the present performance of the organization with that of its past. This enables the managers to draw useful conclusions and make proper decisions.
-
- **7. Less scope for fraud or theft:** It is difficult to conceal fraud or theft etc., because of the balancing of the books of accounts periodically. As the work is divided among many persons, there will be check and counter check.
- **8. Settlement of Taxation Liability:** If accounts are properly maintained, it will be of great help to the businessman in settling the income tax and sales tax liability otherwise tax authorities may impose any amount of tax which the businessman will have to pay.

ADVANTAGES/ IMPORTANCE OF FINANCIAL ACCOUNTING

9. **Documentary evidence:** Accounting records can also be used as evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. As such, courts accept these records as evidence.

10. **Helpful to management:** Accounting is useful to the management in various ways. It enables the management to assess the achievement of its performance. The weaknesses of the business can be identified and corrective measures can be applied to remove them with of the accounting.

11. Replacement **of memory:** In a large business it is very difficult for a business man to remember all the transactions. Accounting provides records which will furnish information as and when desired and thus it replaces human memory.

LIMITATIONS / DISADVANTAGES OF FINANCIAL ACCOUNTING

- **1. Records only monetary transactions:** Accounting records only those transactions which can be measured in monetary terms. Those transactions which can not be measured in monetary terms as conflict between production manager and marketing manager , office management etc., may be very important for concern but not recorded in the business books.
- **2. Effect of price level changes not considered:** Accounting transactions are recorded at cost in the books. The effect of price level changes is not brought into the books with the result that comparison of various years becomes difficult. For example, the sales to total assets in 2007 would be much higher than in 2003 due to rising prices, fixed assets being shown at cost and not at market price.
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- **3. No realistic information:** Accounting information may not be realistic as accounting statements are properly prepared by following basic concepts and conventions. For example, going concern concept gives us an idea that the business will continue and assets are to be recorded at cost but the book value which the asset is showing may not be actually realizable. Similarly, by following the principles of conservation the financial statements will not reflect the true position of the business.

LIMITATIONS / DISADVANTAGES OF FINANCIAL ACCOUNTING

- **4. No real test of managerial performance:** Profit earned during an accounting period is the test of managerial performance. Profit may be shown in excess by manipulation of accounts by suppressing such costs as depreciation, advertisement and research and development or taking excess value of closing stock. Consequently real idea of managerial performance may not be available by manipulated profit.
- **5. Historical in nature:** Usually accounting supplies information in the form of Profit and Loss Account and Balance Sheet at the end of the year. So, the information provided is of historical interest and only gives post-mortem analysis of the past accounting information. For control and planning purposes management is interested in quick and timely information which is not provided by financial accounting.
- **6. Personal bias / judgement of Accountant affects the accounting Statements:** Accounting statements are influenced by the personal judgement of the accountant. He may select any method of depreciation, valuation of stock, amortization of fixed assets and treatment of deferred revenue expenditure. Such judgment based on integrity and competency of the accountant will definitely affect the preparation of accounting statements.

LIMITATIONS / DISADVANTAGES OF FINANCIAL ACCOUNTING

7. **Permits alternative treatments:** Accounting permits alternative treatments within generally accepted accounting concepts and conventions. For example, method of charging depreciation may be straight line method or diminishing balance method or some other method. Similarly, closing stock may be valued by FIFO(First-in-First Out) or LIFO(Last in First Out) or Average Price Method. Application of different methods may give different results and results may not be comparable.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

- **MEANING OF DOUBLE ENTRY SYSTEM**

- Double entry system is a scientific way of presenting accounts. As such all the business concerns feel it convenient to prepare the accounts under double entry system. The taxation authorities also compel the businessmen to prepare the accounts under Double Entry System.
- Under dual aspect the Account deals with the two aspects of business transaction i.e., (1) receiving aspect and (2) giving aspect. Receiving aspect is known as Debit aspect and giving aspect is known as Credit aspect. Under which system these two aspects of transactions are recorded in chronological manner in the books of the business concern is known as Double Entry System. In Double Entry System these two aspects are recorded facilitating the preparation of Trial Balance and the Final Accounts there from.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

- **PRINCIPLE OF DOUBLE ENTRY SYSTEM**
- **Every business transaction has got two accounts, where one account is debited and the other account is credited. If one account receives a benefit, there should be another account to impart the benefit. The principle of Double Entry is based on the fact that there can be no giving without receiving nor can there be receiving without something giving. The receiving account is debited (i.e., entered on the debit side of the account) and the giving account is credited (i.e., entered on the credit side of the account).**
- **The principle under which both debit and credit aspects are recorded is known as the principle of double entry. According to this principle every debit must necessarily have a corresponding credit and vice versa.**

ADVANTAGES OF DOUBLE ENTRY SYSTEM

1. **Scientific system:** Double entry system records, classifies and summarizes business transactions in a systematic manner and, thus, produces useful information for decision makers. It is more scientific as compared to single entry of book-keeping.
2. **Full Information:** Full and authentic information can be had about all transactions as the trader maintains the ledger with all types of accounts.
3. **Assessment of Profit and Loss:** The businessman/trader will be able to know correctly whether he had earned profit or sustained loss. It facilitates the trader to take such steps so as to increase the efficiency of the firm.
4. **Knowledge of Debtors:** The trader will be able to know exactly what amounts are owed by different customers to the firm. If any amount is pending for a long time from any customer, he may stop credit facility to that customer.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

5. **Knowledge of Creditors:** The trader is also knows the exact amounts owed by the firm to others and he will be able to arrange prompt payment to obtain cash discount.
6. **Arithmetical Accuracy:** The arithmetical accuracy of the books can be proved by the trial balance.
7. **Assessment of Financial Position:** The trader will be able to prepare the Balance Sheet which will help the interested parties to know fully about the financial position of the firm.
8. **Comparison of Results:** It facilitates the comparison of current year results with those of previous years.
9. **Maintenance according to Income Tax Rules:** Proper maintenance of books will satisfy the tax authorities and facilitates accurate assessment. In India Joint stock companies should maintain accounts under double entry system.
10. **Detection of Frauds:** The systematic and scientific recording of business transactions on the basis of this system minimizes the chances of embezzlement and frauds or errors. The frauds or errors can be easily detected by vouching, verification and auditing of accounts.

DISADVANTAGES/ LIMITATIONS OF DOUBLE ENTRY SYSTEM

- **1. Not Practical to All Concerns:** This system requires the maintenance of a number of books of accounts which is not practical in small concerns.
- **2. Costly system:** This system is costly because of a number of records are to be maintained.
- **3. No guarantee of Absolute Accuracy of the Books of Account:** There is no guarantee of absolute accuracy of the books of account inspite of agreement of the trial balance because of there are some errors like errors of principles, errors of omission, compensating errors etc., which remain understand inspite of agreement of trial balance.
- **4. Errors of Omission:** In case the entire transaction is not recorded in the books of accounts, the mistake cannot be detected by accounting. The Trial Balance will tally inspite of the mistakes.

DISADVANTAGES/ LIMITATIONS OF DOUBLE ENTRY SYSTEM

- **5. Errors of Principle:** Double entry is based upon the fact that every debit has its corresponding credit and vice versa. It will not be able to detect the mistake such as debiting Ram's account instead of Rao's account or Building account in place of Repairs account.
- **6. Compensating Errors:** If Rahim's account is by mistake debited with Rs. 15 lesser and Mohan's account is also by mistake credited with Rs.15 lesser, the Trial Balance will tally but mistake will remain in accounts.

ACCOUNTING CONCEPTS

- Account is a system evolves to achieve a set of objectives. In order to achieve the goals, we need a set of rules or guide lines. These guide lines are termed as “Basic accounting concepts”. The term concept means an idea or thought. Basic accounting concepts are the fundamental ideas or basic assumptions underlying theory and practice of financial accounting.
- These concepts are termed as “generally accepted accounting principles”. These are broad working rules of accounting activity. They are evolved over a period in response to changing business environment. They are developed and accepted by accounting profession. The concepts guide the identification of events and transactions to be accounted for.

- The concepts help in bringing about uniformity in the practice in accounting. In accountancy following concepts are quite popular.
- **1. Business Entity Concept:**
- Business is treated separate from the proprietor. All the transactions are recorded in the books of the proprietor. The proprietor is also treated as a creditor for the business. When he contributes capital, he is treated as a person who has invested his amount in the business. Therefore, capital appears in the liabilities of balance sheet of the proprietor.
- **Effects of this Concept:**
- Financial position of the business can be easily found out.
- Earning position of the business can be easily ascertained.

- **2. Going Concern Concept:** This concept relates with the long life of the business. The assumption is that business will continue to exist unlimited period unless it is dissolved due to some reason or the other. When final accounts are prepared, record is made for outstanding expenses and prepaid expenses because of the assumption that business will continue. Going concern concept helps other business undertaking to make contracts with specific business unit for business dealing in future.
- **Effects of this concept:**

i) Working life of asset is taken into consideration for writing of depreciation because of this concept. (ii)Accountant always remains hopeful about continuity of the business. Therefore, he does not stop writing transactions even though the condition of business is deteriorating.

- **3. Money Measurement Concept:**
- **Only those transactions are recorded in accounting which cannot be expressed in terms of money. The transactions which cannot be expressed in money fall beyond the scope of accounting. One serious short coming of this concept is that the money value of that date is recorded on which transaction has taken place. It does not recognize the changes in the purchasing power of monitory unit.**
- **Effects of this concept:**

(i) In the absence of this concept, it would have not been possible to add various processions. For example : A proprietor has 40 chairs, 50 tables, 15 machines and 20 acres of land. He cannot add them. But total amount of all these processions can be easily

(ii) It fails to keep any record of such matters which cannot be expressed in terms of money. For example: ability of the board of directors, quality of the articles produced and efficiency of workers cannot be recorded.

4. **Cost Concept:** According to this concept, an asset is recorded at its cost in the books of account, i.e., the price, which is paid at the time of acquiring it. In balance sheet, these assets appear not at cost price every year, but depreciation is deducted and they appear at the amount, which is cost less depreciation. Under this concept, all such events are ignored which affect the business but have no cost. For example, if an important and influential director dies, then the earning capacity and position of the business will be affected. But this event has no cost. Hence it will not be recorded in account books.

- **Effects of the cost concept:**

(i) Under this concept market price is ignored. Balance sheet indicates financial position on cost and expired cost less.

(ii) This concept is mainly for fixed assets. Current assets are not affected by it. Current assets appear in balance sheet at cost or market price whichever is lower. But both these assets are acquired at cost price.

- ## 5. Account Period Concept:
- Every businessman wants to know the result of his investment and efforts after a certain period. Usually one-year period is regarded as an ideal for this purpose. The life of the business is considered to be indefinite, but the measurement of income cannot be postponed for a very long period of time. Therefore, it is necessary to have a period for which the operational results are assessed for external reporting. Hence a period of one year i.e., twelve months is considered as accounting period. It may be a calendar year (January to December or any period of one year.) In India, the accounting period begins on 1st April every year and ends on 31st March every year. This concept implies that at the end of each accounting period, financial statements i.e., profit & loss account and balance sheet are to be prepared. It is mandatory under Income Tax Act to assess profit of the business every year and determine tax liability.

Effects of Accounting Period concept:

(i) Financial position and earning capacity of one year maybe compared with another year.

(ii) These comparisons help the management in planning and increasing the efficiency of business.

- **6. Dual Aspect Concept:** **Under this concept, every transaction has got a twofold aspects i.e., (i) receiving aspect/ receiving benefit and (ii) giving aspect/ giving of benefit. For instance, when a firm acquires an asset (receiving of the benefit), it must have to pay cash (giving of benefit).**
- **Therefore, two accounts are to be passed in the books of accounts. One for the receiving benefit and the other for the giving of benefit. Thus, there will be a double entry for every transaction – debit for receiving the benefit and credit for giving the benefit.**

Effects of Dual aspect concept:

(i) This concept is of great help in indicating the true position of the business.

(ii) This concept helps in detecting the errors of employees and in having strict control over them.

(iii) The accounting equation, i.e., Assets= Equities (or liabilities + capital) is based on this concept.

7. **Matching Concept:** Every businessman is eager to make maximum profit at minimum cost. Hence, he tries to find out revenue and cost during the accounting period. An accountant records all expenses of a year (whether they are paid in cash or are outstanding) and all revenues of a year (whether they are received in cash or accrued).

- Expenses, which are incurred during a particular accounting period for earning the revenue of.

- **All expenses incurred during the accounting period must not be taken. Only relevant cost should be deducted from the revenue of a period for periodic income statement. the related period, are to be considered to revenue is called “Matching process”. While ascertaining profit, other appropriate cost which are not directly related to cost of goods sold are to be taken into consideration. Example, rent paid, interest paid, depreciation etc., Thus appropriate costs have to be matched against the appropriate revenues for the accounting period.**
- **Effects of this Concept:**

(i) Proprietor can easily know about his profit or loss.

(ii) On the basis of this concept, he can make efforts to create economy, increasing efficiently and increasing his income.

8. Realisation Concept:

This concept is also known as “revenue recognition concept”. Revenue results out of sale of goods and services. According to this concept revenue is realized when a sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. No profit or income will arise without the realization of sales. Likely sales and anticipated revenues are not to be recorded in account books. The realization concept is important in ascertaining the exact profit earned during a period in a business concern. According to this concept, the revenue should be considered only when it is realized. Any business transaction should be recorded only after it actually taken place. Production of goods does not mean that the total production is sold, it should be recorded only when they are sold and cash realized or obligation created.

9. **Objectivity Concept:** This concept implies that all accounting records should be supported by proper documents. Cash memos, invoices, correspondence, agreements, vouchers, etc., are examples of business documents. These documents supply the information. They form the basis for record of entries in the books of account. Accounting record based on documentary evidence is readily and objectively verifiable.

- 10. **Accrual Concept:** This concept implies that revenue is recognized in the period in which it is earned irrespective of the fact whether it is received or not during the period. For example, commission Rs.2,000 earned in the year 2008, but received in cash in the year 2009, then the commission is to be taken as income for the year 2008 only, not as income of the year 2009.

ACCOUNTING CONVENTIONS

- **In accounting, convention means a custom or tradition, used as a guide for the preparation of accounting statement. The following are the accounting conventions:**

  1. Convention of Full Disclosure: Accounting to this convention, accounts should be prepared honestly and they should disclose all materials and significant information. Every company shall keep proper books of accounts. Auditor records expenses, incomes, profits, losses, assets and liabilities. The essential items to be disclosed in the Profit and Loss Account are given. There is legal form for the balance sheet.

ACCOUNTING CONVENTIONS

- **2. Convention of Consistency:** In every business, the management draws important conclusion from the financial statements, regarding working of the concern, for this purpose in preparing the final accounts.
- The same principle and practices should be followed from year to year.

3. Convention of Conservation: This is very important in preparing final accounts. This term suggests caution. All prospective profits should be ignored. All outstanding expenses should be taken into account. Adequate reserves or provisions should be provided for. This means that there should be no window dressing and secret reserves.

ACCOUNTING CONVENTIONS

4. Convention of Materiality:

This is also called the convention of reasonable degree of accuracy. According to this, the information given in the accounts should be reasonable accurate. All the entries should be exact. Fraction of a rupee is avoided.

5. Convention of Relevance:

As per this convention, the firm should give relevant accounting information whenever required with documentary evidence like, purchases or sales invoices, vouchers etc., as documentary proof of a transaction.

PROCESS OF ACCOUNTING

1. THE JOURNAL

- The word Journal is derived from the French word 'Jour' which means a day. Journal, therefore, means a daily record of business transactions. Journal is a book of original entry/prime entry because transaction is first written in the journal from which it is posted to the ledger at any convenient time. The journal is a complete and chronological record of business transactions. It is recorded in a systematic manner. The process of recording a transaction in the journal is called **Journalising**. The entries made in the book are called **Journal Entries**.

- **Proforma of Journal**

- **Journal Entries in the books of-------------**

Date	Particulars	L.F	Debit A mount (Rs.)	Credit Amount (Rs.)

ADVANTAGES OF JOURNAL

- **1. Availability of Full information/Complete Record:**
- All business transactions date-wise will be recorded in the Journal As such the total information for every transaction can be obtained very easily without late. So Journal serves as a complete record. It provides a chronological record of all transactions and hence provides permanent record.
- **2. Posting becomes easy:**
- When once the transactions are entered in the Journal, recording the same in the relevant accounts in the ledger can be made easily. The businessman can have an understanding on debit and credit principles in the beginning itself. It provides information of debit and credit in an entry and an explanation to make it understandable properly.

ADVANTAGES OF JOURNAL

3. **Explanation of the transaction:** Every Journal entry will be briefly explained with a narration. Narration helps in proper understanding of the entry.
4. **Location of the errors easy:** Journal helps to locate the errors easily. Both debit and credit aspects of a transaction are recorded in the journal. Since the amount recorded in debit amount column and credit amount column must be equal. Therefore, the possibility of committing errors is reduced and the detection of errors, if any, committed becomes easy.
5. **Chronological order:** Transactions are recorded in a chronological order in the Journal. Hence, when any information is required, the information can be traced out quickly and easily.

ADVANTAGES OF JOURNAL

- **6. Eliminates the need for reliance on memory:** It eliminates the need for a reliance on memory of the accounts keeper. Some transactions are of a complicated nature and without the journal, the entries may be difficult, if not impossible.
- **7. Journal provides information relating to the following aspects:**
- (a) Credit sale and purchase of fixed assets, investment or any thing else not dealt in by the firm.
- (b) Special allowances received from suppliers or given to the customers.
- (c) Writing off extra-ordinary losses viz. losses due to fire, earth quakes, theft etc., and bad debts.

ADVANTAGES OF JOURNAL

- (d) Recording in the reduction of the assets i.e., depreciation.
- (e) Receipt and issue of bills of exchange, promissory notes, hundies and their dishonour, renewal etc.,
- (f) Transactions with Bank(unless bank column added to the cash book)
- (g) Income earned but not received in cash.
- (h) Expenses incurred but not yet paid for in cash and other similar adjusting entries.
- (i) Transfer entries viz. posting total of subsidiary books to the respective impersonal accounts in the ledger at the end of every month, transfer of gross profit or loss to the Profit & Loss A/c and net profit or net loss and also drawings A/c to the Capital A/c at the end of the trading period.
- (j) Closing entries-entries to close the books at the time of preparing trading and profit &loss account.

LIMITATIONS OF JOURNAL

The following are the main limitations of the journal.

1. The Journal will be too long and becomes unwieldy if all transactions are recorded in the journal.
2. The Journal is unable to ascertain daily cash balance. That is why cash transactions are directly recorded in a separate cash book so that daily cash balances may be available.
3. It becomes difficult in practice to post each and every transaction from the Journal to the ledger. Hence in order to make the accounting easier and systematic, transactions are recorded in total in different books.

THE LEDGER

- The second stage in the accounting cycle is ledger posting it means posting transactions entered in the journal into their respective accounts in the ledger. It is the book of final entry. The Ledger is designed to accommodate the various accounts maintained by a trader. It contains the final and permanent record of all transactions in duly classified form. A ledger is a book which contains various accounts. The process of transferring the entries from the journal into the ledger is called posting.
- A Ledger may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect. The up to date state of any account can be easily known by referring to the ledger.

FEATURES OF LEDGER

- i. Ledger contains all the accounts-personal, real and nominal accounts.
- ii. It is a permanent record of business transactions.
- iii. It provides a means of easy reference.
- iv. It provides final balance of the accounts.
- Ledger is the principal book of accounts because it helps us in achieving the objectives of accounting. It gives answers to the following pertinent questions.

  1. How much amount is due from others to the business?
  2. How much amount is owed to others?
  3. What are the total sales to an individual customer and what are the total
- purchases from an individual supplier?
- 4. What is the amount of profit or loss made during a particular period?
- 5. What is the financial position of the firm on a particular date?

ADVANTAGES OF LEDGER

The following are the main utilities of Ledger

1. It provides complete information about all accounts in one book.
2. It is easy to ascertain how much money is due to suppliers (trade creditors from creditors’ ledger) and how much money is due from customers (trade debtors from debtors’ ledger).
3. It enables to ascertain, what are the main items of revenues/incomes (Nominal accounts).
4. It enables to ascertain, What are the main items of expenses(Nominal accounts)
5. It enables to know the kind of assets the enterprise holds and their respective values(Real Accounts)
6. It facilitates preparation of trial balance and thereafter preparation of financial statements i.e., profit and loss account and balance sheet.

DIFFERENCES BETWEEN JOURNAL AND LEDGER

POINT OF DIFFERENCE	JOURNAL	LEDGER
1. Nature	It is a book of original entry	It is a book of final entry
2. Object	It is prepared to record all the transactions.	It is prepare to know the net effect of various transactions affecting a particular account.
3. Basis of preparation	It is prepared on the basis of source document (voucher) of transaction.	It is prepared on the basis of journal.
4.Stage of recording	Recording in the journal is the first stage.	Recording in the ledger is the second stage.
5. Balancing	Journal is not balanced.	All ledger accounts are balanced.
6. Narration	Narration is written for each entry.	No narration is given.
7. Format	In journal there are five columns viz.,date,particulars, ledger folio, debit and credit.	In the ledger there are four columns on debit and credit side viz., date, particulars, journal folio and amount.
8. Name of the process of recording entries	The process of recording in journal is called journalizing.	The process of recording in the ledger is called posting.
9.Basis for Preparation of final accounts	Journal directly does not serve as basis for preparation of Final accounts.	Ledger serves as basis for preparation of Trial Balance and Final Accounts.

TRIAL BALANCE

Trial Balance is a statement in which debit and credit balances of all ledger accounts are shown to test the Arithmetical accuracy of the books of account. Trial Balance is not conclusive proof of accuracy of books of accounts.

Definitions of Trial Balance:

1. **According to J.R.Batliboi, " A Trial Balance is a statement of Debit and Credit balances extracted from the various accounts in the ledger with a view to test the arithmetical accuracy of the books."**
2. **According to Spicer and Peglar, " A Trial Balance is a list of all the balances sttanding on the ledger accounts and cash book of a concern at any given date."**

FEATURES OF TRIAL BALANCE

1. It is not an account., it is only a statement which is prepared to verify the arithmetical accuracy of ledger accounts.
2. It contains debit and credit balances of ledger account.
3. It is prepared on a particular date generally at the end o f business year.
4. Trial Balance helps in preparing final accounts.
5. As it is prepared by taking up the ledger account balances, both debit and credit side of a Trial Balance are always equal.
6. The preparation of Trial Balance is not compulsory. There is no hard fast rule in this regard.

IMPORTANCE OF TRIAL BALANCE

1. **Proof of Arithmetical accuracy:** It helps in checking the arithmetical accuracy of books of accounts.
2. **Preparation of financial statements:** It helps in the preparation of final accounts i.e., Trading Account, Profit & Loss Account and Balance Sheet.
3. **Detection of Errors:** It will help in detection of errors in the books of accounts and in their rectification.
4. **Rectification of Errors:** It serves as instrument for carrying out the job of rectification of errors.
5. **Easy Checking:** It is possible to find out the balances of various accounts at one place.

LIMITATIONS OF TRIAL BALANCE

1. Trial balance can be prepared only in those concerns where double entry system of accounting is adopted. This system is very costly and time consuming. It cannot be adopted by the small business concerns.
2. Though Trial Balance gives arithmetical accuracy of the books of accounts but there are certain errors which are not disclosed by Trial Balance. That is why it is said that Trial balance is not a conclusive proof of the accuracy of the books of accounts.
3. If Trial Balance is not prepared correctly then the final accounts prepared will not reflect the true and fair view of the state of the affairs/financial position of the business. Whatever conclusions and decisions are made by the various groups of persons will not be correct and will mislead such persons.

5. Trial Balance tallies even though errors are existing in the books of accounts.
6. Even some transactions are omitted the Trial Balance tallies.

OBJECTIVES OF TRIAL BALANCE

The following are the main objectives of preparing the Trial Balance.

1. To have balances of all the accounts of the ledger in order to avoid the necessity of going through the pages of the ledger to find it out.
2. To have a proof that the double entry of each transaction has been recorded because of its agreement.
3. To have arithmetical accuracy of the books of accounts because of the agreement of the Trial Balance.
4. To have material for preparing the profit or loss account and balance sheet of the business.

METHODS FOR PREPARING TRIAL BALANCE

1. **Totals Method:** Under this method the total of debits and credits of all ledger accounts are shown in the debit and credit side of the Trial Balance. The Trial Balance prepared under this method is known as gross Trial Balance.
2. **Balances Method:** Under this method all the balances of each and every account will be shown against the debit or credit side of the Trial Balance. If an account has no balance then it will not be shown in the Trial Balance. This method is more convenient and commonly used.
3. **Totals and Balances Method / Compound Method:** Under this method, the above two methods are combined. Under this method statement of trial balance contains seven columns instead of two columns.
4. **Elimination of Equal Totals Method:** Under this method equal totals of accounts will be eliminated from the trial balance.

TRADING ACCOUNT

This account is prepared to know the trading results or gross margin on trading of business, i.e., how much gross profit of the business has earned from buying and selling during a particular period. The difference between the sales and cost of goods sold is gross profit. This is a nominal account in its nature hence all the trading expenses should be debited where as all the trading incomes should be credited to Trading Account. The balance of trading account will be considered as Gross Profit (credit balance) or Gross Loss (debit balance) and will be transferred to profit and loss A/c. While preparing the trading A/c the following equations also can be used.

- Sales less returns – Cost of goods sold = Gross Profit or Gross Loss
- Sales = Total cash sales + credit sales.
- Cost of goods sold = Opening stock + purchases less purchase returns + Direct expenses– Closing stock of goods.

IMPORTANCE OF TRADING ACCOUNT

1. **Information of Gross profit or Gross Loss:**

- Trading Account provides information regarding gross profit and sets the upper limit within which indirect expenses are to be incurred. Indirect expenses should be much less than the gross profit so that a good amount of profit may be earned. If trading account discloses gross loss , it is better to close the business rather than running at a gross loss because gross loss will further increase when indirect expenses are added to it.
- Gross Profit Ratio: This ratio is calculated as follows:
- Gross profit Ratio = Gross Profit / Sales X 100
- Higher the ratio, it is better condition. Gross profit ratio can be calculated with the help the Trading account year after year and comparison of performance of year after year can be made. A low ratio indicates unfavorable trend in the form of reduction in selling prices not accompanied by the proportionate decrease in cost of goods purchased or increase in cost of production.

2. **Comparison of Closing Stock with Opening Stock :**

- Comparison of stock figures of one period with another period will be helpful in avoiding overstocking. Investment in stock should be reasonable so that production and sales go on smoothly.

3. **Fixation of selling price:** In case of a new product, the selling price can be easily fixed by adding in the cost of purchases or cost of goods manufactured the desired percentage of gross profit.
4. It enables the comparison of sales, purchases and direct expenses of one period with another period. The comparative study helps the management to control the affairs of the business and take sound decisions.
5. It helps to check the direct expenses. 6. It gives us the information about the proportion of gross profit or gross loss to the direct expenses. This study helps the management in arresting the unnecessary expenditure on any time.

PROFIT AND LOSS ACCOUNT

This account is prepared to calculate the net profit or net loss of the business concern.

There are certain items of incomes and expenses of the business which must be taken into consideration for calculating net profit or net loss of the business concern.

These are of indirect nature i.e., the whole business and relating to various activities which are done by the business for the purpose of making the goods available to the customers.

Indirect expenses may be administrative expenses or management expenses, selling and distribution expenses, financial expenses and extra-ordinary losses and expenses to maintain the assets into working order.

This account is prepared from nominal accounts and its balance is transferred to capital account as the whole the profit or loss will be that of the owner and it will increase or decrease the capital.

IMPORTANCE OF PROFIT AND LOSS ACCOUNT

1. **Information of Net profit or Net loss:** One of the important objectives of maintains the accounts are to see whether the business has earned profit of suffered loss during the accounting period. Profit and Loss A/c provides information regarding this important objective because it gives information about the profitability or otherwise of the business.
2. **Comparison of current profit with the last year profit:** Profit and Loss A/c affords comparison of the current year's net profit with those of the past years. With this comparison it can be ascertained whether net profit of the business is showing a rising trend or down ward trend.
3. **Comparison of expenses:** Comparison of various expenses included in the profit and loss account with expenses of the previous period helps in taking effective steps for control of unnecessary expenses.

IMPORTANCE OF PROFIT AND LOSS ACCOUNT

4. **Helpful in preparation of Balance Sheet:** Net profit or Net loss disclosed by the profit and loss A/c is transferred to capital Account and Capital Account appears on the liabilities side of the Balance Sheet. Without taking net profit or net loss, the balance sheet cannot be completed. Thus, the profit and loss account helps in the preparation of the balance sheet.
5. **Helpful in future Growth of business:** On the basis of their profit figures of the current and previous period, estimates about the profits in the years to come can be made and projections about the expansion of the business can be made.

BALANCE SHEET

A Balance Sheet a statement prepared with a view to measure the financial position of a business on a certain fixed date. The financial position of a concern is indicated by its assets on a given date and its liabilities on that date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company.

A Balance sheet is also described as a "statement showing the sources and application of the capital". It is a statement and not an account and prepared from real and personal accounts. Sources or liabilities are shown on the left hand side of the Balance Sheet. Application of funds (Assets) is shown on the right hand side of the Balance Sheet.

CHARACTERISTICS OF BALANCE SHEET

Characteristics of Balance Sheet:

1. It is prepared on a particular date and not for a particular period.
2. It is prepared after preparation of the Trading and Profit & Loss A/c.
3. As assets must be equal to the total liabilities. The two sides of the Balance must have the same total.
4. It shows the financial position of a business as a going concern.
5. It is a statement of assets and liabilities and not an account.

IMPORTANCE OF BALANCE SHEET

Information that Balance Sheet convey to Outsiders (Importance):

1. The nature and the value of assets.
2. It shows the nature and extent of liabilities.
3. It shows the owner's equity (i.e., assets-liabilities = capital)
4. It tells about the creditworthiness and solvency of the firm.
5. It reflects the liquidity of a firm.
6. It reveals other information required to changes in economic reserves and obligations.

FINANCIAL RATIOS

- Alexander Wall is considered to be the pioneer of Ratio Analysis. He presented the detailed system of Ratio Analysis in 1909 and explained its usefulness in financial analysis.
- Ratio Analysis is most widely used powerful tool of financial analysis. It is an important technique of analysis and interpretation of financial statements.
- It is also used to analyze various aspects of operational efficiency and degree of profitability.
- Ratio Analysis is based on different ratios which are calculated from the accounting information contained in the financial statements. Different ratios are used for different purposes.

Meaning of Ratio

- **Ratio is a figure expressed in terms of another.**
- **It is an expression of relationship between one figure , two figures and the other figures which are mutually inter-dependent.**
- **In other words a ratio is a mathematical relationship between two items expressed in a quantitative form. When ratio is explained with reference to the items shown in the financial statements.**
- **It is called as an Accounting Ratio.**
- **The ratio analysis facilitates easy understanding of financial statements.**

Advantages/ importance/significance of Ratio Analysis

- **Ratio Analysis is an important technique of financial analysis.**
- **It is used as a device to analyze and interpret the financial health of enterprises.**
- **Its usefulness is not only confined to business managers but also extends to various interested parties like government, creditors, employees, investors, consumers etc.**

1. Helps in Decision making:

- **Though Financial Statements provide necessary data for decision making.**
- **It is not possible to take appropriate decisions merely on the basis of each data.**
- **Ratio Analysis provides a meaningful analysis and interpretation to the data contained in Financial Statements.**
- **This ratio analysis facilitates the managers to take correct decisions.**

2. Helps in Financial Forecasting and Planning

- **Ratios calculated for a number of years reveal the trends in the phenomenon.**
- **As such, it is possible to make predictions for a future period.**
- **Thus, ratio analysis helps in financial forecasting and planning.**

3. Helps in assessing the operational efficiency:

- **Ratio Analysis helps in analyzing the strengths and weaknesses of a concern.**
- **It helps in diagnosing the financial health of a concern in terms of liquidity, solvency, profitability etc.**

4. Helps in controlling business:

- **With the help of ratio analysis, it is possible to identify the weak spots with regard to the performance of the managers.**
- **Weakness in financial structure due to incorrect policies in the past and present is revealed by the ratios.**
- **These weaknesses may be communicated to the people concerned and as such ratio analysis helps in better communication, Coordination and control of unfavorable situations.**

5. Helps in comparison of performance:

- **Through accounting ratios comparison can be made between one departments of a firm with another of the same firm in order to evaluate the performance of various departments in the firm.**
- **This is needed for the smooth functioning of the departments.**

6. **Ratio analysis simplifies the complex financial data. It reveal the change in the financial position.**

7. **Ratio analysis may be used as instruments of management control, particularly in the area of sales and control.**

8. **Ratios facilitates the function of communication and enhance the value of financial statements.**

9. **Ratios are helpful in assessing the financial position and profitability of a concern.**
10. **Ratio Analysis also helps in effective control of business – measuring performance, control of costs etc., Effective control is a keystone of better management.**
11. **Ratio analysis helps the investors in making investment decisions to make a profitable investment.**

12. **It helps to know the relationship between different related items of financial statements.**
13. **It helps in investigating the factors responsible for financial soundness/ deterioration of a particular situation.**
14. **It helps in analyzing and interpreting the financial data of the enterprise.**
15. **The ratios are calculated based upon past results. So it help management to frame sound business policies for business in future.**

Limitations of Ratio Analysis

1.Limited use of a Single Ratio:

- A single ratio does not convey meaningful message. As such, a number of ratios will have to be calculated for a better understanding of particular situation.
- Thus, a series of ratios computed may create confusion.
- Ratios can be useful only when they are computed in a sufficient large number.
- calculation of more ratios some times confuses the analysts than help him.

2. Lack of Adequate Standards:

- Expecting a few situations, in majority cases, universally accepted standards for ratios are not available.
- It renders interpretation of ratios difficult.

3. Lack of comparability:

- The results of two firms are comparable with the help of accounting ratios only if they follow the same accounting methods.
- Comparison becomes difficult if they follow different methods.
- Similarly, utilization of facilities , availability of facilities and scale of operation affects the Financial Statements of different firms.
- Comparison of such firms would be misleading.

4. Inherent Limitations of Accounting:

- Accounting records contain historical data. As such, ratios based on data drawn from accounting records also suffer from the inherent weaknesses of accounting records.
- Thus, accounting ratios of the past may not be true indicators of the future.

5. Changes in Accounting Procedures:

- **Change in accounting procedure by a firm often makes ratio analysis misleading.**
- **E.g., a change in the valuation of methods of inventories from FIFO to LIFIO Increase the cost of sales and reduces the value of the closing stock which makes inventory turnover ratio to be impressive and an unfavorable gross profit ratio.**

6. Window Dressing:

- **Financial statements easily be window dressed to present a better picture of its financial and profitability position to outsiders.**
- **Hence, one has to be very careful in making a decision from ratios calculated from such Financial Statements.**
- **However, it may be difficult for an outsider to learn about the window dressing made by a firm.**

7. Price-Level Changes:

Since ratios are computed for historicaldata,no consideration is made to the changes in price levels and this makes the interpretation of ratios invalid.

8. Personal Bias:

- Ratios are only means of financial analysis and not an end in itself.
- They have to be interpreted and different people may interpret the same ratio in different ways.

9. Ignoring qualitative factors:

Ratio analysis ignores the qualitative factors which generally influence the conclusions derived.

10. Reliability of data:

- **The accuracy and correctness of ratios are totally dependent upon reliability of data contained in financial statements.**
- **If there are any mistakes or omissions in the financial statements, ratio analysis presents a wrong picture about the concern.**

Thank You