1.1 Nature and Scope of Business

The word "business" means the state of being busy. Business means "the whole complex field of commerce and industry, the basic industries, processing and manufacturing industries and the network of ancillary services, distribution, banking, insurance, transport and so on which serve and interpenetrate the world of business as a whole."¹

1.2 Kinds of Business

Broadly business activities may be divided into five classes: 1) those that produce goods, 2) those that render services, 3) those that distribute goods and services 4) those that help the distribution of goods and services, and 5) those that render financial assistance to any of the first four.²

Industry is the name given to the first group of business activities. It may again be subdivided into four sub-groups: a) genetic b) extractive c) manufacturing and d) construction. Genetic industry is that which consists in the reproduction of wealth such as fishing, cattle breeding, poultry farming etc. Extractive industry extracts or draws out wealth from nature as mining, hunting, agriculture, lumbering etc. Manufacturing industry is engaged in the creation of wealth by imparting "form" utility. The process of converting raw material into a finished or partly finished product as pig iron into steel, raw cotton into cloth, wood into furniture or partly finished product into a finished product as steel into joist, cloth into garment comes under manufacturing. Construction of a building, road, bridge or dam is also a kind of industry, it creates something useful by the suitable combination and fabrication of a number of materials.

A manufacturing industry may also be classified under one or other of three different categories a) analytical, b) synthetic, and c) processing. An analytical type industry breaks up a product into several parts or sub-products. A synthetic type industry blends a number of raw materials or finished or semi-finished products and turns out a new product. A processing or fabricating type industry submits materials or semi-finished products to some manufacturing process to get some finished products. Services provided by business enterprises are also diverse: a) transportation business
provides the service of moving goods or passengers from place to place as in the case of buses and trucks, railways, shipping lines, airways; b) communication business conveys information or ideas from one source to another like telephone, post and telegraphs; c) there are utility enterprises which provide services in the form of electricity, gas etc. and d) entertainment houses like cinema halls and theatres provide recreation service to the people.

Activities, which distribute goods, are synonymous with commerce or trade. The function of a trading or commercial concern is to bring about the transfer of goods from producers to users or ultimate consumers. A manufacturer too is a trader because ultimately he also has to sell the goods manufactured by him. When goods are exchanged within a country, the transaction is domestic trade. When goods made at home are sold abroad or goods made abroad are purchased at home, the resulting transaction is foreign trade. The former is called export and the latter import. Trade may be wholesale or retail. Wholesale trade consists in buying goods in large quantities from the manufacturers and selling them to dealers or shop-keepers who in turn sell them retail—that is on a piecemeal basis or in small quantities to consumers. They provide the link between the manufacturers and retailers. It is the retailers who sell goods ultimately to consumers.

There are many hindrances to the transfer of goods from producers to consumers. Commerce is defined as “the sum total of those processes which are engaged in the removal of the
hindrances of persons (trade), place (transport and insurance) and time (warehousing) in the exchange (banking) of commodities.\(^3\) Thus important aids to the distributive process include transport, advertising, warehousing and insurance. There is the need to acquaint consumers with the goods produced by manufacturers. Advertising fills this need. Goods purchased by wholesalers from manufacturers may not be sold immediately to the retailers nor can those purchased by retailers be always disposed of then and there. Associated with the work of distribution is the function of storage or warehousing. Both in storage and transit, goods are exposed to many risks. It is the function of insurance to cover these risks. Business of all kinds require finance. Businessmen who undertake the risks of business need not themselves supply all the money required to start it, keep it going or expand its activities. There are institutions like banks and investment trusts which mobilize the savings of the community and lend them in turn to businessmen against suitable security. They are in the nature of intermediate agencies that establish a link between those who have surplus money and those who require it for investment. Again, there are institutions like stock exchange, issue houses, underwriters, whose job is to encourage savers to directly invest in business and to facilitate such investment.

\(^3\) J. Stephen (1951). *Principles and Practice of Commerce*, Sir Isaac Pitman and Sons Ltd., London, p.95
1.3 Public Finance vs. Business Finance

Finance is usually divided into categories according to the type of entity or organisation served. The major classification of this nature is two-fold: public finance and business finance. The former is normally concerned with the income and expenditure of public authorities. Hence public finance deals with the finances of government. Business finance involves an analysis of the various means of securing money for private business enterprise and the administration of this money by individuals, voluntary associations and corporations. Both the divisions of finance are distinct. Under the present democratic set-up the policy of public revenue and expenditure is associated with the welfare of the society and the money is procured and spent in order to achieve this objective. In case of business finance, the money is spent, rather invested, with the object of getting the maximum return, irrespective of its effect on public welfare.

Thus financing of business enterprise known as business finance serves as an essential, facilitating agency in the primary economic functions of production, exchange, consumption and distribution.

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1.4 Meaning of Finance

In its simplest sense finance refers to those activities involved in seeing that an individual or organisation has the cash with which to pay its bills promptly. The encyclopaedia Britannica attempts to convey the ideas as follows.\(^8\)

"Without suggesting that a word of such extensive practical application can be adequately defined by any simple formula, we may indicate its significance by saying that finance is the act of providing the means of payment. The immediate aim thereby assigned to finance in any business is simply that of maintaining at all times an adequate cash balance (in money or bank credit). But the means employed include all the multifarious methods of borrowing money and of exchanging one sort of pecuniary right against another."

The concept of finance is somewhat broadened by defining finance as that administrative area or set of administrative functions in an organisation which have to do with the management of the flow of cash so that the organisation will have the means to carry out its objective as satisfactorily as possible and at the same time meets its obligations as they become due.\(^9\)

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In order to give more concreteness to this formal definition, the chief activities necessary to ensure the successful administration of the finances of any organisation are:

1. Financial planning or estimating and planning for the future flow of cash receipts and disbursements.

   The methods of planning expenditures for equipment, stocks of merchandise, and current expenses so that they will be in-keeping with need and not be beyond the probable means to pay are fundamental to any financial management.

2. Financing or raising the needed funds not available from ordinary day-to-day receipts to carry on operations.

   A major part of any study on financial management has to do with the financial instruments and the institutions through which an organisation can raise funds.

3. Financial control or checking the past and current operations and disbursements so as to ensure that the cash flow is proceeding according to plan or that deviations are handled in a manner compatible with continued financial health of the business.

   Such control is especially necessary for two reasons. One is the human tendency to be swayed from original plans by day-to-day events and the other is the constant ups and downs of changing business conditions that require continuing modification of one's
plans to keep step. Business recession for example may shrink sales below estimated figures and require a prompt revision of purchases and expenses.

Metaphorically finance is the lubricant of the process of economic growth.\(^{10}\) When finance becomes available, industrial development is initiated and new investment opportunities arise. This newly developed access to funds on reasonable terms induces or encourages entrepreneurs to expand their horizon of conceivable opportunities. Not simply access to funds, but the entire financial milieu, and the rationalism it implies triggers creative entrepreneurial responses.\(^{11}\) It attracts those who are inhibited for lack of capital and also boosts the animal spirit of those who were earlier reluctant to tread untrodden path. Thus the process of economic development sets in. This tends to increase the capacity of businessmen to perform risky operations in two ways. On the one hand it raises their incomes and this enables them to perform activities which involve the risk of incurring larger losses. On the other hand a more prosperous economy provides businessmen with better risk-reducing and risk-shifting devices than poorer ones.\(^{12}\)


1.5 Factors Influencing the Choice of Finance

There are at least four factors that greatly influence the financing decision. These are:

- Cost
- Flexibility
- Accessibility
- Control

Cost

The expected profitability of an investment project can be ascertained by comparing its yield with the investor's cost of capital. It follows that the cost of capital is the minimum rate of return a business must earn on investments to satisfy the requirements of the providers of capital, whether lenders or shareholders. The economic and other influences that have a bearing on the costs of individual types of finance are:

- The term structure of interest rates which relates interest to the length of the borrowing period; traditionally short-term loans carry a lower rate of interest than long-term ones because of the promise of earlier liquidity and lower risk of non-repayment.
- Forecast rates of inflation: The rates at which money is loaned must include some compensation for the expected fall in its purchasing power when it is eventually repaid.

- Government borrowings: A higher borrowing requirement of the government will add to the demand for money and can raise the interest rates.

- Cost of money to the lender: A finance house must charge its borrowers rates of interests on their hire purchase contracts that more than cover the interest on deposits paid by them.

- Risk: The higher the project risk to which the finance is exposed, the higher will be the rate of return expected.

- Taxation: If there is an interest element in the cost, this is chargeable against profits for tax purposes, effectively reducing the costs of such finance.

- The costs of arranging the finance

- The security offered for loans: Generally saleable tangible assets would be preferred to intangible assets.

1.5.1 Flexibility

Flexibility in financing means keeping one’s options open in relation to borrowing and lending. Housing Finance Institutions build flexibility into their various savings schemes by offering
progressively higher rates of interests to depositors who are willing to lock in their funds for longer durations. Flexibility in financing can also be assured by offering floating interest rates instead of fixed rates.

1.5.2 Accessibility

Accessibility to finance does not worry the large well-established companies, which can probably rely on internally generated funds for most of their needs. Generally, smaller firms find finance for expansion not only harder to access but also comparatively dearer than larger companies since the latter are generally considered to be less risky.

1.5.3 Control

The choice of finance also depends on the degree of control expected by the borrower. In many cases it will be a choice between diluting control and expanding or retaining control and stagnating.

1.5.4 Need for Finance

Business requires finance for many purposes. First a large sum of money has to be spent on investigating the soundness of a

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business scheme before it is taken up for implementation. If the scheme is large and is organised as a joint stock company, drafting and printing of necessary documents, registration of the company etc. involve expenses. All these have to be done before the commencement of business. Secondly in the case of a manufacturing organisation a factory building has to be erected and machinery installed before production can be undertaken. Thirdly, money is needed to purchase raw materials semi-finished parts and miscellaneous stores and to pay the workers. Finally the procurement of money itself involves some expense. It is incurred on advertising, preparation of documents, maintenance of books and staff for the purpose, payment of interest, creation of funds for repayment and so on.

1.5.5 Kinds of finance

Broadly, business finance may be divided into two classes-long term and short term.

a) Long term finance is needed for the purchase of assets like land, machinery and other fixtures, which can be used for long periods. These assets are also called fixed or block capital because their value is dissipated slowly and they cannot be readily converted into cash.14

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b) Short term finance is required for the current transactions of business such as purchase of raw materials, for making finished products, payment of wages and salary of staff, rent etc. It is called working capital because it is utilised in the day-to-day work of the enterprise. It is also called liquid capital, because either it is held in the form of cash or can be easily converted into cash. The proportions of fixed and working capital depend upon the nature of business, the stage of development reached by it, its scale of operation etc. Working capital is generally financed by own as well as borrowed sources.

1.5.6 Supply of Finance

The supply of finance has to be channelized through specialized financial and developmental institutions that act as pump primers rather than simply conduits for the factors of production\textsuperscript{15}, and draw more and more people from different walks of life into the vortex of industry. These institutions have not only to make finance available but also perform an allocative function.\textsuperscript{16}

\textsuperscript{16} The ICICI (1964). Ninth Annual General Meeting, Chairman’s statement held on 09-04-1964, p. 81.
1.5.7 Sources of Capital Funds

Capital for various purposes is usually of different origins.\textsuperscript{17} Two primary sources of capital are the savings of individuals and the undistributed profits of business enterprises. Fixed capital is obtained largely from secondary sources such as trusts estates, savings banks and insurance companies. Short term capital comes mainly from commercial banks.\textsuperscript{18} Of considerable importance in periods of depression are the distress funds and financing through government business agencies which have been coming in ever increasing volume from these agencies. Some characteristics of these sources are:

(1) Savings of individuals: From the financial side, capital formation appears first as savings or sums not used for current consumption. Such savings are accumulated both by individuals and by business enterprises. In the latter case, they appear as undistributed profits, the effects of which are not essentially different, except for the influence of personal income taxation, from the declaration of dividends and their immediate reinvestment in the same company by the stockholder.


(2) Undistributed profits: The profits retained as new capital in business enterprises are another form of savings. In case of farming, individuals do not keep their business accounts separate from their personal accounts and hence it is difficult to draw a distinction between business and personal savings.

(3) Depreciation and obsolescence reserves: Business concerns customarily set up reserves out of current earnings to replace capital equipment that is wearing out or is becoming technologically outmoded. Such reserves normally provide only for renewal of existing capital goods and not for creation of new ones.

(4) Commercial banks: Capital requirements of business are in large part provided by commercial banks which advance the funds for the purchases of raw materials and to meet other current expenses of established business enterprises. Such loans are for short terms. The volume of such loans naturally fluctuates rather closely with business activity and the volume of production.

(5) Other Financial Institutions: Fixed capital requirements are met through the issuance of bonds and mortgages on the property of the company. While some such securities are sold to individuals directly, the majority have in recent years been bought by trusts, estates savings banks, and insurance companies.
1.6 Credit and its Instruments

Credit is of outstanding significance in the modern economic system. It plays a vital role in business finance. A major portion of the capital, particularly short-term capital is provided on credit.

The word "credit" is used in two senses. One of them is that credit is a loan, a current advance against future repayment. Credit is also used to mean the credit standing of the borrower. The essence of credit is confidence. The lender advances money or goods on the belief that the borrower will repay it or return them. Confidence is created by the financial capacity as well as character of the borrower. In order to be eligible for credit, a man must have ostensible means of repayment. At the same time he must prove his integrity and willingness to repay. Apart from these, credit is advanced on the pledge of some asset, which means that if it is not repaid, the asset is forfeited and the proceeds utilized for repayment. Both security and reputation are needed for securing credit.

Every economy characterized by specialization and interdependence in labour and industry - be it primitive, capitalist or communist - depends on a mechanism for the transfer of unused purchasing power accumulated in some parts of the economy to

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other parts where purchasing power may be more useful. This is particularly true of modern industrial economies, which depend on heavy capital investment and large markets for exploitation of the efficiencies of large-scale production. In such economies, most income takes the form of wages and salaries. The chief recipients of income therefore are households few of which undertake business capital investment. The households often cannot finance even purchases of "consumer" capital goods such as homes, cars and appliances out of current income and the funds must be borrowed, usually through the services of financial intermediary institutions, from other households that are in financial surplus.20

Thus the institution of credit serves to transfer the financial surplus of savers to those who are eager and able to put this purchasing power to use. In the absence of such a mechanism the material resources at the command of this purchasing power might remain unemployed and go waste. The surplus is lent to those borrowers offering the best return, often taking account of all dimensions of the credit contract, including rate of interest, risk and pertinent tax and other official regulations.

The volume of flow of credit depends primarily on the level of income, the proportion of income that is surplus and the willingness

of the savers to lend the surplus. Short-run fluctuations in the credit and debt expansion occur in response to the business cycle and to the actions of the authorities controlling the rate of monetary growth.2

By definition credit and debt are created and destroyed simultaneously i.e., the granting of credit by one party necessarily implies the assumption of a debt by another, and repayment of the debt extinguishes the credit.

As in any voluntary exchange, a credit transaction benefits both parties to a transaction. The borrower may use the proceeds to buy some consumer goods or services. A business firm may borrow to put the loan proceeds to work in income-producing assets such as raw materials, inventories, machinery or securities which are expected to earn in due course more than the amount borrowed. The lender in turn receives the interest as remuneration for his expenses and for bearing the risks that unforeseen developments may cause payment of principal or interest or both to be delayed or defaulted.

1.7 Importance of Borrowings

Borrowing operations bridge the gap between the expenditure requirements and income receipts in the production economy.

The terms of repayment, the cost of credit, the security demanded for it - all these terms and conditions of credit would determine the profitable use of credit. Credit by definition is obtaining of resources at one period of time with an obligation to repay the same during a subsequent period according to the terms and conditions of credit. In any money market, the conditions of credit are (1) intimate knowledge of the borrower by the lender (2) complete security to the lender as regards the title of the security offered. (3) recovery of capital and interest on due date. Thus consideration of credit requirement is closely related to the concept of credit-worthiness. One of the most important factors in the mechanism of modern finance is the use of credit.

1.7.1 Meaning of Money Market

The centre in which any financial agencies-whether organised or unorganised-operate is called money market. It is a centre of supply of and demand of short-term funds. The centre in which organised financial institutions operate is called organised money market and the centre where indigenous financial agencies operate is known as unorganised money market. The successful working of a money market in any economy is conditioned by the pattern and structure of financial institutions that exist in that market. The efficiency of the money market primarily depends on the extent to which it can mobilise surplus resources of the
community and transfer these into the hands of those who can use them most effectively in industry and trade. Thus the money market performs two essential functions. (1) it supplies money (2) it facilitates the transfer of money. A developed money market helps the channeling of funds into the uses most needed for the expansion of the economy and facilitates the most efficient utilization of domestic savings.

1.7.2 Characteristics of Indian Money Market

The Reserve Bank of India pointed out that the outstanding characteristic of Indian money market was its dichotomy; it comprised various organised and unorganised markets with a divergence in the structure of interest rates. The organised and unorganised sectors are not wholly unconnected with each other, but there is no complete integration of the two into a single system. The active stringency in the money market, particularly of a seasonal character, has long been one of its most serious defects. In the Indian money market there is no effective leadership, unorganised sector is left unregulated.

1.7.3 Characteristics of Unorganised Money Market

The local money market is purely indigenous in character and is unorganised. This market consists of a group of various
indigenous agencies each with different business practices and a different structure of interest rates. The indigenous agencies in unorganised money market are scattered, and there is no adequate organisation in that market for the utilization of all surplus short-term liquid funds. Finance in this sector is not impersonalised as is found in the organised market i.e. loans are granted more on personal basis. It was alleged that non-institutional sources did not insist on punctual repayment and that they were willing to lend money more freely without collateral.

Another feature of this market is that there may exist a situation of tight money with one agency along with an easy condition with another agency. This is mainly because of the lack of fluidity in the money market i.e. funds in this market do not flow freely from one agency to another or from one center to another. This results in an imbalance in the demand for and supply of finance. The borrowers of this market are traders, merchants, industrialists, agriculturists and others. There is considerably higher rate of interest and lower turnover in the market because of smaller resource compared to that of organised money market. In India unorganised market is largely from the resource point of view made up of indigenous bankers and is very unstable. In fact ups and downs in that sector are connected with the imperfect working of the institutions of money and credit.
1.7.4 Meaning of Indigenous Financial Agencies

These agencies supply a part or whole of the financial requirements of the community in a manner, which is different from that of the modern banks. They are not organised like those of modern Financial Institutions and their methods of business are different from those of Joint Stock banks. These agencies are native in character and operate in unorganised money market.

The broad categories of these agencies are (1) indigenous bankers and (2) indigenous moneylenders. This distinction is based on the type of business operation of these agencies. The moneylender's operation is quite distinct from that of an indigenous banker.

1.7.5 Differences between indigenous financial agencies and organised financial institutions

The noticeable difference between the organised financial institutions and the indigenous financial agencies are:

(1) Deposits form a very small portion of the capital of the agencies, while the organised institutions mainly work on public deposits. In may cases indigenous agencies neither attract nor accept deposits i.e. they hardly even make it a policy to invite deposits, instead work on their own capital.
(2) the agencies, except indigenous bankers in big cities accommodate their customers with cash while the modern organised banks mostly deal in credit instruments.

(3) the agencies were not required under the company Law to register themselves, whereas the organised institutions have to do this. The agencies did not maintain (a) proper record of loans, (b) standard books of accounts and (c) uniform accounting procedure. In the earlier periods anyone who had sufficient funds over and above his usual requirements and who could part away with those funds could lend to those who needed money. But now indigenous moneylenders have to obtain license to perform their business and have to maintain a systematic account of the transactions. The organised institutions have to publish their audited annual balance sheets for the benefit of the shareholders. The agencies are free from this obligation.

Banks are not merely purveyors of money but also manufacturers of money. The process of creation of bank deposits is an exchange of claims. The financial intermediaries are different from the banks though the former does many of the functions of the banks, viz., accepting deposits and investing in productive uses. They do not provide a medium of exchange though their assets can be converted into liquid assets and also they do not manufacture
money i.e. credit. Hence these intermediaries are known not as banks but as financial intermediaries.

Indigenous bankers provide a medium of exchange i.e. hundi or bill and also manufacture money i.e. credit in a restricted sense, with the help of those hundis or bills. Hence these agencies can be termed as quasi banks since they cannot be called as banks for legal and other reasons.